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**AICPA professional standards as of June 1, 2015, Volume 2:  
accounting and review services, code of professional conduct,  
bylaws, valuation services, consulting services, quality control,  
peer review, tax services, personal financial planning, continuing  
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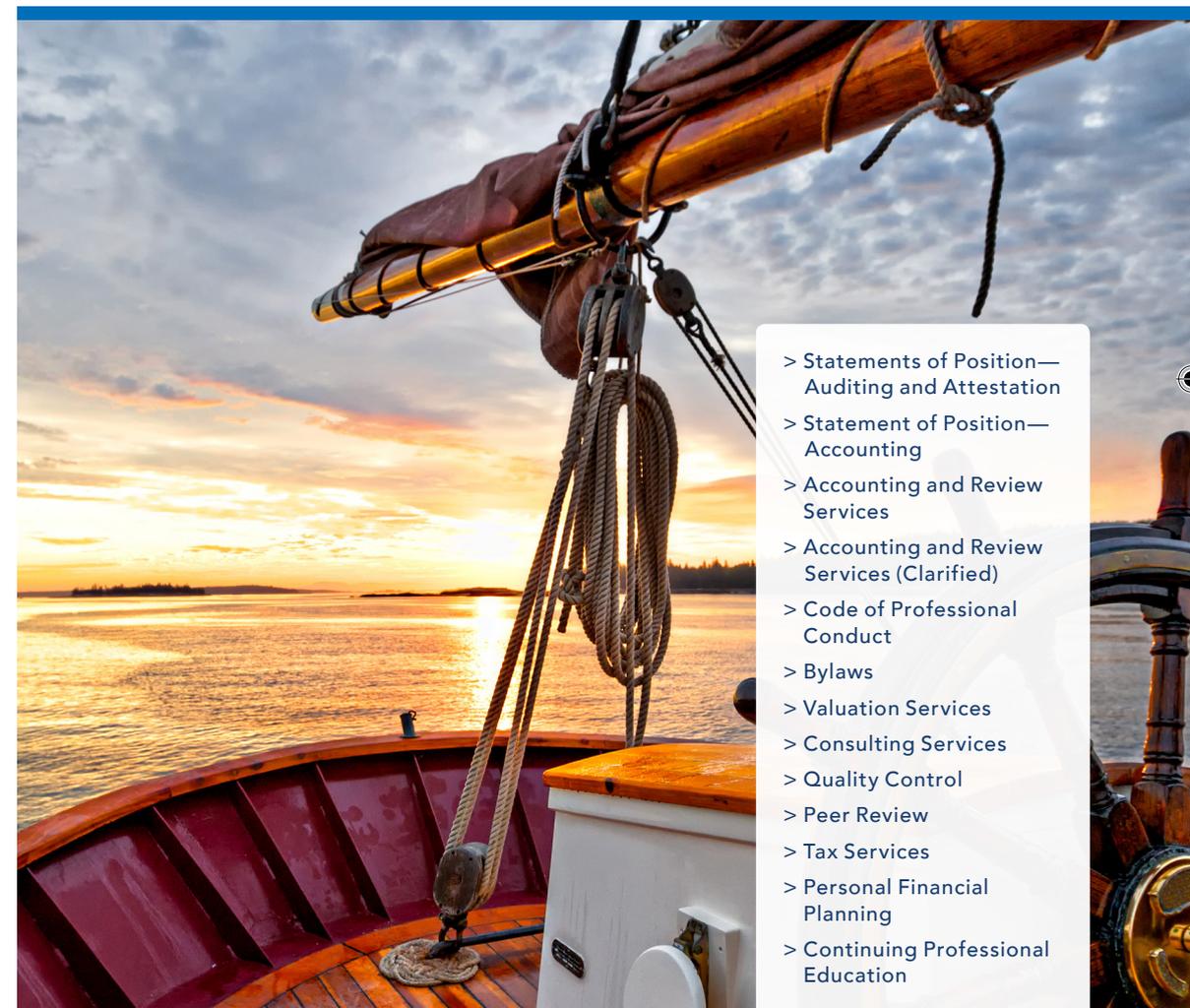
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# AICPA Professional Standards

As of June 1, 2015



- > Statements of Position—Auditing and Attestation
- > Statement of Position—Accounting
- > Accounting and Review Services
- > Accounting and Review Services (Clarified)
- > Code of Professional Conduct
- > Bylaws
- > Valuation Services
- > Consulting Services
- > Quality Control
- > Peer Review
- > Tax Services
- > Personal Financial Planning
- > Continuing Professional Education

**AICPA Professional Standards**  
As of June 1, 2015



## AICPA Professional Standards



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**AICPA**®

VOLUME 2



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As of June 1, 2015

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Auditing and Attestation
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Education

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VOLUME 2



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## AUD Section

# STATEMENTS OF POSITION—AUDITING AND ATTESTATION

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## Introduction

Auditing and Attestation Statements of Position (SOPs) are issued to achieve one or more of several objectives: to revise, clarify, or supplement guidance in previously issued Audit and Accounting Guides; to describe and provide implementation guidance for specific types of audit and attestation engagements; or to provide guidance on specialized areas in audit and attestation engagements.

## Auditing SOPs

An auditing SOP is recognized as an interpretive publication as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of generally accepted auditing standards (GAAS) in specific circumstances, including engagements for entities in specialized industries.

An interpretive publication is issued under the authority of the AICPA Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. The members of the ASB have found this SOP to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

## Attestation SOPs

An attestation SOP is recognized as an attestation interpretation as defined in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Attestation interpretations are recommendations on the application of Statements on Standards for Attestation Engagements (SSAEs) in specific circumstances, including engagements for entities in specialized industries. Attestation interpretations are issued under the authority of the ASB. The members of the ASB have found this SOP to be consistent with existing SSAEs.

A practitioner should be aware of and consider attestation interpretations applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions of this SOP.



## AUD Section

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## AUD Section 10

# ***Statement of Position 92-8 Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions***

October 1992

### **NOTE**

This AICPA Statement of Position (SOP) has been developed by the AICPA Insurance Companies Committee to provide guidance regarding the audit of property/casualty insurance entities' statutory financial statements in applying certain requirements of the National Association of Insurance Commissioners' Annual Statement Instructions.

This SOP is recognized as an interpretive publication as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of generally accepted auditing standards (GAAS) in specific circumstances, including engagements for entities in specialized industries.

An interpretive publication is issued under the authority of the AICPA Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. The members of the ASB have found this SOP to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

## **Applicability**

**.01** This statement of position (SOP) provides guidance on the impact of certain requirements of the National Association of Insurance Commissioners' (NAIC's) Annual Statement Instructions—Property and Casualty on the auditor's procedures in the audit of statutory financial statements of property/casualty insurance entities.

## Introduction

**.02** The NAIC's Annual Statement Instructions direct property/casualty insurers to require their independent certified public accountants to subject the current Schedule P-Part 1 (excluding those amounts related to bulk and incurred-but-not-reported [IBNR] reserves and claim counts) to the auditing procedures applied in the audit of the current statutory financial statements to determine whether Schedule P-Part 1 is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole. Schedule P-Part 1 includes Part 1-Summary and Part 1A-1R.

**.03** Although no separate report on Schedule P-Part 1 is required by the NAIC, the provisions of AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), and the provisions of this SOP apply when information in Schedule P-Part 1 is subjected to auditing procedures applied in the audit of the basic statutory financial statements. The requirements of this SOP do not preclude an auditor from issuing a report similar to those illustrated in paragraph .A17 of AU-C section 725. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

## Auditing Procedures

**.04** Certain of the information in Schedule P-Part 1 is typically subjected to auditing procedures applied in the audit of the basic statutory financial statements (for example, premiums earned and losses paid). Other information not directly related to the basic statutory financial statements is also presented (for example, lines of business classifications for immaterial lines). Although such information may not have been subjected to auditing procedures applied in the audit of the basic statutory financial statements in all instances, such information may have been derived from accounting records that have been tested by the auditor.

**.05** Paragraph .A5 of AU-C section 725 states that although an auditor has no obligation to apply auditing procedures to supplementary information presented outside the basic financial statements, the auditor may choose to modify or redirect certain of the procedures to be applied in the audit of the basic financial statements so that the auditor may express an opinion on the supplementary information in relation to the financial statements as a whole. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

**.06** Chapter 4, "The Loss Reserving and Claims Cycle," of the AICPA Audit and Accounting Guide *Property and Liability Insurance Entities* (the guide), addresses auditing the claims data base, and is applicable when applying auditing procedures to the information presented in Schedule P-Part 1. Chapter 4 also provides a comprehensive discussion of auditing loss reserves and the claims cycle. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.07** As stated in chapter 4 of the guide, because claim data and characteristics such as dates and types of loss can significantly influence reserve estimation, the auditor should test the completeness, accuracy, and classification of the claim loss data during the audit of the statutory financial statements. In

extending those procedures to Schedule P-Part 1, the auditor should determine that

- a. The data presented on Schedule P-Part 1 is properly reconciled to the statistical records of the company.
- b. Changes between the prior-year and current-year Schedule P-Part 1 are properly reconciled to the current-year audited statutory financial statements.
- c. The source of the data for the auditing procedures applied to the claim loss and loss adjustment expense data during the current calendar year (for example, tests of payments on claims for all accident years that were paid during the current calendar year) is the same as (or reconciles to) the statistical records that support the data presented on Schedule P-Part 1.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.08** If, as a result of the procedures performed during the audit of the statutory financial statements, the auditor concludes, on the basis of facts known to the auditor, that Schedule P-Part 1 is materially misstated in relation to the basic financial statements as a whole, the auditor should communicate to the company's management and the opining actuary that Schedule P-Part 1 is not fairly stated and should describe the misstatement. If the company will not agree to revise Schedule P-Part 1, the auditor should issue a report on Schedule P-Part 1 and should include a description of the misstatement in that report. (The auditor should refer to AU-C section 725 when a report will be issued.) The auditor should consider the impact of a misstatement in Schedule P-Part 1 on the auditor's report on the statutory financial statements. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

## Effective Date

**.09** This SOP is effective for audits of statutory-basis financial statements of property/casualty insurance entities for periods ending after December 15, 1992.

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## AUD Section 15

# ***Statement of Position 99-1 Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of Its Corporate Compliance Program***

May 21, 1999

### NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA Health Care Pilot Task Force of the AICPA Auditing Standards Board (ASB) to provide guidance regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to agreed-upon procedures attestation engagements performed to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a Corporate Integrity Agreement entered into with the Office of Inspector General of the U.S. Department of Health and Human Services.

This SOP is recognized as an attestation interpretation as defined in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Attestation interpretations are recommendations on the application of SSAEs in specific circumstances, including engagements for entities in specialized industries. Attestation interpretations are issued under the authority of the ASB. The members of the ASB have found this SOP to be consistent with existing SSAEs.

A practitioner should be aware of and consider attestation interpretations applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions of this SOP.

## Summary

This Statement of Position (SOP) provides guidance to practitioners in conducting and reporting on an agreed-upon procedures engagement performed pursuant to the AICPA Statements on Standards for Attestation Engagements (SSAEs) to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a Corporate Integrity Agreement (CIA) entered into with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services. CIAs are specific

to the entity involved; consequently, users of this SOP should be familiar with the specific requirements of the entity's CIA.

## Introduction and Background

**.01** Within the past several years, the health care industry has experienced a significant increase in the number and magnitude of allegations of fraud and abuse involving federal health care programs (for example, Medicare and Medicaid) and private health care insurance. These allegations have triggered regulatory scrutiny, litigation, significant monetary settlements, and negative publicity related to—among other things—coding and billing practices, patient referrals, cost reporting, quality of care, and clinical practices. Typically, as part of the global resolution of these allegations, the entity enters into a CIA with the OIG of the U.S. Department of Health and Human Services. Such agreements require that management annually report on its compliance with the terms of the CIA and that there be an assessment of the entity's compliance with the CIA. This assessment includes a billing analysis, which may be performed by an independent review organization (such as a practitioner or consultant) or the provider (if permitted by the OIG), and an agreed-upon procedures engagement.

**.02** This SOP provides guidance to practitioners in conducting and reporting on an agreed-upon procedures engagement performed pursuant to the AICPA Statements on Standards for Attestation Engagements to assist an entity in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a CIA.<sup>1</sup> The terms of a CIA are unique to the entity; consequently, users of this SOP need to be familiar with the actual CIA and its requirements.

**.03** This SOP applies to agreed-upon procedures engagements to assist in evaluating an entity's compliance for a specified period. Such engagements should follow the AICPA attestation standards, including AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*), and the applicable sections of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), and AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*). The engagement should be conducted in accordance with standards established by the AICPA, including the criteria set forth in this SOP. However, this SOP is not intended to provide all the required criteria set forth in individual CIAs, nor all the applicable standards established by the AICPA. Additionally, the SOP contains some guidance that may be applied in evaluating an organization's corporate compliance program, even though the program was not imposed by a CIA.

## Overview of a Typical Corporate Integrity Agreement

**.04** A CIA is an agreement between a health care provider and the OIG in conjunction with a global settlement of a fraud investigation. Such an agreement typically seeks to establish a compliance program within the health care provider (for example, hospital, clinical lab, physician group) that will promote

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<sup>1</sup> The practitioner also might be engaged to assist in other areas beyond an agreed-upon procedures engagement such as providing consulting services in connection with evaluating the company's billing practices, policies, and procedures as required by the CIA or in implementing, assessing, and reporting on voluntarily adopted compliance programs. In addition, the practitioner may assist in preparing an entity's self-disclosure reports to federal health agencies related to billing errors and other compliance matters. Similarly, practitioners may be involved in an entity's preparation of government-required (but not CIA-imposed) compliance reporting (for example, contract requirements for Medicare part C) beyond an agreed-upon procedures engagement.

compliance with the requirements of Medicare, Medicaid, and all other federal health care programs.

**.05** CIAs are case-specific. Their terms are tailored to address the organizational and operating deficiencies related to providing and billing for health care services that have been identified by the OIG, the entity, or others. Detailed compliance requirements are imposed as a condition for continued participation in federal health care programs. A sample CIA, provided by the OIG and intended to identify potential requirements, is included in appendix A [paragraph .32], "Sample Corporate Integrity Agreement Between the Office of Inspector General of the Department of Health and Human Services and [Provider]." Typical agreements cover five years and require the entity to address the following areas:

- Appointment of a compliance officer and establishment of a compliance committee
- Establishment of a code of conduct
- Establishment of policies and procedures regarding the compliance program
- Development of an information and education program as to the CIA requirements, compliance program and code of conduct
- Annual assessment of billing policies, procedures, and practices
- Establishment of a confidential disclosure program
- Prohibition of employment of excluded or convicted persons
- Notification to OIG of investigation or legal proceedings
- Reporting of credible evidence of misconduct
- Notifications to OIG of new provider locations
- Provision of implementation and annual reports
- Proper notification and submission of required reports
- Granting of OIG access to documents and individuals to conduct assessments
- Documentation of record retention requirements
- Awareness of disclosure criteria
- Agreement to comply with certain default provisions, penalties, and remedies
- Review of rights as to dispute resolution
- Review of effective and binding agreement clauses

## Conditions for Engagement Performance

**.06** A practitioner may perform an agreed-upon procedures engagement related to management's compliance with a CIA if all of the conditions specified in AT sections 201 and 601 are met.

**.07** As discussed more fully in the AT sections identified in paragraph .06, management's assertions as to its compliance must be capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in or attached to the practitioner's report in a sufficiently clear and comprehensive manner. Generally, to avoid confusion, management's assertions, which are based on the specific terms of its CIA, should be attached

to the practitioner's report. If the entity is not required to have a CIA, management may develop its assertions using the model CIA. A sample based on the model CIA, which is not meant to be all-inclusive, is included as appendix B (paragraph .33), "Sample Statement of Management's Assertions." [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Establishing an Understanding With the Client

**.08** The practitioner should document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter. Appendix C [paragraph .34], "Sample Engagement Letter," contains a sample engagement letter that may be used for this kind of engagement.

## Responsibilities of Specified Parties

**.09** AT section 201 identifies the users of an agreed-upon procedures report as specified parties. The specified parties to the agreed upon procedures report described in this SOP typically would be the management of the health care provider and the OIG. Management is responsible for ensuring that the entity complies with the requirements of the CIA. That responsibility encompasses (a) identifying applicable compliance requirements, (b) establishing and maintaining internal control policies and procedures to provide reasonable assurance that the entity complies with those requirements, (c) evaluating and monitoring the entity's compliance, and (d) preparing reports that satisfy legal, regulatory, or contractual requirements. Management's evaluation may include documentation such as accounting or statistical data, policy manuals, accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, internal auditors' reports, and other special studies or analyses. The form and extent of documentation will vary depending on the nature of the compliance requirements and the size and complexity of the entity. Management may engage the practitioner to gather information to assist it in evaluating the entity's compliance. Regardless of the procedures performed by the practitioner, management must accept responsibility for its assertions and must not base such assertions solely on the practitioner's procedures. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.10** The specified parties are responsible for the sufficiency (nature, timing, and extent) of the agreed-upon procedures because they best understand their own needs. The specified parties assume the risk that such procedures might be insufficient for their purposes. In addition, the specified parties assume the risk that they might misunderstand or otherwise inappropriately use findings properly reported by the practitioner. Use of an agreed-upon procedures report is restricted to the specified parties. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Practitioner's Responsibilities

**.11** The objective of the practitioner's agreed-upon procedures is to present specific findings to assist the specified parties in evaluating an entity's compliance with the requirements specified in the CIA. (See appendix D [paragraph .35], "Sample Procedures.") [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.12** The practitioner's procedures generally may be as limited or extensive as the specified parties desire, as long as the specified parties agree upon the procedures performed or to be performed and take responsibility for the sufficiency of the agreed-upon procedures for their purposes. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.13** To satisfy the requirements that the practitioner and the specified parties agree upon the procedures performed or to be performed and that the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified parties. For the purposes of these engagements, an effective way to obtain this agreement ordinarily is to distribute a draft of the report, detailing the procedures, that is expected to be issued to the OIG with a request for any comments it may have. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.14** To avoid possible misunderstandings, the practitioner should circulate the draft with a legend stating that these are the procedures expected to be performed, and unless informed otherwise, the practitioner assumes that there are no additional procedures that he or she is expected to perform. A legend such as the following might be used.

This draft is furnished solely for the purpose of indicating the form of report that we would expect to be able to furnish pursuant to the request by Management of [Provider] for our performance of limited procedures relating to [Provider's] compliance with the Corporate Integrity Agreement with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services. Based on our discussions with [Provider], it is our understanding that the procedures outlined in this draft report are those we are expected to follow. Unless informed otherwise within ninety (90) days of this transmittal, we shall assume that there are no additional procedures that we are expected to follow. The text of the definitive report will depend, of course, on the results of the procedures.

## Involvement of a Specialist<sup>2</sup>

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

- An attorney might provide assistance concerning the application of laws, regulations, or rules to a client's situation.
- A medical specialist might provide assistance in understanding the characteristics of diagnosis codes documented in patient medical records.

**.16** The practitioner and the specified parties should agree to the involvement of a specialist in assisting a practitioner in the performance of an agreed-upon procedures engagement. This agreement may be reached when obtaining

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<sup>2</sup> A *specialist* is a person (or firm) possessing special skill or knowledge in a particular field other than the attest function. As used herein, a specialist does not include a person employed by the practitioner's firm who participates in the attestation engagement.

agreement on the procedures performed or to be performed and acknowledgment of responsibility for the sufficiency of the procedures, as discussed previously. The practitioner's report should describe the nature of the assistance provided by the specialist. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

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

### Internal Auditors and Other Personnel<sup>3</sup>

.18 The agreed-upon procedures to be enumerated or referred to in the practitioner's report are to be performed entirely by the practitioner except as discussed in paragraphs .16–.18 of this SOP. However, internal auditors or other personnel may prepare schedules, accumulate data, perform an internal assessment of management's compliance, or provide other information for the practitioner's use in performing the agreed-upon procedures.

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

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

.20 However, it is inappropriate for the practitioner to

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

### Planning the Engagement

.21 Planning an agreed-upon procedures engagement involves working with the specified parties to develop an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners should have adequate technical training and proficiency in the attestation standards and have adequate knowledge in health care regulatory matters to enable them to sufficiently understand the events, transactions, and practices that, in their

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<sup>3</sup> AU-C section 610A, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*), does not apply to agreed-upon procedures engagements. [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

judgment, have a significant effect on the presentation of the assertions. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Documentation

**.22** The practitioner should prepare and maintain attest documentation, the form and content of which should be designed to meet the circumstances of the particular attest engagement. Attest documentation is the principal record of attest procedures applied, information obtained, and conclusions or findings reached by the practitioner in the engagement. The quantity, type, and content of attest documentation are matters of the practitioner's professional judgment and are discussed in paragraphs .100–.103 of AT section 101. Paragraphs .104–.107 of AT section 101 present further requirements and guidance regarding attest documentation. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.23** Concern over access to the practitioner's documentation might cause some clients to inquire about documentation requirements. In situations where the practitioner is requested to not maintain copies of certain client documentation, or to not prepare and maintain documentation similar to client documents, the practitioner may refer to Interpretation No. 1, "The Effect of an Inability to Obtain Audit Evidence Relating to Income Tax Accruals," of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*, AU-C sec. 9500 par. .01–.22), for guidance. See Interpretation No. 4, "Providing Access to or Copies of Attest Documentation to a Regulator," of AT section 101 (AICPA, *Professional Standards*, AT sec. 9101 par. .43–.46), for guidance related to providing access to or copies of attest documentation to a regulator in connection with work performed on an attestation engagement. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

## Management's Representations

**.24** The practitioner should obtain written representation from management on various matters including the following:

- a. Acknowledging management's responsibility for complying with the CIA
- b. Acknowledging management's responsibility for establishing and maintaining effective internal control over compliance
- c. Stating that management has performed an evaluation of the entity's compliance with CIA-specified requirements
- d. Stating management's assertions about the entity's compliance with all aspects of the CIA, including the specific issues that gave rise to the CIA<sup>4,5</sup>

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<sup>4</sup> Footnote 21 in paragraph .100 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), indicates that attest documentation may also be referred to as working papers. [Footnote added, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

<sup>5</sup> Depending on the circumstances, representations in the following areas might be appropriate.

- Violations or possible violations of laws or regulations, such as those related to the Medicare and Medicaid antifraud and abuse statutes

(continued)

- e. Stating that management has disclosed to the practitioner all known noncompliance with the CIA
- f. Stating that management has made available all documentation relating to compliance with the CIA
- g. Stating management's interpretation of any compliance requirements that have varying interpretations
- h. Stating that management has disclosed any communication from regulatory agencies, internal auditors, legal counsel, and other parties concerning matters regarding the design, implementation, and monitoring of the policies and procedures in place, including communication received between the end of the reporting period and the date of the practitioner's report (the date of signature)
- i. Stating that management has disclosed any known noncompliance occurring subsequent to the end of the reporting period
- j. Describing any related material fraud or abuse, other fraud, abuse or illegal acts that, whether or not material, involve management or other employees who have a significant role in the entity's design, implementation, and monitoring of the policies and procedures in place upon which compliance is based
- k. Stating that management has disclosed to the practitioners, orally or in writing, information about past noncompliance issues covered in the settlement agreement that gave rise to the CIA and the related corrective measures taken to support compliance in those areas

Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the engagement sufficient to require withdrawal from the engagement.<sup>6</sup>

## Reporting Considerations

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

**.26** The practitioner should report all findings from the application of the agreed-upon procedures. The concept of materiality does not apply to findings to be reported in an agreed-upon procedures engagement unless the definition

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*(footnote continued)*

- Compliance of third-party billings with applicable coding guidelines (for example, ICD-9-CM, CPT) and laws and regulations (including medical necessity, proper approvals, and proper rendering of care)
- Proper filing of all required Medicare, Medicaid, and similar reports under the applicable reimbursement rules and regulations (including nature of costs—allowable, patient-related, properly allocated, in accordance with applicable rules and regulations, properly adjusted to reflect prior audit adjustments) and adequacy of disclosures (including disputed costs) [Footnote renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

<sup>6</sup> See paragraph .62 of AT section 101. [Footnote added, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

of materiality is agreed to by the specified parties. Any agreed-upon materiality limits should be described in the practitioner's report. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.27** The practitioner has no obligation to perform procedures beyond the agreed-upon procedures. However, if noncompliance related to management's assertion comes to the practitioner's attention by other means, such information ordinarily should be included in his or her report.

**.28** The practitioner may become aware of noncompliance related to management's assertion that occurs subsequent to the reporting period but before the date of the practitioner's report. The practitioner should consider including information regarding such noncompliance in his or her report. However, the practitioner has no responsibility to perform procedures to detect such noncompliance other than obtaining management's representation about noncompliance in the subsequent period.

**.29** The practitioner should follow the reporting guidance in AT section 201. A sample report is included in appendix E (paragraph .36), "Sample Report."

**.30** Evaluating compliance with certain requirements may require interpretation of the laws, regulations, rules, contracts, or other agreements that establish those requirements. In such situations, the practitioner should consider whether he or she is provided with the reasonable criteria required to evaluate an assertion under the third general attestation standard. If these interpretations are significant, the practitioner may include a paragraph stating the description and the source of interpretations made by the entity's management. An example of such a paragraph, which should precede the procedures and findings paragraph(s), follows:

We have been informed that, under [*name of entity's*] interpretation of [*identify the compliance requirement*], [*explain the nature and source of the relevant interpretation*].

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

## Appendix A—Sample Corporate Integrity Agreement Between the Office of Inspector General of the Department of Health and Human Services and [Provider]

### I. Preamble

[*Provider*] ("*Provider*") hereby enters into this Corporate Integrity Agreement ("CIA") with the Office of Inspector General ("OIG") of the United States Department of Health and Human Services ("HHS") to ensure compliance by its employees with the requirements of Medicare, Medicaid and all other Federal health care programs (as defined in 42 U.S.C. 1320a-7b(f)) (hereinafter collectively referred to as the "Federal health care programs"). [*Provider's*] compliance with the terms and conditions in this CIA shall constitute an element of [*Provider's*] present responsibility with regard to participation in the Federal health care programs. Contemporaneously with this CIA, [*Provider*] is entering into a Settlement Agreement with the United States, and this CIA is incorporated by reference into the Settlement Agreement.

### II. Term of the CIA

The period of the compliance obligations assumed by [*Provider*] under this CIA shall be 5 years from the effective date of this CIA (unless otherwise specified). The effective date of this CIA will be the date on which the final signatory of this CIA executes this CIA (the "effective date").\*

### III. Corporate Integrity Obligations

[*Provider*] shall establish a compliance program that includes the following elements:

#### A. Compliance Officer

Within ninety (90) days after the effective date of this CIA, [*Provider*] shall appoint an individual to serve as Compliance Officer, who shall be responsible for developing and implementing policies, procedures, and practices designed to ensure compliance with the requirements set forth in this CIA and with the requirements of the Federal health care programs. The Compliance Officer shall be a member of senior management of [*Provider*], shall make regular (at least quarterly) reports regarding compliance matters directly to the CEO and/or to the Board of Directors of [*Provider*] and shall be authorized to report to the Board of Directors at any time. The Compliance Officer shall be responsible for monitoring the day-to-day activities engaged in by [*Provider*] to further its compliance objectives as well as any reporting obligations created under this CIA. In the event a new Compliance Officer is appointed during the term of this CIA, [*Provider*] shall notify the OIG, in writing, within fifteen (15) days of such a change.

[*Provider*] shall also appoint a Compliance Committee within ninety (90) days after the effective date of this CIA. The Compliance Committee shall, at a minimum, include the Compliance Officer and any other appropriate officers as

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\* Source: Office of the Inspector General of the United States Department of Health and Human Services.

necessary to meet the requirements of this CIA within the provider's corporate structure (e.g., senior executives of each major department, such as billing, clinical, human resources, audit, and operations). The Compliance Officer shall chair the Compliance Committee and the Committee shall support the Compliance Officer in fulfilling his/her responsibilities.

### **B. Written Standards**

1. *Code of Conduct.* Within ninety (90) days of the effective date of this CIA, [Provider] shall establish a Code of Conduct. The Code of Conduct shall be distributed to all employees within ninety (90) days of the effective date of this CIA. [Provider] shall make the promotion of, and adherence to, the Code of Conduct an element in evaluating the performance of managers, supervisors, and all other employees. The Code of Conduct shall, at a minimum, set forth:
  - a. [Provider's] commitment to full compliance with all statutes, regulations, and guidelines applicable to Federal health care programs, including its commitment to prepare and submit accurate billings consistent with Federal health care program regulations and procedures or instructions otherwise communicated by the Health Care Financing Administration ("HCFA") (or other appropriate regulatory agencies) and/or its agents;
  - b. [Provider's] requirement that all of its employees shall be expected to comply with all statutes, regulations, and guidelines applicable to Federal health care programs and with [Provider's] own policies and procedures (including the requirements of this CIA);
  - c. the requirement that all of [Provider's] employees shall be expected to report suspected violations of any statute, regulation, or guideline applicable to Federal health care programs or with [Provider's] own policies and procedures;
  - d. the possible consequences to both [Provider] and to any employee of failure to comply with all statutes, regulations, and guidelines applicable to Federal health care programs and with [Provider's] own policies and procedures or of failure to report such non-compliance; and
  - e. the right of all employees to use the confidential disclosure program, as well as [Provider's] commitment to confidentiality and non-retaliation with respect to disclosures.

Within ninety (90) days of the effective date of the CIA, each employee shall certify, in writing, that he or she has received, read, understands, and will abide by [Provider's] Code of Conduct. New employees shall receive the Code of Conduct and shall complete the required certification within two (2) weeks after the commencement of their employment or within ninety (90) days of the effective date of the CIA, whichever is later.

[Provider] will annually review the Code of Conduct and will make any necessary revisions. These revisions shall be distributed within thirty (30) days of initiating such a change. Employees shall certify on an annual basis that they have received, read, understand and will abide by the Code of Conduct.

2. *Policies and Procedures.* Within ninety (90) days of the effective date of this CIA, [Provider] shall develop and initiate implementation of written Policies and Procedures regarding the operation of

[*Provider's*] compliance program and its compliance with all federal and state health care statutes, regulations, and guidelines, including the requirements of the Federal health care programs. At a minimum, the Policies and Procedures shall specifically address [*insert language relevant to allegations in the case*]. In addition, the Policies and Procedures shall include disciplinary guidelines and methods for employees to make disclosures or otherwise report on compliance issues to [*Provider*] management through the Confidential Disclosure Program required by section III.E. [*Provider*] shall assess and update as necessary the Policies and Procedures at least annually and more frequently, as appropriate. A summary of the Policies and Procedures will be provided to OIG in the Implementation Report. The Policies and Procedures will be available to OIG upon request.

Within ninety (90) days of the effective date of the CIA, the relevant portions of the Policies and Procedures shall be distributed to all appropriate employees. Compliance staff or supervisors should be available to explain any and all policies and procedures.

### C. Training and Education

1. *General Training.* Within ninety (90) days of the effective date of this CIA, [*Provider*] shall provide at least two (2) hours of training to each employee. This general training shall explain [*Provider's*]:
  - a. Corporate Integrity Agreement requirements;
  - b. Compliance Program (including the Policies and Procedures as they pertain to general compliance issues); and
  - c. Code of Conduct.

These training materials shall be made available to the OIG, upon request.

New employees shall receive the general training described above within thirty (30) days of the beginning of their employment or within ninety (90) days after the effective date of this CIA, whichever is later. Each year, every employee shall receive such general training on an annual basis.

2. *Specific Training.* Within ninety (90) days of the effective date of this CIA, each employee who is involved directly or indirectly in the delivery of patient care and/or in the preparation or submission of claims for reimbursement for such care (including, but not limited to, coding and billing) for any Federal health care programs shall receive at least [*insert number of training hours*] hours of training in addition to the general training required above. This training shall include a discussion of:
  - a. the submission of accurate bills for services rendered to Medicare and/or Medicaid patients;
  - b. policies, procedures and other requirements applicable to the documentation of medical records;
  - c. the personal obligation of each individual involved in the billing process to ensure that such billings are accurate;
  - d. applicable reimbursement rules and statutes;
  - e. the legal sanctions for improper billings; and
  - f. examples of proper and improper billing practices.

These training materials shall be made available to OIG, upon request. Persons providing the training must be knowledgeable about the subject area.

Affected new employees shall receive this training within thirty (30) days of the beginning of their employment or within ninety (90) days of the effective date of this CIA, whichever is later. If a new employee has any responsibility for the delivery of patient care, the preparation or submission of claims and/or the assignment of procedure codes prior to completing this specific training, a [Provider] employee who has completed the substantive training shall review all of the untrained person's work regarding the assignment of billing codes.

Each year, every employee shall receive such specific training on an annual basis.

3. *Certification.* Each employee shall certify, in writing, that he or she has attended the required training. The certification shall specify the type of training received and the date received. The Compliance Officer shall retain the certifications, along with specific course materials. These shall be made available to OIG upon request.

#### ***D. Review Procedures***

[Provider] shall retain an entity, such as an accounting, auditing or consulting firm (hereinafter "Independent Review Organization"), to perform review procedures to assist [Provider] in assessing the adequacy of its billing and compliance practices pursuant to this CIA. This shall be an annual requirement and shall cover a twelve (12) month period. The Independent Review Organization must have expertise in the billing, coding, reporting and other requirements of the Federal health care programs from which [Provider] seeks reimbursement. The Independent Review Organization must be retained to conduct the assessment of the first year within ninety (90) days of the effective date of this CIA. For purposes of complying with this review procedures requirement, the OIG at its discretion, may permit the [Provider] to utilize internal auditors to perform the review(s). In such case, the [Provider] will engage the Independent Review Organization to verify the propriety of the internal auditors' methods and accuracy of their results. The [Provider] will request the Independent Review Organization to produce a report on its findings which report shall be included in the Annual Report to the OIG.

The Independent Review Organization (or the [Provider], if permitted by the OIG, as set forth above) will conduct two separate engagements. One will be an analysis of [Provider's] billing to the Federal health care programs to assist the [Provider] and OIG in determining compliance with all applicable statutes, regulations, and directives/guidance ("billing engagement"). The second engagement will assist the [Provider] and OIG in determining whether [Provider] is in compliance with this CIA ("compliance engagement").

1. *Billing Engagement.* The billing engagement shall consist of a review of a statistically valid sample of claims for the relevant period. The sample size shall be determined through the use of a probe sample.<sup>1</sup> At a minimum, the full sample must be within a ninety (90) percent confidence level and a precision of twenty-five (25) percent. The probe sample must contain at least thirty (30) sample units and cannot be used as part of the full sample. Both the probe sample and the sample must be selected through random numbers. [Provider] shall use OIG's Office of Audit Services Statistical Sampling Software, also known as "RAT-STATS", which is available through the Internet at <https://oig.hhs.gov/compliance/rat-stats/index.asp>.

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<sup>1</sup> Probe sample is defined as a small, random preliminary sample.

Each annual billing engagement analysis shall include the following components in its methodology:

- a. **Billing Engagement Objective:** Provide a statement stating clearly the objective intended to be achieved by the billing engagement and the procedure or combination of procedures that will be applied to achieve the objective.
- b. **Billing Engagement Population:** Identify the population, which is the group about which information is needed. Explain the methodology used to develop the population and provide the basis for this determination.
- c. **Sources of Data:** Provide a full description of the source of the information upon which the billing engagement conclusions will be based, including the legal or other standards applied, documents relied upon, payment data, and/or any contractual obligations.
- d. **Sampling Unit:** Define the sampling unit, which is any of the designated elements that comprise the population of interest.
- e. **Sampling Frame:** Identify the sampling frame, which is the totality of the sampling units from which the sample will be selected.

As part of the billing engagement:

- a. Inquire of management as to the procedures and controls affecting the billing process subject to the annual assessment as specified in the CIA. Document that aspect of the billing process (e.g., flow of documents, processing activities), and those controls that will be tested in the sample. The documentation may consist of flow charts, excerpts from policies and procedures manuals, control questionnaires, etc.
  - b. Report the sample results, including the overall error rate and the nature of the errors found (e.g., no documentation, inadequate documentation, assignment of incorrect code).
  - c. Document findings related to [Provider's] procedures to correct inaccurate billings and codings to the Federal health care programs and findings regarding the steps [Provider] is taking to bring its operations into compliance or to correct problems identified by the audit.
2. **Agreed-upon Procedures or Compliance Engagement.** An Independent Review Organization (or the [Provider], if permitted by the OIG) shall also conduct an agreed-upon procedures or compliance engagement, which shall assist the users in determining whether [Provider's] program, policies, procedures, and operations comply with the terms of this CIA. This engagement shall include a section by section analysis of the requirements of this CIA.

A complete copy of the Independent Review Organization's billing and agreed-upon procedures or compliance engagement shall be included in each of [Provider's] Annual Reports to OIG.

3. **Disclosure of Overpayments and Material Deficiencies.** If, as a result of these engagements, [Provider] or the Independent Review

Organization identifies any billing, coding or other policies, procedures and/or practices that result in an overpayment, [Provider] shall notify the payor (e.g., Medicare fiscal intermediary or carrier) within 30 days of discovering the deficiency or overpayment and take remedial steps within 60 days of discovery (or such additional time as may be agreed to by the payor) to correct the problem, including preventing the deficiency from recurring. The notice to the payor shall include:

- a. a statement that the refund is being made pursuant to this CIA;
- b. a description of the complete circumstances surrounding the overpayment;
- c. the methodology by which the overpayment was determined;
- d. the amount of the overpayment;
- e. any claim-specific information used to determine the overpayment (e.g., beneficiary health insurance number, claim number, service date, and payment date);
- f. the cost reporting period; and
- g. the provider identification number under which the repayment is being made.

If [Provider] determines an overpayment represents a material deficiency, contemporaneous with [Provider's] notification to the payor as provided above, [Provider] shall also notify OIG of:

- a. a complete description of the material deficiency;
- b. amount of overpayment due to the material deficiency;
- c. [Provider's] action(s) to correct and prevent such material deficiency from recurring;
- d. the payor's name, address, and contact person where the overpayment was sent;
- e. the date of the check and identification number (or electronic transaction number) on which the overpayment was repaid.

For purposes of this CIA, an "overpayment" shall mean the amount of money the provider has received in excess of the amount due and payable under the Federal health care programs' statutes, regulations or program directives, including carrier and intermediary instructions.

For purposes of this CIA, a "material deficiency" shall mean anything that involves: (i) a substantial overpayment or improper payment relating to the Medicare and/or Medicaid programs; (ii) conduct or policies that clearly violate the Medicare and/or Medicaid statute, regulations or directives issued by HCFA and/or its agents; or (iii) serious quality of care implications for federal health care beneficiaries or recipients. A material deficiency may be the result of an isolated event or a series of occurrences.

4. *Verification/Validation.* In the event that the OIG determines that it is necessary to conduct an independent review to determine whether or the extent to which [Provider] is complying with its obligations under this CIA, [Provider] agrees to pay for the reasonable cost of any such review or engagement by the OIG or any of its designated agents.

### ***E. Confidential Disclosure Program***

Within ninety (90) days after the effective date of this CIA, [Provider] shall establish a Confidential Disclosure Program, which must include measures (e.g., a toll-free compliance telephone line) to enable employees, contractors, agents or other individuals to disclose, to the Compliance Officer or some other person who is not in the reporting individual's chain of command, any identified issues or questions associated with [Provider's] policies, practices or procedures with respect to the Federal health care program, believed by the individual to be inappropriate. [Provider] shall publicize the existence of the hotline (e.g., e-mail to employees or post hotline number in prominent common areas).

The Confidential Disclosure Program shall emphasize a non-retribution, non-retaliation policy, and shall include a reporting mechanism for anonymous, confidential communication. Upon receipt of a complaint, the Compliance Officer (or designee) shall gather the information in such a way as to elicit all relevant information from the individual reporting the alleged misconduct. The Compliance Officer (or designee) shall make a preliminary good faith inquiry into the allegations set forth in every disclosure to ensure that he or she has obtained all of the information necessary to determine whether a further review should be conducted. For any disclosure that is sufficiently specific so that it reasonably: (1) permits a determination of the appropriateness of the alleged improper practice, and (2) provides an opportunity for taking corrective action, [Provider] shall conduct an internal review of the allegations set forth in such a disclosure and ensure that proper follow-up is conducted.

The Compliance Officer shall maintain a confidential disclosure log, which shall include a record and summary of each allegation received, the status of the respective investigations, and any corrective action taken in response to the investigation.

### ***F. Ineligible Persons***

[Provider] shall not hire or engage as contractors any "Ineligible Person." For purposes of this CIA, an "Ineligible Person" shall be any individual or entity who: (i) is currently excluded, suspended, debarred or otherwise ineligible to participate in the Federal health care programs; or (ii) has been convicted of a criminal offense related to the provision of health care items or services and has not been reinstated in the Federal health care programs after a period of exclusion, suspension, debarment, or ineligibility.

Within ninety (90) days of the effective date of this CIA, [Provider] will review its list of current employees and contractors against the General Services Administration's List of Parties Excluded from Federal Programs (available through the Internet at [www.arnet.gov/epl](http://www.arnet.gov/epl)) and the HHS/OIG Cumulative Sanction Report (available through the Internet at [www.dhhs.gov/progorg/oig](http://www.dhhs.gov/progorg/oig)) to ensure that it is not currently employing or contracting with any Ineligible Person. Thereafter, [Provider] will review the list once semi-annually to ensure that no current employees or contractors are or have become Ineligible Persons.

To prevent hiring or contracting with any Ineligible Person, [Provider] shall screen all prospective employees and prospective contractors prior to engaging their services by (i) requiring applicants to disclose whether they are Ineligible Persons, and (ii) reviewing the General Services Administration's List of Parties Excluded from Federal Programs (available through the Internet at [www.arnet.gov/epl](http://www.arnet.gov/epl)) and the HHS/OIG Cumulative Sanction Report (available through the Internet at [www.dhhs.gov/progorg/oig](http://www.dhhs.gov/progorg/oig)).

If [Provider] has notice that an employee or agent is charged with a criminal offense related to any Federal health care program, or is suspended or proposed for exclusion during his or her employment or contract with [Provider], within

10 days of receiving such notice [Provider] will remove such employee from responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs until the resolution of such criminal action, suspension, or proposed exclusion. If [Provider] has notice that an employee or agent has become an Ineligible Person, [Provider] will remove such person from responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs and shall remove such person from any position for which the person's salary or the items or services rendered, ordered, or prescribed by the person are paid in whole or in part, directly or indirectly, by Federal health care programs or otherwise with Federal funds at least until such time as the person is reinstated into participation in the Federal health care programs.

### **G. Notification of Proceedings**

Within thirty (30) days of discovery, [Provider] shall notify OIG, in writing, of any ongoing investigation or legal proceeding conducted or brought by a governmental entity or its agents involving an allegation that [Provider] has committed a crime or has engaged in fraudulent activities or any other knowing misconduct. This notification shall include a description of the allegation, the identity of the investigating or prosecuting agency, and the status of such investigation or legal proceeding. [Provider] shall also provide written notice to OIG within thirty (30) days of the resolution of the matter, and shall provide OIG with a description of the findings and/or results of the proceedings, if any.

### **H. Reporting**

1. *Credible evidence of misconduct.* If [Provider] discovers credible evidence of misconduct from any source and, after reasonable inquiry, has reason to believe that the misconduct may violate criminal, civil, or administrative law concerning [Provider's] practices relating to the Federal health care programs, then [Provider] shall promptly report the probable violation of law to OIG. Defendants shall make this disclosure as soon as practicable, but, not later than thirty (30) days after becoming aware of the existence of the probable violation. The [Provider's] report to OIG shall include:
  - a. the findings concerning the probable violation, including the nature and extent of the probable violation;
  - b. [Provider's] actions to correct such probable violation; and
  - c. any further steps it plans to take to address such probable violation and prevent it from recurring.

To the extent the misconduct involves an overpayment, the report shall include the information listed in section III.D.3 regarding material deficiencies.

2. *Inappropriate Billing.* If [Provider] discovers inappropriate or incorrect billing through means other than the Independent Review Organization's engagement, the provider shall follow procedures in section III.D.3 regarding overpayments and material deficiencies.

### **IV. New Locations**

In the event that [Provider] purchases or establishes new business units after the effective date of this CIA, [Provider] shall notify OIG of this fact within thirty (30) days of the date of purchase or establishment. This notification shall include the location of the new operation(s), phone number, fax number, Federal health care program provider number(s) (if any), and the corresponding payor(s) (contractor specific) that has issued each provider number. All employees at

such locations shall be subject to the requirements in this CIA that apply to new employees (e.g., completing certifications and undergoing training).

## V. Implementation and Annual Reports

### A. Implementation Report

Within one hundred and twenty (120) days after the effective date of this CIA, [Provider] shall submit a written report to OIG summarizing the status of its implementation of the requirements of this CIA. This Implementation Report shall include:

1. the name, address, phone number and position description of the Compliance Officer required by section III.A;
2. the names and positions of the members of the Compliance Committee required by section III.A;
3. a copy of [Provider's] Code of Conduct required by section III.B.1;
4. the summary of the Policies and Procedures required by section III.B.2;
5. a description of the training programs required by section III.C including a description of the targeted audiences and a schedule of when the training sessions were held;
6. a certification by the Compliance Officer that:
  - a. the Policies and Procedures required by section III.B have been developed, are being implemented, and have been distributed to all pertinent employees;
  - b. all employees have completed the Code of Conduct certification required by section III.B.1; and
  - c. all employees have completed the training and executed the certification required by section III.C;
7. a description of the confidential disclosure program required by section III.E;
8. the identity of the Independent Review Organization(s) and the proposed start and completion date of the first audit; and
9. a summary of personnel actions taken pursuant to section III.F.

### B. Annual Reports

[Provider] shall submit to OIG an Annual Report with respect to the status and findings of [Provider's] compliance activities. The Annual Reports shall include:

1. any change in the identity or position description of the Compliance Officer and/or members of the Compliance Committee described in section III.A;
2. a certification by the Compliance Officer that:
  - a. all employees have completed the annual Code of Conduct certification required by section III.B.1; and
  - b. all employees have completed the training and executed the certification required by section III.C;

3. notification of any changes or amendments to the Policies and Procedures required by section III.B and the reasons for such changes (e.g., change in contractor policy);
4. a complete copy of the report prepared pursuant to the Independent Review Organization's billing and compliance engagement, including a copy of the methodology used;
5. [Provider's] response/corrective action plan to any issues raised by the Independent Review Organization;
6. a summary of material deficiencies reported throughout the course of the previous twelve (12) months pursuant to III.D.3 and III.H;
7. a report of the aggregate overpayments that have been returned to the Federal health care programs that were discovered as a direct or indirect result of implementing this CIA. Overpayment amounts should be broken down into the following categories: Medicare, Medicaid (report each applicable state separately) and other Federal health care programs;
8. a copy of the confidential disclosure log required by section III.E;
9. a description of any personnel action (other than hiring) taken by [Provider] as a result of the obligations in section III.F;
10. a summary describing any ongoing investigation or legal proceeding conducted or brought by a government entity involving an allegation that [Provider] has committed a crime or has engaged in fraudulent activities, which have been reported pursuant to section III.G. The statement shall include a description of the allegation, the identity of the investigating or prosecuting agency, and the status of such investigation, legal proceeding or requests for information;
11. a corrective action plan to address the probable violations of law identified in section III.H; and
12. a listing of all of the [Provider's] locations (including locations and mailing addresses), the corresponding name under which each location is doing business, the corresponding phone numbers and fax numbers, each location's Federal health care program provider identification number(s) and the payor (specific contractor) that issued each provider identification number.

The first Annual Report shall be received by the OIG no later than one year and thirty (30) days after the effective date of this CIA. Subsequent Annual Reports shall be submitted no later than the anniversary date of the due date of the first Annual Report.

### ***C. Certifications***

The Implementation Report and Annual Reports shall include a certification by the Compliance Officer under penalty of perjury, that: (1) [Provider] is in compliance with all of the requirements of this CIA, to the best of his or her knowledge; and (2) the Compliance Officer has reviewed the Report and has made reasonable inquiry regarding its content and believes that, upon such inquiry, the information is accurate and truthful.

## VI. Notifications and Submission of Reports

Unless otherwise stated in writing subsequent to the effective date of this CIA, all notifications and reports required under this CIA shall be submitted to the entities listed below:

OIG:

Civil Recoveries Branch—Compliance Unit  
Office of Counsel to the Inspector General  
Office of Inspector General  
U.S. Department of Health and Human Services  
Cohen Building, Room 5527  
330 Independence Avenue, SW  
Washington, DC 20201  
Phone 202-619-2078; Fax 202-205-0604

[*Provider*]:

[*Address and Telephone number of Provider's Compliance Contact*]

## VII. OIG Inspection, Audit and Review Rights

In addition to any other rights OIG may have by statute, regulation, or contract, OIG or its duly authorized representative(s), may examine [*Provider's*] books, records, and other documents and supporting materials for the purpose of verifying and evaluating: (a) [*Provider's*] compliance with the terms of this CIA; and (b) [*Provider's*] compliance with the requirements of the Federal health care programs in which it participates. The documentation described above shall be made available by [*Provider*] to OIG or its duly authorized representative(s) at all reasonable times for inspection, audit or reproduction. Furthermore, for purposes of this provision, OIG or its duly authorized representative(s) may interview any of [*Provider's*] employees who consent to be interviewed at the employee's place of business during normal business hours or at such other place and time as may be mutually agreed upon between the employee and OIG. [*Provider*] agrees to assist OIG in contacting and arranging interviews with such employees upon OIG's request. [*Provider's*] employees may elect to be interviewed with or without a representative of [*Provider*] present.

## VIII. Document and Record Retention

[*Provider*] shall maintain for inspection all documents and records relating to reimbursement from the Federal health care programs or to compliance with this CIA one year longer than the term of this CIA (or longer if otherwise required by law).

## IX. Disclosures

Subject to HHS's Freedom of Information Act ("FOIA") procedures, set forth in 45 C.F.R. Part 5, the OIG shall make a reasonable effort to notify [*Provider*] prior to any release by OIG of information submitted by [*Provider*] pursuant to its obligations under this CIA and identified upon submission by [*Provider*] as trade secrets, commercial or financial information and privileged and confidential under the FOIA rules. [*Provider*] shall refrain from identifying any information as trade secrets, commercial or financial information and privileged and confidential that does not meet the criteria for exemption from disclosure under FOIA.

## X. Breach and Default Provisions

[*Provider*] is expected to fully and timely comply with all of the obligations herein throughout the term of this CIA or other time frames herein agreed to.

**A. Stipulated Penalties for Failure to Comply with Certain Obligations**

As a contractual remedy, [Provider] and OIG hereby agree that failure to comply with certain obligations set forth in this CIA may lead to the imposition of the following monetary penalties (hereinafter referred to as "Stipulated Penalties") in accordance with the following provisions.

1. A Stipulated Penalty of \$2,500 (which shall begin to accrue on the day after the date the obligation became due) for each day, beginning 120 days after the effective date of this CIA and concluding at the end of the term of this CIA, [Provider] fails to have in place any of the following:
  - a. a Compliance Officer;
  - b. a Compliance Committee;
  - c. a written Code of Conduct;
  - d. written Policies and Procedures;
  - e. a training program; and
  - f. a Confidential Disclosure Program;
2. A Stipulated Penalty of \$2,500 (which shall begin to accrue on the day after the date the obligation became due) for each day [Provider] fails to meet any of the deadlines to submit the Implementation Report or the Annual Reports to the OIG.
3. A Stipulated Penalty of \$2,000 (which shall begin to accrue on the date the failure to comply began) for each day [Provider]:
  - a. hires or contracts with an Ineligible Person after that person has been listed by a federal agency as excluded, debarred, suspended or otherwise ineligible for participation in the Medicare, Medicaid or any other Federal health care program (as defined in 42 U.S.C. 1320a7b(f)). This Stipulated Penalty shall not be demanded for any time period if [Provider] can demonstrate that it did not discover the person's exclusion or other ineligibility after making a reasonable inquiry (as described in section III.F) as to the status of the person;
  - b. employs or contracts with an Ineligible Person and that person: (i) has responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs or (ii) is in a position for which the person's salary or the items or services rendered, ordered, or prescribed by the person are paid in whole or in part, directly or indirectly, by the Federal health care programs or otherwise with Federal funds (this Stipulated Penalty shall not be demanded for any time period during which [Provider] can demonstrate that it did not discover the person's exclusion or other ineligibility after making a reasonable inquiry (as described in III.F) as to the status of the person);
  - c. employs or contracts with a person who: (i) has been charged with a criminal offense related to

any Federal health care program, or (ii) is suspended or proposed for exclusion, and that person has responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs (this Stipulated Penalty shall not be demanded for any time period before 10 days after [Provider] received notice of the relevant matter or after the resolution of the matter).

4. A Stipulated Penalty of \$1,500 (which shall begin to accrue on the date the [Provider] fails to grant access) for each day [Provider] fails to grant access to the information or documentation as required in section V of this CIA.
5. A Stipulated Penalty of \$1,000 (which shall begin to accrue ten (10) days after the date that OIG provides notice to [Provider] of the failure to comply) for each day [Provider] fails to comply fully and adequately with any obligation of this CIA. In its notice to [Provider], the OIG shall state the specific grounds for its determination that the [Provider] has failed to comply fully and adequately with the CIA obligation(s) at issue.

### ***B. Payment of Stipulated Penalties***

1. *Demand Letter.* Upon a finding that [Provider] has failed to comply with any of the obligations described in section X.A and determining that Stipulated Penalties are appropriate, OIG shall notify [Provider] by personal service or certified mail of (a) [Provider's] failure to comply; and (b) the OIG's exercise of its contractual right to demand payment of the Stipulated Penalties (this notification is hereinafter referred to as the "Demand Letter").

Within fifteen (15) days of the date of the Demand Letter, [Provider] shall either (a) cure the breach to the OIG's satisfaction and pay the applicable stipulated penalties, or (b) request a hearing before an HHS administrative law judge ("ALJ") to dispute the OIG's determination of noncompliance, pursuant to the agreed-upon provisions set forth below in section X.D. In the event [Provider] elects to request an ALJ hearing, the Stipulated Penalties shall continue to accrue until [Provider] cures, to the OIG's satisfaction, the alleged breach in dispute. Failure to respond to the Demand Letter in one of these two manners within the allowed time period shall be considered a material breach of this CIA and shall be grounds for exclusion under section X.C.

2. *Timely Written Requests for Extensions.* [Provider] may submit a timely written request for an extension of time to perform any act or file any notification or report required by this CIA. Notwithstanding any other provision in this section, if OIG grants the timely written request with respect to an act, notification, or report, Stipulated Penalties for failure to perform the act or file the notification or report shall not begin to accrue until one day after [Provider] fails to meet the revised deadline as agreed to by the OIG-approved extension. Notwithstanding any other provision in this section, if OIG denies such a timely written request, Stipulated Penalties for failure to perform the act or file the notification or report shall not begin to accrue until two (2) business days after

[Provider] receives OIG's written denial of such request. A "timely written request" is defined as a request in writing received by OIG at least five (5) business days prior to the date by which any act is due to be performed or any notification or report is due to be filed.

3. *Form of Payment.* Payment of the Stipulated Penalties shall be made by certified or cashier's check, payable to "Secretary of the Department of Health and Human Services," and submitted to OIG at the address set forth in section VI.
4. *Independence from Material Breach Determination.* Except as otherwise noted, these provisions for payment of Stipulated Penalties shall not affect or otherwise set a standard for the OIG's determination that [Provider] has materially breached this CIA, which decision shall be made at the OIG's discretion and governed by the provisions in section X.C, below.

### **C. Exclusion for Material Breach of this CIA**

1. *Notice of Material Breach and Intent to Exclude.* The parties agree that a material breach of this CIA by [Provider] constitutes an independent basis for [Provider's] exclusion from participation in the Federal health care programs (as defined in 42 U.S.C. 1320a7b(f)). Upon a determination by OIG that [Provider] has materially breached this CIA and that exclusion should be imposed, the OIG shall notify [Provider] by certified mail of (a) [Provider's] material breach; and (b) OIG's intent to exercise its contractual right to impose exclusion (this notification is hereinafter referred to as the "Notice of Material Breach and Intent to Exclude").
2. *Opportunity to Cure.* [Provider] shall have thirty-five (35) days from the date of the Notice of Material Breach and Intent to Exclude Letter to demonstrate to the OIG's satisfaction that:
  - a. [Provider] is in full compliance with this CIA;
  - b. the alleged material breach has been cured; or
  - c. the alleged material breach cannot be cured within the 35-day period, but that: (i) [Provider] has begun to take action to cure the material breach, (ii) [Provider] is pursuing such action with due diligence, and (iii) [Provider] has provided to OIG a reasonable timetable for curing the material breach.
3. *Exclusion Letter.* If at the conclusion of the thirty-five (35) day period, [Provider] fails to satisfy the requirements of section X.C.2, OIG may exclude [Provider] from participation in the Federal health care programs. OIG will notify [Provider] in writing of its determination to exclude [Provider] (this letter shall be referred to hereinafter as the "Exclusion Letter"). Subject to the Dispute Resolution provisions in section X.D, below, the exclusion shall go into effect thirty (30) days after the date of the Exclusion Letter. The exclusion shall have national effect and will also apply to all other federal procurement and non-procurement programs. If [Provider] is excluded under the provisions of this CIA, [Provider] may seek reinstatement pursuant to the provisions at 42 C.F.R. §§ 1001.3001–.3004.
4. *Material Breach.* A material breach of this CIA means:

- a. a failure by [Provider] to report a material deficiency, take corrective action and pay the appropriate refunds, as provided in section III.D;
- b. repeated or flagrant violations of the obligations under this CIA, including, but not limited to, the obligations addressed in section X.A of this CIA;
- c. a failure to respond to a Demand Letter concerning the payment of Stipulated Penalties in accordance with section X.B above; or
- d. a failure to retain and use an Independent Review Organization for review purposes in accordance with section III.D.

#### **D. Dispute Resolution**

1. *Review Rights.* Upon the OIG's delivery to [Provider] of its Demand Letter or of its Exclusion Letter, and as an agreed-upon contractual remedy for the resolution of disputes arising under the obligation of this CIA, [Provider] shall be afforded certain review rights comparable to the ones that are provided in 42 U.S.C. §§1320a7(f) and 42 C.F.R. §1005 as if they applied to the Stipulated Penalties or exclusion sought pursuant to this CIA. Specifically, the OIG's determination to demand payment of Stipulated Penalties or to seek exclusion shall be subject to review by an ALJ and, in the event of an appeal, the Departmental Appeals Board ("DAB"), in a manner consistent with the provisions in 42 C.F.R. §§1005.2–.21. Notwithstanding the language in 42 C.F.R. §1005.2(c), the request for a hearing involving stipulated penalties shall be made within fifteen (15) days of the date of the Demand Letter and the request for a hearing involving exclusion shall be made within thirty (30) days of the date of the Exclusion Letter.
2. *Stipulated Penalties Review.* Notwithstanding any provision of Title 42 of the United States Code or Chapter 42 of the Code of Federal Regulations, the only issues in a proceeding for stipulated penalties under this CIA shall be (a) whether [Provider] was in full and timely compliance with the obligations of this CIA for which the OIG demands payment; and (b) the period of noncompliance. [Provider] shall have the burden of proving its full and timely compliance and the steps taken to cure the noncompliance, if any. If the ALJ finds for the OIG with regard to a finding of a breach of this CIA and orders [Provider] to pay Stipulated Penalties, such Stipulated Penalties shall become due and payable twenty (20) days after the ALJ issues such a decision notwithstanding that [Provider] may request review of the ALJ decision by the DAB.
3. *Exclusion Review.* Notwithstanding any provision of Title 42 of the United States Code or Chapter 42 of the Code of Federal Regulations, the only issues in a proceeding for exclusion based on a material breach of this CIA shall be (a) whether [Provider] was in material breach of this CIA; (b) whether such breach was continuing on the date of the Exclusion Letter; and (c) the alleged material breach cannot be cured within the 35-day period, but that (i) [Provider] has begun to take action to cure the material breach, (ii) [Provider] is pursuing such action with due diligence,

and (iii) [Provider] has provided to OIG a reasonable timetable for curing the material breach.

For purposes of the exclusion herein, exclusion shall take effect only after an ALJ decision that is favorable to the OIG. [Provider's] election of its contractual right to appeal to the DAB shall not abrogate the OIG's authority to exclude [Provider] upon the issuance of the ALJ's decision. If the ALJ sustains the determination of the OIG and determines that exclusion is authorized, such exclusion shall take effect twenty (20) days after the ALJ issues such a decision, notwithstanding that [Provider] may request review of the ALJ decision by the DAB.

4. *Finality of Decision.* The review by an ALJ or DAB provided for above shall not be considered to be an appeal right arising under any statutes or regulations. Consequently, the parties to this CIA agree that the DAB's decision (or the ALJ's decision if not appealed) shall be considered final for all purposes under this CIA and [Provider] agrees to waive any right it may have to appeal the decision administratively, judicially or otherwise seek review by any court or other adjudicative forum.

**XI. Effective and Binding Agreement**

Consistent with the provisions in the Settlement Agreement pursuant to which this CIA is entered, and into which this CIA is incorporated, [Provider] and OIG agree as follows:

- a. This CIA shall be binding on the successors, assigns and transferees of [Provider];
- b. This CIA shall become final and binding on the date the final signature is obtained on the CIA;
- c. Any modifications to this CIA shall be made with the prior written consent of the parties to this CIA; and
- d. The undersigned [Provider] signatories represent and warrant that they are authorized to execute this CIA. The undersigned OIG signatory represents that he is signing this CIA in his official capacity and that he is authorized to execute this CIA.

**On Behalf of [Provider]**

_____	_____
	<i>Date</i>
_____	_____
	<i>Date</i>
_____	_____
	<i>Date</i>

[Please identify all signatories]

**ON BEHALF OF THE OFFICE OF INSPECTOR GENERAL  
OF THE DEPARTMENT OF HEALTH AND HUMAN  
SERVICES**

_____	_____
Lewis Morris	<i>[Date]</i>

**Assistant Inspector General for Legal Affairs  
Office of Inspector General  
U.S. Department of Health and Human Services**

## Appendix B

### Sample Statement of Management's Assertions

[Date]

In connection with the Corporate Integrity Agreement (CIA) entered into with the Office of the Inspector General of the United States Department of Health and Human Services dated [date], we make the following assertions, which are true to the best of our knowledge and belief.

#### Governance

Within 90 days of the date of the CIA, we—

1. Established a Compliance Committee, which meets at least monthly and requires a quorum to meet.
2. Appointed to our Compliance Committee members who include at a minimum those individuals specified in the CIA.
3. Delegated to the Compliance Committee the authority to implement and monitor the CIA, as evidenced by the organization chart or the Compliance Committee's charter.
4. Appointed a compliance officer, who reports directly to the individual specified in the CIA.

We appointed a compliance officer who—

1. Has sufficient staff and resources to carry out his or her responsibilities.
2. Actively participates in compliance training.
3. Has authority to conduct full and complete internal investigations without restriction.
4. Periodically revises the compliance program to meet changing circumstances and risks.

#### Billing Practices, Policies, and Procedures

Although no system of internal controls can provide absolute assurance that all bills comply in all respects with Medicare, Medicaid, and other federal health care program guidelines, we are not aware of any material weaknesses in our billing practices, policies, and procedures. Billings to third-party payors comply in all material respects with applicable coding principles and laws and regulations (including those dealing with Medicare and Medicaid antifraud and abuse) and only reflect charges for goods and services that were medically necessary, properly approved by regulatory bodies (e.g., the Food and Drug Administration), if required and properly rendered. [Insert other assertions as necessary to address matters covered in the CIA.] Any Medicare, Medicaid, and other federal health program billing deficiencies that we identified have been properly reported to the applicable payor within 60 days of discovery of the deficiency.

#### Corporate Integrity Policy

1. Our policy was developed and implemented within [number] days of execution of the CIA.

2. The policy addresses the Company's commitment to preparation and submission of accurate billings consistent with the standards set forth in federal health care program statutes, regulations, procedures and guidelines or as otherwise communicated by Health Care Financing Administration (HCFA), its agents or any other agency engaged in the administration of the applicable federal health care program.
3. The policy addressed the specific issues that gave rise to the settlement, as well as other risk areas identified by the OIG in published Fraud Alerts issued through [date].
4. Further details on the development and implementation of our policy were provided to the OIG in our letter dated [date].
5. Our policy was distributed to all employees, physicians and independent contractors involved in submitting or preparing requests for reimbursement.
6. We have prominently displayed a copy of our policy on the Company's premises.

### **Information and Education Program**

As discussed more fully in our letter to the OIG dated [date], we conducted an Information and Education Program within [number] days of the CIA. The Information and Education Program requires that each officer, employee, agent and contractor charged with administering federal health care programs (including, but not limited to billers, coders, nurses, physicians, medical records, hospital administration and other individuals directly involved in billing federal health care programs) receive at least [number] hours of training.

The training provided to employees involved in billing, coding, and/or charge capture consisted of instructions on submitting accurate bills, the personal obligations of each individual to ensure billings are accurate, the nature of company-imposed disciplinary actions on individuals who violate company policies and/or laws and regulations, applicable federal health care program rules, legal sanctions against the company for submission of false or fraudulent information, and how to report potential abuses or fraud. The training material addresses those issues underlying our settlement with the OIG.

The experience of the trainers is consistent with the topics presented.

### **Confidential Disclosure Program**

Our Confidential Disclosure Program—

1. Was established within [number] days of the CIA.
2. Enables any employee to disclose any practices or billing procedures relating to federal health care programs.
3. Provides a toll-free telephone line maintained by the Company, which Company representatives have indicated is maintained twenty-four hours a day, seven days a week, for the purpose of making any disclosures regarding compliance with the Company's Compliance Program, the obligations in the CIA, and Company's overall compliance with federal and state standards.
4. Includes policies requiring the review of any disclosures to permit a determination of the appropriateness of the billing practice alleged to be involved and any corrective action to be taken to ensure that proper follow-up is conducted.

5. A detailed summary of the communications (including the number of disclosures by employees and the dates of such disclosures) concerning billing practices reported as, and found to be, inappropriate under the Confidential Disclosure Program, and the results of any internal review and the follow-up on such disclosures are summarized in Attachment [title] to our Annual Report.

**Excluded Individuals or Entities**

Company policy—

1. Prohibits the employment of or contracting with an individual or entity that is listed by a federal agency as convicted of abuse or excluded, suspended or otherwise ineligible for participation in federal health care programs.
2. Includes a process to make an inquiry into the status of any potential employee or independent contractor.
3. Provides for an annual review of the status of all existing employees and contractors to verify whether any individual had been suspended or excluded or charged with a criminal offense relating to the provision of federal health care services.

We are not aware of any individuals employed in contravention of the prohibitions in the CIA.

**Record Retention**

Our record retention policy is consistent with the requirements of the CIA.

Signed by:

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[Chief Executive Officer]

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[Chief Financial Officer]

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[Corporate Compliance Officer]

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## Appendix C

### Sample Engagement Letter

The following is an illustration of a sample engagement letter that may be used for this kind of engagement.

[CPA Firm Letterhead]

[Client's Name and Address]

Dear \_\_\_\_\_:

This will confirm our understanding of the arrangements for our performance of certain agreed-upon procedures in connection with management's compliance with the terms of the Corporate Integrity Agreement (CIA) with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services (HHS) dated [date of CIA] for the period ending [date].

We will perform those procedures enumerated in the attachment to this letter. Our responsibility is to carry out these procedures and report our findings. We will conduct our engagement in accordance with standards established by the American Institute of Certified Public Accountants. Our planned procedures were agreed to by management and will be communicated to the OIG for its review and are based on the terms specified in the CIA. The sufficiency of these procedures is solely the responsibility of the specified parties to the report. Consequently, it is understood that we make no representation regarding the sufficiency of the procedures described in the attachment for the purpose for which this report has been requested or for any other purpose.

Management is responsible for the Company's compliance with all applicable laws, regulations, and contracts and agreements, including the CIA. Management also is responsible for the design, implementation, and monitoring of the policies and procedures upon which compliance is based.

Our engagement to perform agreed-upon procedures is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's compliance with the CIA. Accordingly, we will not express such an opinion or any other form of assurance thereon.<sup>1</sup>

Working papers that are prepared in connection with this engagement are the property of the independent accountant. The working papers are prepared for the purpose of providing the principal support for the independent accountant's report. At the completion of our work, we expect to issue an agreed-upon procedures report in the attached form.

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<sup>1</sup> The independent accountant may wish to include an understanding with the client about any limitation or other arrangements regarding liability of the practitioner or the client in the engagement letter. For example, the following might be included in the letter:

Our maximum liability relating to services rendered under this letter (regardless of form of action, whether in contract, negligence or otherwise) shall be limited to the charges paid to us for the portion of the services or work products giving rise to liability. We will not be liable for consequential or punitive damages (including lost profits or savings) even if aware of their possible existence.

You will indemnify us against any damage or expense that may result from any third-party claim relating to our services or any use by you of any work product, and you will reimburse us for all expenses (including counsel fees) as incurred by us in connection with any such claim, except to the extent such claim (i) is finally determined to have resulted from our gross negligence or willful misconduct or (ii) is covered by any of the preceding indemnities.

If, however, we are not able to complete all of the specified procedures, we will so advise you. At that time, we will discuss with you the form of communication, if any, that you desire for our findings. We will ask you to confirm your request in writing at that time. If you request that we delay issuance of our report until corrective action is taken that will result in compliance with all aspects of the CIA, we will do so only at your written request. Our working papers will be retained in accordance with our firm's working paper retention policy.

The distribution of the independent accountant's report will be restricted to the governing board and management of the Company and the OIG.

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees.

We agree that to the extent required by law, we will allow the Comptroller General of the United States, HHS, and their duly authorized representatives to have access to this engagement letter and our documents and records to the extent necessary to verify the nature and amount of costs of the services provided to the Company, until the expiration of four years after we have concluded providing services to the Company that are performed pursuant to this Engagement Letter. In the event the Comptroller General, HHS, or their duly authorized representatives request such records, we agree to notify the Company of such request as soon as practicable.

In the event we are requested or authorized by the Company 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 Company, the Company 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.

If this letter correctly expresses your understanding of this engagement, please sign the enclosed copy where indicated and return it to us. We appreciate the opportunity to serve you.

Sincerely, \_\_\_\_\_

*[Partner's Signature]*

*[Firm Name or Firm Representative]*

Accepted and agreed to: \_\_\_\_\_

*[Client Representative's Signature]*

*[Title]* \_\_\_\_\_

*[Date]* \_\_\_\_\_

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

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## Appendix D

### Sample Procedures

#### *Procedure*

#### *Findings*

##### **Governance**

1. We read the Company's corporate minutes and organization chart and ascertained that, within [number] days of the date of the Corporate Integrity Agreement (CIA), the Company—
  - a. Established a Compliance Committee, which is to meet meets at least monthly and requires a quorum to meet.
  - b. Appointed to its Compliance Committee members who include, at a minimum, those individuals specified in the CIA.
  - c. Delegated to the Compliance Committee the authority to implement and monitor the CIA, as evidenced by the organization chart or the Compliance Committee's charter.
  - d. Appointed a compliance officer who reports directly to the individual specified in the CIA.
2. We interviewed the compliance officer and were informed that, in his or her opinion, the Compliance Officer—
  - a. Has sufficient staff and resources to carry out his or her responsibilities.
  - b. Actively participates in compliance training.
  - c. Has the authority to conduct full and complete internal investigations without restriction.
  - d. Periodically revises the compliance program to meet changing circumstances and risks.
3. We read the OIG notification letter as specified in the CIA and noted that the appropriate official signed the letter, that it was addressed to the OIG, that it covered items (a) through (d) in Step 1, and that it was dated within [number of] days of the execution of the CIA.

##### **Billing Practices, Policies, and Procedures**

*The practitioner might be engaged to provide consulting services in connection with the evaluation of the company's billing practices, policies, and procedures. If so, generally no agreed-upon procedures would be performed relating to this area. Alternatively, if the procedures relating to the Company's billing practices, policies, and procedures are performed by others such as the Company's internal audit staff, the practitioner performs Steps 4 through 9.*

4. We read the compliance work plan and noted the following:
  - a. The work plan's stated objectives include the determination that billings are accurate and complete, for services rendered that have been deemed by medical specialists as being necessary, and are submitted in accordance with federal program guidelines.
  - b. The work plan sampling methodology sets confidence levels consistent with those defined in the CIA.
  - c. The work plan identifies risk areas, as defined in the CIA (if applicable), and specifies testing procedures by risk area.
  - d. The work plan specifies that samples are taken in risk areas (if applicable) identified by the CIA.
  - e. The work plan includes testing procedures, which the practitioner should modify as required by the CIA, for the following risks areas (if applicable) identified in the CIA:

**Procedure****Findings**

- (1) Clinical documentation, as follows:
  - (i) No documentation of service
  - (ii) Insufficient documentation of service
  - (iii) Improper diagnosis or treatment plan giving rise to the provision of a medically unnecessary service or treatment
  - (iv) Service or treatment does not conform medically with the documented diagnosis or treatment plan
  - (v) Services incorrectly coded
- (2) Billing and coding, as follows:
  - (i) Noncovered or unallowable service
  - (ii) Duplicate payment
  - (iii) DRG window error
  - (iv) Unbundling
  - (v) Utilization
  - (vi) Medicare credit balances

[*Note to Practitioner:* Modify the preceding list as required by the CIA.]

5. We selected [*quantity*] probe samples performed by the independent review organization for the following risk areas [*list risk areas tested*]. For the probe samples selected, we noted that the—
  - a. Sample patient billing files were randomly selected.
  - b. Sample size reflected confidence levels specified in the CIA.
  - c. Sample plan describes how missing items (if any) would be treated.
  - d. Patient billing files tested were pulled per the listing of random numbers and all patient billing files were accounted for in the working papers.
  - e. Work plans for the specific sample described the risk areas (if applicable) being tested and the testing approach/procedures.
  - f. Working papers noted the completion of each work plan step.
  - g. Working papers contained a summary of findings for the sample.
6. We reperformed the work plan steps [*list of specific steps performed*] for the sample patient billing files. The reperformance of work plan steps related to the medical review of the sample patient billing files was performed by the following individuals [*note the professional qualifications of individuals without listing names*]. Any exceptions between our findings and the Company's are summarized in the Attachment to this report.
7. We read the summary findings of all internal compliance reviews that the Company's Internal Audit department indicated it had performed for the Company and noted that all material billing deficiencies [*specify material threshold as defined by the Company*] noted therein were discussed in written communications addressed to the appropriate payor (for example, Medicare Part B carrier) and were dated within 60 days from the time the deficiency occurred.<sup>1</sup>
8. We inquired of [*individual*] as to whether the Company took remedial steps within [*number of*] days (or such additional time as agreed to by the payor) to correct all material billing deficiencies noted in Step 7. We were informed that such remedial steps had been taken.

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<sup>1</sup> The CIA provides its own legal definition of a "material deficiency." Determination of whether a billing or other act meets this definition is normally beyond the auditor's professional competence and may have to await final determination by a court of law. Accordingly, to avoid confusion, a working definition different from that provided in the CIA (e.g., a specified dollar threshold) may be necessary.

**Procedure****Findings**

9. By reading applicable correspondence, we noted that any material billing deficiencies noted in Step 7 were communicated to the OIG, including specific findings relative to the deficiency, the Company's actions taken to correct the deficiency, and any further steps the Company plans to take to prevent any similar deficiencies from recurring.

**Corporate Integrity Policy**

10. We read the Company's Corporate Integrity Policy and noted the following.
- a. The policy was developed and implemented within [number of] days of execution of the CIA.
  - b. The policy addressed the Company's commitment to preparation and submission of accurate billings consistent with the standards set forth in federal health care program statutes, regulations, procedures, and guidelines or as otherwise communicated by HCFA, its agents, or any other agency engaged in the administration of the applicable federal health care program.
  - c. The policy addressed the specific issues that gave rise to the settlement, as well as other risk areas identified by the OIG in published Fraud Alerts issued through [agency].
  - d. Correspondence addressed to the OIG covered the development and implementation of the policy.
  - e. Documentation indicating that the policy was distributed to all employees, physicians, and independent contractors involved in submitting or preparing requests for reimbursement.
  - f. The prominent display of a copy of the policy on the Company's premises.
11. We selected a sample of ten employees (involved in submitting and preparing requests for reimbursement) and examined written confirmation in the employee's personnel file indicating receipt of a copy of the Corporate Integrity Policy.

**Information and Education Program**

12. We read the Company's Information and Education Program and noted the following.
- a. The Information and Education Program agenda was dated within [number of] days of execution of the CIA.
  - b. Correspondence covering the development and implementation of the Information and Education Program was addressed to the OIG.
  - c. The Information and Education Program requires that each officer, employee, agent, and contractor charged with administering federal health care programs (including, but not limited to billers, coders, nurses, physicians, medical records, hospital administration and other individuals directly involved in billing federal health care programs) receive at least [number of] hours of training.
13. We selected a sample of ten employees involved in billing, coding and/or charge capture and examined sign-in logs of the training classes and noted that each had signed indicating that they had received at least [number of] hours of training as specified in the Information and Education Program. We also reviewed tests and surveys completed by each of the ten trained employees noting evidence that they were completed.
14. We inquired as to the training of individuals not present during the regularly scheduled training programs and were informed that each such individual is trained either individually or in a separate make-up session. We inquired as to the names of individuals not initially present and selected one such individual and examined that individual's post-training test and survey for completion.

**Procedure****Findings**

15. We read the course agenda and noted that the training provided to employees involved in billing, coding, and/or charge capture consisted of instructions on submitting accurate bills, the personal obligations of each individual to ensure billings are accurate, the nature of company-imposed disciplinary actions on individuals who violate company policies and/or laws and regulations applicable to federal health care program rules, legal sanctions against the company for submission of false or fraudulent information, and how to report potential abuses or fraud. We also noted that the training material addressed the following issues which gave rise to the settlement [*practitioner list*].
16. We inquired of the Corporate Compliance Officer as to the qualifications and experience of the trainers and were informed that, in the Corporate Compliance Officer's opinion, they were consistent with the topics presented.
17. We noted that the Company's draft Annual Report to the OIG dated [*date*] addresses certification of training.

**Confidential Disclosure Program**

18. We read documentation of the Company's Confidential Disclosure Program and noted that it—
  - a. Includes the printed effective date that was within [*number of*] days of execution of the CIA.
  - b. Consists of a confidential disclosure program enabling any employee to disclose any practices or billing procedures relating to federal health care programs.
  - c. Provides a toll-free telephone line maintained by the Company, which Company representatives have indicated is maintained twenty-four hours a day, seven days a week, for the purpose of making any disclosures regarding compliance with the Company's Compliance Program, the obligations in the CIA, and Company's overall compliance with federal and state standards.
  - d. Includes policies requiring the review of any disclosures to permit a determination of the appropriateness of the billing practice alleged to be involved and any corrective action to be taken to ensure that proper follow-up is conducted.
19. We made five test calls to the toll free telephone line (hotline) and noted the following.
  - a. Each call was captured in the hotline logs and reported with all other incoming calls.
  - b. Anonymity is not discouraged.
20. We noted that the Company included in its draft Annual Report addressed to OIG dated [*date*] a detailed summary of the communications (including the number of disclosures by employees and the dates of such disclosures) concerning billing practices reported as, and found to be, inappropriate under the Confidential Disclosure Program, and the results of any internal review and the follow-up on such disclosures.
21. We observed the display of the Company's Confidential Disclosure Program, including notice of the availability of its hotline, on the Company's premises.

**Excluded Individuals or Entities**

22. We read the Company's written policy relating to dealing with excluded or convicted persons or entities and noted that the policy—
  - a. Prohibits the hiring of or contracting with an individual or entity that is listed by a federal agency as convicted of abuse or excluded, suspended, or otherwise ineligible for participation in federal health care programs.
  - b. Includes a process to make an inquiry into the status of any potential employee or independent contractor.
  - c. Provides for a semi-annual review of the status of all existing employees and contractors to verify whether any individual had been suspended or excluded or charged with a criminal offense relating to the provision of federal health care services.

**Procedure****Findings**

23. We selected a sample of ten employees hired over the course of the test period as defined in the CIA and examined support in the employee's personnel file documenting inquiries made into the status of the employee, including documentation of comparison to the *[source specified in the CIA]*.
24. We performed the following procedures related to the Company's semi-annual review of employee status.
- a. Read documentation of the semi-annual review as evidence that a review was performed.
  - b. Selected and reviewed the lesser of ten or all exceptions and determined that such employees were removed from responsibility for or involvement with Provider business operations related to the Federal health care programs.
  - c. Examined a notification letter addressed to the OIG and dated within 30 days of the employee's removal from employment.
  - d. Inquired of *[officer]* as to whether he or she was aware of any individuals employed in contravention of the prohibitions in the CIA. If so, we further noted that *[indicate specific procedures]* to confirm that such situation was cured within 30 days by *[indicate how situation was cured]*.

**Annual Report**

25. We read the Company's draft Annual Report dated *[date]* and determined that it included the following items, to be modified as appropriate, by the practitioner:
- a. Compliance Program Charter and organization chart
  - b. Amendments to policies
  - c. Detailed descriptions of reviews and audits
  - d. Summary of hotline communications
  - e. Summary of annual review of employees
  - f. Cross-referencing to items noted in the CIA

**Record Retention**

26. We read the Company's record retention policy and noted that it was consistent with the requirements as outlined in the CIA.

## Appendix E

### Sample Report

#### Independent Accountant's Report

[Date]

[Sample Health Care Provider]

Office of Inspector General of the U.S. Department of Health and Human Services

We have performed the procedures enumerated in the Attachment, which were agreed to by Sample Health Care Provider (Company) and the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services, solely to assist the users in evaluating management's assertion about [name of entity's] compliance with the Corporate Integrity Agreement (CIA) with the OIG dated [date of CIA] for the [period] ending [date], which is included as Attachment A to this report. This agreed-upon procedures engagement was performed in accordance with standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described in Attachment B either for the purpose for which this report has been requested or for any other purpose.

We were not engaged to and did not perform an examination, the objective of which would be the expression of an opinion on management's compliance with the CIA. 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 Compliance Committee and management of the Company and the OIG, and is not intended to be and should not be used by anyone other than those specified parties.

[Include as Attachments the CIA and the summary that enumerates procedures and findings.]

[Signature]

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## AUD Section 20

# Statement of Position 00-1 Auditing Health Care Third-Party Revenues and Related Receivables

March 10, 2000

### NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA Health Care Third-Party Revenue Recognition Task Force of the AICPA Auditing Standards Board (ASB) to provide guidance regarding auditing financial statement assertions about third-party revenues and related receivables of health care entities. This SOP is recognized as an interpretive publication as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of generally accepted auditing standards (GAAS) 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 GAAS. The members of the ASB have found this SOP to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

## Summary

This Statement of Position (SOP) provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition. It discusses auditing matters related to testing third-party revenues and related receivables, and provides guidance regarding the sufficiency and appropriateness of audit evidence and reporting on financial statements, prepared in accordance with generally accepted accounting principles (GAAP), of health care entities exposed to material uncertainties. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.

Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

## Introduction and Background

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

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

.03 Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 954-605-45-2 states, in part, that "service revenue shall be reported net of contractual and other adjustments in the statement of operations, including patient service revenue." As a result, patient receivables, including amounts due from third-party payors, are also reported net of expected contractual and other adjustments. However, amounts ultimately realizable will not be known until some future date, which may be several years after the period in which the services were rendered. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.04 This SOP provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition. It discusses auditing matters related to testing third-party revenue and related receivables, including the effects of settlements (both cost-based and non-cost-based third-party payment programs), and provides guidance regarding the sufficiency and appropriateness of audit evidence and reporting on financial statements of health care entities exposed to material uncertainties. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Scope and Applicability

.05 This SOP applies to audits of health care entities falling within the scope of the AICPA Audit and Accounting Guide *Health Care Entities* (the guide). Its provisions are effective for audits of periods ending on or after June 30, 2000. Early application of the provisions of this SOP is permitted.

## Third-Party Revenues and Related Receivables—Inherent Uncertainties

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

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

- a health care entity's revenues may be subject to adjustment as a result of examination by government agencies or contractors. The audit process and the resolution of significant related matters (including disputes based on differing interpretations of the regulations) often are not finalized until several years after the services were rendered.
- different fiscal intermediaries (entities that contract with the federal government to assist in the administration of the Medicare program) may interpret governmental regulations differently.
- differing opinions on a patient's principal medical diagnosis, including the appropriate sequencing of codes used to submit claims for payment, can have a significant effect on the payment amount.<sup>1</sup>
- otherwise valid claims may be determined to be nonallowable after the fact due to differing opinions on medical necessity.
- claims for services rendered may be nonallowable if they are later determined to have been based on inappropriate referrals.<sup>2</sup>
- governmental agencies may make changes in program interpretations, requirements, or "conditions of participation," some of which may have implications for amounts previously estimated.

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

## **Management's Responsibilities**

**.09** Management and, when appropriate, those charged with governance are responsible for the preparation and fair presentation of its financial statements in accordance with GAAP as well as for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. Despite the inherent uncertainties, management is responsible for estimating the amounts recorded in the financial statements and making the required disclosures in accordance with GAAP, based on management's analysis of existing conditions. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.

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<sup>1</sup> Historically, the Health Care Financing Administration contracted with Peer Review Organizations to validate the appropriateness of admissions and the clinical coding from which reimbursement was determined. Such reviews were typically performed within ninety days of the claim submission date. However, the government has modified its policies with respect to such reviews and now analyzes coding errors through other means, including in conjunction with investigations conducted by the Office of the Inspector General of the U. S. Department of Health and Human Services.

<sup>2</sup> Effective January 1, 1995, the Limitation on Certain Physician Referrals law prohibited physicians from referring Medicare and Medicaid patients to health care entities with which they had a financial relationship for the furnishing of designated health services. Implementing regulations have not yet been adopted as of the date of this publication.

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**.10** Management's assertions regarding proper valuation of its revenues and receivables are embodied in the financial statements. Management is responsible for recognizing revenues when their realization is reasonably assured. As a result, management makes a reasonable estimate of amounts that ultimately will be realized, considering—among other things—adjustments associated with regulatory reviews, audits, billing reviews, investigations, or other proceedings. Estimates that are significant to management's assertions about revenue include the provision for third-party payor contractual adjustments and allowances. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

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

## The Auditor's Responsibilities

**.12** The auditor's responsibility is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework. Reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. In developing an opinion, the auditor should conclude whether the auditor has obtained reasonable assurance, which includes considering whether, among other matters,

- sufficient appropriate audit evidence has been obtained.
- uncorrected misstatements are material, individually or in aggregate.
- the financial statements are prepared and fairly presented, in all material respects, in accordance with GAAP.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

**.13** Current industry conditions, as well as specific matters affecting the entity,<sup>3</sup> provide relevant information when planning the audit. Among a number of procedures, the auditor's procedures may include an analysis of historical results (for example, prior fiscal intermediary audit adjustments and comparisons with industry benchmarks and norms) that enable the auditor to better assess the risk of material misstatements in the current period. When there are heightened risks, the auditor should perform audit procedures that respond to those risks, for example, more extensive tests covering the current period. Exhibit 10-1 of the guide includes examples of procedures auditors may perform. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect

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

conforming changes necessary due to the issuance of the 2012 edition of the Audit and Accounting Guide *Health Care Entities*.]

.14 With respect to auditing third-party revenues, a relevant consideration in addition to the usual revenue recognition considerations, is whether ultimately realizable amounts are known or will be presently known, or whether those amounts are uncertain because they are dependent on some other future, prospective actions or confirming events. For example, under a typical fee-for-service contract with a commercial payor, if the provider has performed a service for a covered individual, the revenue to which the provider is entitled should be determinable at the time the service is rendered. On the other hand, if the service was provided under a cost-based government contract, the revenue ultimately collectible may not be known until certain future events occur (for example, a cost report has been submitted and finalized after desk review or audit). In this case, management estimates the effect of such potential future adjustments. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.15 As stated previously, management is responsible for preparing the estimates contained in the financial statements. The auditor should evaluate the sufficiency and appropriateness of the evidence supporting those estimates, including the facts supporting management's judgments, and the judgments made based on conditions existing at the time of the audit. The fact that net revenues recorded at the time services are rendered differ materially from amounts that ultimately are realized does not necessarily mean the audit was not properly planned or carried out. Similarly, the fact that future events may differ materially from management's assumptions or estimates does not necessarily mean that management's estimates were not valid or the auditor did not follow generally accepted auditing standards as described in this SOP with respect to auditing estimates. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Audit Evidence

.16 The measurement of estimates is inherently uncertain and depends on the outcome of future events. AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), and AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), provide guidance to the auditor when the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related audit evidence are prospective. In the current health care environment, conclusive evidence concerning amounts ultimately realizable cannot be expected to exist at the time of the financial statement audit because the uncertainty associated with future program audits, administrative reviews, billing reviews, regulatory investigations, or other actions will not be resolved until sometime in the future. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.17 The fact that information related to the effects of future program audits, administrative reviews, regulatory investigations, or other actions does not exist does not lead to a conclusion that the evidence supporting management's assertions is not sufficient to support management's estimates. Rather, the auditor's professional judgment regarding the sufficiency of the audit evidence is based on the audit evidence that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that

sufficient appropriate audit evidence supports management's assertions about the nature of a matter involving an uncertainty (in this example, the valuation of revenues and receivables), and their presentation or disclosure in the financial statements, an unmodified opinion ordinarily is appropriate. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

**.18** The inability to obtain sufficient appropriate audit evidence that the auditor needs to conclude that the financial statements as a whole are free from material misstatement would require the auditor to express a qualified opinion or to disclaim an opinion because of a scope limitation. For example, if an entity has conducted an internal evaluation (for example, of coding or other billing matters) under attorney-client privilege and management and its legal counsel refuse to respond to the auditor's inquiries and the auditor determines the information is necessary, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor would express a qualified opinion for a scope limitation. If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive, the auditor would disclaim an opinion. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

**.19** The accuracy of management's assumptions will not be known until future events occur. In evaluating the accuracy of those assumptions, the entity's historical experience in making past estimates and the auditor's experience in the industry are relevant. For certain matters, the best evidence available to the auditor (particularly as it relates to clinical and legal interpretations) may be the representations of management and its legal counsel, as well as information obtained through reviewing correspondence from regulatory agencies. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

**.20** Pursuant to AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), the auditor should request management to provide written representations that all instances of identified or suspected noncompliance with laws and regulations whose effects should be considered by management when preparing financial statements have been disclosed to the auditor. Examples of specific representations include the following:

- Receivables
  - Adequate consideration has been given to, and appropriate provision made for, estimated adjustments to revenue, such as for denied claims and changes to home health resource group, resource utilization group, ambulatory payment classification, and diagnosis-related group assignments.
  - Recorded valuation allowances are necessary, appropriate, and properly supported.
  - All peer review organizations, fiscal intermediary, and third-party payor reports and information have been made available.
- Cost reports filed with third parties

- All required Medicare, Medicaid, and similar reports have been properly filed.
  - Management is responsible for the accuracy and propriety of all filed cost reports.
  - All costs reflected on such reports are appropriate and allowable under applicable reimbursement rules and regulations and are patient-related and properly allocated to applicable payors.
  - The employed reimbursement methodologies and principles are in accordance with applicable rules and regulations.
  - Adequate consideration has been given to, and appropriate provision made for, audit adjustments by intermediaries, third-party payors, or other regulatory agencies.
  - All items required to be disclosed, including disputed costs that are being claimed to establish a basis for a subsequent appeal, have been fully disclosed in the cost report.
  - Recorded third-party settlements include differences between filed (and to be filed) cost reports and calculated settlements, which are necessary based on historical experience or new or ambiguous regulations that may be subject to differing interpretations. Although management believes that the entity is entitled to all amounts claimed on the cost reports, management also believes the amounts of these differences are appropriate.
- Contingencies
    - No violations or possible violations of laws or regulations exist, such as those related to Medicare and Medicaid antifraud and abuse statutes, in any jurisdiction, whose effects are considered for disclosure in the financial statements or as a basis for recording a loss contingency other than those disclosed or accrued in the financial statements. This is including, but not limited to, the anti-kickback statute of the Medicare and Medicaid Patient and Program Protection Act of 1987, limitations on certain physician referrals (the Stark law), and the False Claims Act.
    - Billings to third-party payors comply in all material respects with applicable coding guidelines (for example, ICD-9-CM and CPT-4) and laws and regulations (including those dealing with Medicare and Medicaid antifraud and abuse), and billings reflect only charges for goods and services that were medically necessary; properly approved by regulatory bodies (for example, the Food and Drug Administration), if required; and properly rendered.
    - There have been no internal or external investigations relating to compliance with applicable laws and regulations, including investigations in progress, that would have an effect on the amounts reported in the financial statements or on the disclosure in the notes to the financial statements.
    - There have been no oral or written communications from regulatory agencies, governmental representatives,

employees, or others concerning investigations or allegations of noncompliance with laws and regulations in any jurisdiction, including those related to Medicare and Medicaid antifraud and abuse statutes; deficiencies in financial reporting practices; or other matters that could have a material adverse effect on the financial statements.

- Adequate consideration has been given to, and appropriate provision made for, a continuing care retirement community's obligation to provide future services and the use of facilities to current residents.
- Adequate consideration has been given to, and appropriate provision made for, a prepaid health care provider's obligation to provide future health services.
- Guarantees, whether written or oral, under which the health care entity is contingently liable, including guarantee contracts and indemnification agreements pursuant to FASB ASC 460, *Guarantees*, have been properly recorded or disclosed in the (consolidated) financial statements.

The auditor of the health care entity also might obtain specific representations, if applicable, of the following items that are unique or pervasive in the health care industry:

- The health care entity is in compliance with the provisions of Internal Revenue Code (IRC) Section 501(c)(3) and is exempt from federal income tax under IRC Section 501(a), as evidenced by a determination letter, and from state income tax.
- Information returns (Form 990) have been filed on a timely basis.
- Provision has been made, when material, for estimated retroactive adjustments by third-party payors under reimbursement agreements.
- The health care organization is in compliance with bond indentures or other debt instruments.
- For each of its outstanding bond issues, the health care entity is in compliance with postissuance requirements, as specified in the IRC, including, but not limited to, the areas of arbitrage and private business use.
- Pending changes in the organizational structure, financing arrangements, or other matters that could have a material effect on the financial statements of the entity are properly disclosed.
- The health care entity is in compliance with contractual agreements, grants, and donor restrictions.
- The health care entity has maintained an appropriate composition of net assets in amounts needed to comply with all donor restrictions.
- The internal controls over the receipt and recording of received contributions are adequate.
- The allocation of expenses reported in the notes to the financial statements is reasonable based on the health care entity's current operations.

- The health care entity has properly classified equity securities with readily determinable fair values and all debt securities as either trading or other-than-trading securities and reported these investments at fair value.
- The health care entity has reported to its risk management department all known asserted and unasserted claims and incidents. Adequate and reasonable provision has been made for losses related to asserted and unasserted malpractice, health insurance, worker's compensation, and any other claims.
- The health care entity is (or is not) subject to the requirements of Office of Management and Budget Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*, or Title 45 U.S. Code of Federal Regulations Part 74.26 because it expended (or did not expend) more than \$500,000 in federal awards during the year.
- The health care entity has classified net assets as unrestricted, temporarily restricted, or permanently restricted based on its assessment of the donor's intention, as specified in original donor correspondence, when available. When not available, the entity used other corroborating evidential matter, including minutes of the board, accounting records, and financial statements. To the extent that it was unable to review original donor correspondence to determine the amount of the original gift and donor additions, its determination of such amount was based on its best estimate considering the relevant facts and circumstances. Amounts classified as temporarily restricted are subject to donor-imposed purpose or time restrictions that precluded the health care entity from expending such amounts or recognizing such amounts as unrestricted as of the balance sheet date. Amounts classified as permanently restricted are subject to donor-imposed or statutory restrictions that require these amounts to be held in perpetuity. In addition, the health care entity has classified appreciation and income related to such donations in accordance with relevant donor or statutory restrictions. Losses on investments of a donor-restricted endowment fund have been classified in accordance with FASB ASC 958-205-45. Reclassifications between net asset classes are proper.

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**.21** Management's refusal to furnish written representations constitutes a limitation on the scope of the audit. Such refusal is often sufficient to preclude an unmodified opinion and may 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. [Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

## Potential Departures From GAAP Related to Estimates and Uncertainties

**.22** The auditor also is responsible for determining whether financial statement assertions and disclosures related to accounting estimates have been

presented in accordance with GAAP. Departures from GAAP related to accounting estimates generally fall into one of the following categories:

- Unreasonable accounting estimates
- Inappropriate accounting principles
- Inadequate disclosure

Therefore, in order to render an opinion, the auditor's responsibility is to evaluate the reasonableness of management's estimates based on present circumstances and to determine that estimates are reported in accordance with GAAP and adequately disclosed. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.23** As discussed in AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), the objective of the auditor is to design and perform audit procedures that enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. As discussed previously, exhibit 10-1 of the guide provides a number of sample procedures that the auditor may perform in auditing an entity's patient revenues and accounts receivable, including those derived from third-party payors. For example, the guide notes that the auditor might "test the reasonableness of settlement amounts, including specific and unallocated reserves, in light of the involved payors, the nature of the payment mechanism, the risks associated with future audits, and other relevant factors."<sup>4</sup> [Revised, September 2008, to reflect conforming changes necessary due to the issuance of SAS No. 105. Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of the 2012 edition of the Audit and Accounting Guide *Health Care Entities* and SAS Nos. 122–126.]

## Unreasonable Accounting Estimates

**.24** The basis for management's assumptions regarding the nature of future adjustments and calculations as to the effects of such adjustments are relevant factors when evaluating the reasonableness of management's estimates.<sup>5</sup> The auditor cannot determine with certainty whether such estimates are right or wrong, because the accuracy of management's assumptions cannot be confirmed until future events occur. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.25** Paragraph .08c of AU-C section 540 requires the auditor to obtain an understanding of how management makes the accounting estimates, including the assumptions underlying the accounting estimates to provide a basis for the assessment of the risks of material misstatement for accounting estimates. Based on the assessed risks of material misstatement, the auditor should determine, in accordance with paragraph .12 of AU-C section 540,

- a. whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate and
- b. whether the methods for making the accounting estimates are appropriate and have been applied consistently and whether changes from the prior period, if any, in accounting estimates

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<sup>4</sup> See paragraphs .25–.28.

<sup>5</sup> The lack of such analyses may call into question the reasonableness of recorded amounts.

or the method for making them are appropriate in the circumstances.

In responding to the assessed risks of material misstatement, as required by AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), the auditor should undertake one or more of the following, in accordance with paragraph .13 of AU-C section 540, taking into account the nature of the accounting estimate:

- a. Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.
- b. Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor should evaluate whether
  - i. the method of measurement used is appropriate in the circumstances,
  - ii. the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework, and
  - iii. the data on which the estimate is based is sufficiently reliable for the auditor's purposes.
- c. Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
- d. Develop a point estimate or range to evaluate management's point estimate. For this purpose
  - i. if the auditor uses assumptions or methods that differ from management's, the auditor should obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate.
  - ii. if the auditor concludes that it is appropriate to use a range, the auditor should narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

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**.26** The auditor should evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework or are misstated. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an accounting estimate that differs from management's point estimate. When the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. When the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range. (Paragraph .A122 of AU-C section 540). When management has changed an accounting estimate, or the method in making it, from the prior period based

on a subjective assessment that there has been a change in circumstances, the auditor may conclude, based on the audit evidence, that the accounting estimate is misstated as a result of an arbitrary change by management or may regard it as an indicator of possible management bias (Paragraph .A123 of AU-C section 540). [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

**.27** Approaches and estimates will vary from entity to entity. Some entities with significant prior experience may attempt to quantify the effects of individual potential intermediary or other governmental (for example, the Office of Inspector General and the Department of Justice) or private payor adjustments, basing their estimates on very detailed calculations and assumptions regarding potential future adjustments. Some may prepare cost report<sup>6</sup> analyses to estimate the effect of potential adjustments. Others may base their estimates on an analysis of potential adjustments in the aggregate, in light of the payors involved; the nature of the payment mechanism; the risks associated with future audits; and other relevant factors. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.28** One of the key factors in evaluating the estimate is the historical experience of the entity (for example, the aggregate amount of prior cost-report adjustments and previous regulatory settlements) as well as the risk of potential future adjustments. The fact that an entity currently is not subject to a governmental investigation does not mean that a recorded valuation allowance for potential billing adjustments is not warranted. Nor do these emerging industry trends necessarily indicate that an accrual for a specific entity is warranted. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

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

**.30** Amounts that ultimately will be realized by an entity are dependent on a number of factors, many of which may be unknown at the time the estimate is first made. Further, even if two entities had exactly the same clinical and coding experience, amounts that each might realize could vary materially due

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

to factors outside of their control (for example, differing application of payment rules by fiscal intermediaries, legal interpretations of courts, local enforcement initiatives, timeliness of reviews, and quality of documentation). As a result, because estimates are a matter of judgment and their ultimate accuracy depends on the outcome of future events, different entities in seemingly similar circumstances may develop materially different estimates. The auditor may conclude that both estimates are reasonable in light of the differing assumptions.

## Inappropriate Accounting Principles

**.31** As previously stated, the auditor also is responsible for determining whether financial statement assertions and disclosures related to accounting estimates are presented in accordance with GAAP. When the financial statements are materially affected by a departure from GAAP, the auditor should express a qualified or adverse opinion in accordance with AU-C section 705. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

**.32** Valuation allowances should be recorded so that revenues are not recognized until the revenues are realizable. Valuation allowances are not established based on the provisions of FASB ASC 450, *Contingencies*. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.33** Indicators of possible measurement bias related to valuation allowances include

- valuation allowances that are not associated with any particular program, issue, or time period (for example, cost-report year or year the service was rendered).
- distorted earnings trends over time (for example, building up specific or unallocated valuation allowances in profitable years and drawing them down in unprofitable years).

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Inadequate Disclosure

**.34** If the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in accordance with GAAP, the auditor should express a qualified or adverse opinion in accordance with AU-C section 705. FASB ASC 275-10-50 provides guidance on the information that reporting entities should disclose regarding risks and uncertainties existing as of the date of the financial statements. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

**.35** In the health care environment, it is almost always at least reasonably possible that estimates regarding third-party payments could change in the near term as a result of one or more future confirming events (for example, regulatory actions reflecting local or national audit or enforcement initiatives). For most entities with significant third-party revenues, the effect of the change could be material to the financial statements. Where material exposure exists, the uncertainty regarding revenue realization should be disclosed in the notes to the financial statements. Because representations from legal counsel

are often key audit evidence in evaluating the reasonableness of management's estimates of potential future adjustments, the inability of an attorney to form an opinion on matters about which he or she has been consulted may be indicative of an uncertainty that should be specifically disclosed in the financial statements. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.36** Differences between original estimates and subsequent revisions might arise due to final settlements, ongoing audits and investigations, or passage of time in relation to the statute of limitations. FASB ASC 954-605 requires that these differences be included in the statement of operations in the period in which the revisions are made and disclosed. Such differences are not treated as prior period adjustments unless they meet the criteria for prior period adjustments as set forth in FASB ASC 250-10-45. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.37** Disclosures such as the following may be appropriate:

General Hospital (the Hospital) is a (not-for-profit, for-profit, or governmental hospital or health care system) located in (City, State). The Hospital provides health care services primarily to residents of the region.

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

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

## Appendix—Other Considerations Related to Government Investigations

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

As previously discussed in this Statement of Position, the far-reaching nature of alleged fraud and abuse violations creates an uncertainty with respect to the valuation of revenues, because future allegations of noncompliance with laws and regulations could, if proven, result in a subsequent reduction of revenues. In addition, management makes provisions in the financial statements and disclosures for any contingent liabilities associated with fines and penalties due to violations of such laws. Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*, provides guidance in evaluating contingent liabilities, such as fines and penalties under applicable laws and regulations. Estimates of potential fines and penalties are not accrued unless their payment is probable and reasonably estimable.

The auditor's expertise is in accounting and auditing matters rather than operational, clinical, or legal matters. Accordingly, the auditor's procedures focus on areas that normally are subject to internal control relevant to financial reporting. However, the further that suspected noncompliance with laws and regulations is removed from the events and transactions ordinarily reflected in the financial statements, the less likely the auditor is to become aware of the suspected noncompliance, to recognize its possible noncompliance with laws and regulations, and to evaluate the effect on the financial statements. For example, determining whether a service was medically necessary, obtained through a legally appropriate referral, properly performed (including using only approved devices, rendered in a quality manner), adequately supervised, accurately documented and classified, or rendered and billed by nonsanctioned individuals typically is not within the auditor's professional expertise. As a result, an audit in accordance with generally accepted auditing standards (GAAS) is not designed to detect such matters.

Further, because of the inherent limitations of an audit, an audit conducted in accordance with GAAS provides no assurance that all instances of noncompliance with laws and regulations will be detected.<sup>1</sup>

Nor does an audit under GAAS include providing any assurance on an entity's billings or cost report. In fact, cost reports typically are not prepared and submitted until after the financial statement audit has been completed.

Certain audit procedures, although not specifically designed to detect noncompliance with laws and regulations, may bring possible noncompliance with laws

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

and regulations to an auditor's attention. When suspected noncompliance is detected, the auditor's responsibilities are addressed in AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*). Disclosure of noncompliance with laws and regulations to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and such disclosure would be precluded by the auditor's ethical or legal obligation of confidentiality, unless the matter affects the auditor's opinion on the financial statements.<sup>2</sup> [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

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<sup>2</sup> Paragraph .A28 of AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*), discusses circumstances in which a duty to notify parties outside the entity of identified or suspected noncompliance with laws and regulations may exist. [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

## AUD Section 25

# ***Statement of Position 01-3 Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law***

June 15, 2001

### NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA Reporting on Internal Control Over Derivative Transactions at Insurance Entities Task Force of the AICPA Auditing Standards Board (ASB) to provide guidance regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to agreed-upon procedures engagements performed to comply with the requirements of Section 1410 (b)(5) of the New York State Insurance Law, as amended (the law), which addresses the assessment of internal control over derivative transactions as defined in Section 1401(a) of the law, and Section 178.5 of Regulation No. 163.

This SOP is recognized as an attestation interpretation as defined in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Attestation interpretations are recommendations on the application of SSAEs in specific circumstances, including engagements for entities in specialized industries. Attestation interpretations are issued under the authority of the ASB. The members of the ASB have found this SOP to be consistent with existing SSAEs.

A practitioner should be aware of and consider attestation interpretations applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions of this SOP.

## Introduction and Background

.01 In 1999 and 2000, the New York State Insurance Department (the department) issued regulations to implement the New York Derivative Law (the law) which amends Article 14 of the State of New York Insurance Law, effective July 1, 1999. The law establishes certain requirements for domestic life insurers, domestic property and casualty insurers, domestic reciprocal insurers, domestic mortgage guaranty insurers, domestic cooperative property and casualty insurance corporations, and domestic financial guaranty insurers. Foreign insurers engaging in derivative transactions and derivative instruments are

subject to and required to comply with all of the provisions of the law. However, a foreign insurer may enter into other derivative transactions provided the insurer meets certain conditions of its domestic state law. In this document, an insurer covered by the law is referred to as an *insurance company*.

**.02** The requirements of the law include the following:

- Approval by the board of directors, or a similar body, of derivative transactions
- Submission of a derivative use plan (the DUP) to the Department
- Assessment by an independent certified public accountant (CPA) of the insurance company's internal control over derivative transactions

**.03** In addition to the law, the Department also established Regulation No. 163, "Derivative Transactions" (11 NYCRR 178) (the Regulation), which provides guidance in implementing the law. Section 178.5 of Regulation No. 163 states the following.

As set forth in section 1410 (b)(5) of the Insurance Law, an insurer engaging in derivative transactions shall be required to include, as part of the evaluation of accounting procedures and internal controls required to be filed pursuant to section 307 of the Insurance Law, a statement describing the assessment by the independent certified public accountant of the internal controls relative to derivative transactions. The purpose of this part of the evaluation is to assess the adequacy of the internal controls relative to the derivative transactions being conducted by the insurer. Such an assessment shall be made whether or not the derivative transactions are material in relation to the insurer's financial statements. The independent certified public accountant shall issue a report regarding internal controls relative to derivative transactions, whether or not deficiencies in internal controls would lead to a "reportable condition," as that term is used in auditing standards adhered to by certified public accountants. An assessment in the form of an "agreed upon procedures engagement" or an "attestation engagement," as those terms are used in auditing standards adhered to by certified public accountants, may be used to meet this requirement. If an "agreed upon procedures engagement" is performed, the procedures used shall be those that management and the independent certified public accountant determine are appropriate to meet the purpose of the assessment as set forth above.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**[.04–.05]** [Paragraphs deleted, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.06** An agreed-upon procedures engagement or other attestation engagement may be used to satisfy the requirements of the law. However, this Statement of Position (SOP) only describes an agreed-upon procedures engagement. It does not address any other attestation engagements that might be performed, such as an examination-level attestation engagement. For guidance on performing such other attestation engagements, see AT section 101, *Attest Engagements* (AICPA, *Professional Standards*). [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Applicability

**.07** This SOP was developed to provide practitioners with guidance on performing agreed-upon procedures engagements that address an insurance com-

pany's internal control over derivative transactions to meet the requirements of the law. The engagement described in this SOP is designed only to satisfy the requirements of the law. The procedures, as set forth in this SOP, are not necessarily appropriate for use in any other engagement. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.08 Although the Department has indicated that an agreed-upon procedures engagement pursuant to this SOP can be used to satisfy the requirements for an assessment of internal control over derivative transactions, the Department has not agreed to the sufficiency of the procedures included in this SOP for their purposes.

## The Law

### Definition of a Derivative

.09 Article 14 of the law defines a derivative instrument as including caps, collars, floors, forwards, futures, options, swaps, swaptions, and warrants.

.10 The following definitions are included in the law and are applicable when performing the agreed-upon procedures engagement described in this SOP.

*Cap*—An agreement obligating the seller to make payments to the buyer with each payment based on the amount by which a reference price or level or the performance or value of one or more underlying interests exceeds a predetermined number, sometimes called the strike rate or strike price.

*Collar*—An agreement to receive payments as the buyer of an option, cap, or floor and to make payments as the seller of a different option, cap, or floor.

*Floor*—An agreement obligating the seller to make payments to the buyer in which each payment is based on the amount by which a predetermined number, sometimes called the floor rate or price, exceeds a reference price, level, performance, or value of one or more underlying interests.

*Forward*—An agreement (other than a future) to make or take delivery in the future of one or more underlying interests, or effect a cash settlement, based on the actual or expected price, level, performance, or value of such underlying interests, but shall not mean or include spot transactions effected within customary settlement periods, when-issued purchases, or other similar cash market transactions.

*Future*—An agreement traded on a futures exchange, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance, or value of one or more underlying interests.

*Option*—An agreement giving the buyer the right to buy or receive (a *calloption*), sell or deliver (a *putoption*), enter into, extend or terminate, or effect a cash settlement based on the actual or expected price, spread, level, performance, or value of one or more underlying interests.

*Swap*—An agreement to exchange or to net payments at one or more times based on the actual or expected price, yield, level, performance, or value of one or more underlying interests.

*Swaption*—An option to purchase or sell a swap at a given price and time or at a series of prices and times. A swaption does not mean a swap with an embedded option.

*Warrant*—An instrument that gives the holder the right to purchase or sell the underlying interest at a given price and time or at a series of prices and times outlined in the warrant agreement.

.11 Article 14 of the law permits an insurance company to enter into *replication transactions* provided that certain conditions set forth in the law are met. A replication transaction is defined in the law as follows.

A derivative transaction or combination of derivative transactions effected either separately or in conjunction with cash market investments included in the insurer's investment portfolio in order to replicate the investment characteristic of another authorized transaction, investment or instrument and/or operate as a substitute for cash market transactions. A derivative transaction entered into by the insurer as a hedging transaction or income generation transaction authorized pursuant to this section [of the law] shall not be considered a replication transaction.

## Derivative Use Plan

.12 An insurance company entering into derivative transactions must file a DUP with the Department. The DUP generally should include the following items:<sup>1</sup>

- A certified copy of the authorization by the insurer's board of directors, or other similar body, to file the DUP, which should include authorization of derivative transactions and an assurance that individuals responsible for derivative transactions, processes, and controls have the necessary experience and knowledge
- A section on management oversight standards including a discussion of the following:
  - Limits on identified risks
  - Controls over the nature and amount of identified risks
  - Processes for identifying such risks
  - Processes for documenting, monitoring, and reporting risk exposure
  - Internal audit and review processes that ensure integrity of the overall risk management process
  - Quarterly reporting to the board of directors
  - The establishment of risk tolerance levels
  - Management's measurement and monitoring against those levels
- A section on internal control and reporting including a discussion of the following:
  - The existence of controls over the valuation and effectiveness of derivative instruments
  - Credit risk management
  - The adequacy of professional personnel
  - Technical expertise and systems
  - Management reporting
  - The review and legal enforceability of derivative contracts between parties

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<sup>1</sup> Reference should be made to the law and the Regulation for specific details and exact requirements.

- A section on documentation and reporting requirements which shall for each derivative transaction document the following:
  - The purpose of the transaction
  - The assets or liabilities to which the transaction relates
  - The specific derivative instrument used
  - For over-the-counter (OTC) transactions, the name of the counterparty and counterparty exposure amount
  - For exchange traded transactions, the name of the exchange and the name of the firm handling the trade
- Written guidelines to be followed in engaging in derivative transactions. The guidelines should include or address the following:
  - The type, maturity, and diversification of derivative instruments
  - The limitation on counterparty exposures, including limitations based on credit ratings
  - The limitations on the use of derivatives
  - Asset and liability management practices with respect to derivative transactions
  - The liquidity needs and the insurance company's capital and surplus as it relates to the DUP
  - The policy objectives of management specific enough to outline permissible derivative strategies
  - The relationship of the strategies to the insurer's operations
  - How the strategies relate to the insurer's risk
  - A requirement that management establish and execute management oversight standards as required by the law
  - A requirement that management establish and execute internal control and reporting standards as required by the law
  - A requirement that management establish and execute documentation and reporting standards as required by the law
- Guidelines for the insurer's determination of acceptable levels of basis risk, credit risk, foreign currency risk, interest rate risk, market risk, operational risk, and option risk
- A requirement that the board of directors and senior management comply with risk oversight functions and adhere to laws, rules, regulations, prescribed practices, or ethical standards

## Related Professional Standards

### AT Section 201, *Agreed-Upon Procedures Engagements*

.13 Agreed-upon procedures engagements performed to meet the requirements of the law are to be performed in accordance with AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*). As described in paragraph .03 of AT section 201, an agreed-upon procedures engagement is

one in which a practitioner is engaged by a client to issue a report of findings based on specific procedures performed on the subject matter. Not all of the provisions of AT section 201 are discussed herein. Rather, this SOP includes guidance to assist practitioners in the application of selected aspects of AT section 201.

.14 Paragraph .06 of AT section 201 (states, in part, that the practitioner may perform an agreed-upon procedures engagement provided that, ". . . (c) the practitioner and the specified parties agree upon the procedures performed or to be performed by the practitioner; and (d) the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes."

.15 As previously stated, Regulation No. 163 states that an agreed-upon procedures engagement may be used to meet the requirement for an independent CPA's assessment of internal control over derivative transactions. When performing an agreed-upon procedures engagement under this SOP, practitioners should not eliminate any of the procedures presented in appendix B, "Agreed-Upon Procedures for Testing Internal Control Over Derivative Transactions" (paragraph .37), of this SOP or reduce the extent of the tests. The Department or the insurance company may request that additional procedures be performed and the practitioner may agree to perform such procedures. In those circumstances, it would be expected that the additional procedures would be performed in the context of a separate agreed-upon procedures engagement.

.16 As previously noted, the Department has not agreed to the sufficiency of the procedures included in this SOP for their purposes. *Therefore, the Department should not be named as a specified party to the agreed-upon procedures report, and the use of a practitioner's agreed-upon procedures report, issued in accordance with this SOP, should be restricted to the board of directors and management of the insurance company.* Although the Department is not a specified party, footnote 15 of AT section 101 states the following, in part:

... a regulatory agency as part of its oversight responsibility for an entity may require access to restricted-use reports in which they are not named as a specified party.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## **AU-C section 501, Audit Evidence—Specific Considerations for Selected Items**

.17 AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence, in accordance with AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), and other relevant AU-C sections in *AICPA Professional Standards*, regarding the valuation of investments in securities and derivative instruments. A practitioner performing the agreed-upon procedures engagement described in this SOP may find it helpful to consider the guidance in paragraphs .01–.10 of AU-C section 501 and the related Audit Guide *Special Considerations in Auditing Financial Instruments*. AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), addresses the auditor's responsibilities related to using the work of an individual or organization possessing expertise in a field other than accounting or auditing to assist the auditor in obtaining sufficient appropriate audit evidence. A practitioner should consider the guidance

in AU-C section 620 when the practitioner plans to use the work of a specialist in securities and derivative instruments to perform the agreed upon procedures described in this SOP. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

**.18** The procedures in this SOP are not designed to meet the requirements of generally accepted auditing standards for an audit of the financial statements of an entity that engages in derivative transactions. In addition, performing the audit procedures described in AU-C section 501 would not meet the requirements of this SOP. [Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

**.19** In an audit of financial statements, the auditor may determine that he or she will not perform procedures related to derivative transactions because they are not material to the financial statements. There is no requirement to perform the procedures described in this SOP when performing an audit of financial statements. In contrast, the law requires that an assessment of internal control be performed whether or not the derivative transactions are material to the insurer's financial statements. Accordingly, a decision not to perform procedures related to derivative transactions in an audit of financial statements, because of immateriality, would not alleviate the requirement to perform the agreed-upon procedures engagement described herein.

## Procedures to Be Performed

**.20** The agreed-upon procedures to be performed are directed toward tests of controls over derivative transactions that occurred during the period covered by the practitioner's report. Any projection of the practitioner's findings to the future is subject to the risk that because of change, the controls may no longer be in existence, suitably designed, or operating effectively. Also, the potential effectiveness of controls over derivative transactions is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected.

**.21** The procedures to be performed in the agreed-upon procedures engagement described in this SOP are presented in appendix B (paragraph .37). The procedures have been designed so that the findings resulting from the application of the procedures can be recorded in a tabular format. The three options available to the practitioner for expressing the findings for each procedure are *No Exception*, *Exception*, or *N/A* (not applicable). If a procedure is not applicable to a particular insurance company, the procedure should be marked N/A rather than deleted from the report. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.22** Section 1 of appendix B (paragraph .37) of this SOP is applicable to all insurance companies that enter into derivative transactions. Therefore, the procedures in section 1 are to be performed in all engagements performed in accordance with this SOP. Sections 2–10 of appendix B (paragraph .37) of this SOP each address a specific type of derivative. The procedures in those sections are to be performed only if the insurance company entered into derivative transactions of the type covered by the section. Sections that address types of derivatives not used by the insurance company should not be attached to the agreed-upon procedures report.

**.23** If any portion of a procedure results in an exception, the findings for that entire procedure should be recorded as an exception and described in the section "Description of Exceptions If Any," at the end of each section. The

practitioner should provide a brief factual explanation for each exception that will enable the specified parties to understand the nature of the findings resulting in the exception. If management informs the practitioner that the condition giving rise to the exception was corrected by the date of the practitioner's report, the practitioner's explanation of the exception may include that information; for example, "Management has advised us that the condition resulting in the exception was corrected on Month X, 20XX. We have performed no procedures with respect to management's assertion."

**.24** A practitioner may perform significant portions of the agreed-upon procedures engagement before the end of the period covered by the report. If, during that time, the practitioner identifies conditions that result in an exception in one or more agreed-upon procedures, he or she should report the exception in the findings section of the agreed-upon procedures report, even if management corrects the condition prior to the end of the period.

**.25** The law requires the insurance company to provide the Department with a statement describing the independent CPA's assessment of the insurance company's internal control over derivative transactions. It also requires the insurance company to include a description of any remedial actions taken or proposed to be taken to correct any deficiencies identified by the independent CPA.

**.26** Paragraph .40 of AT section 201 states the following.

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

**.27** A practitioner has no obligation to perform procedures beyond the agreed-upon procedures included in appendix B (paragraph .37) of this SOP. However, if information indicating a weakness in internal control over derivative transactions comes to the practitioner's attention by other means, such information should be included in the practitioner's report. This would apply to conditions or events occurring during the subsequent-events period (subsequent to the period covered by the practitioner's report but prior to the date of the practitioner's report) that either contradict the findings in the report or that would have resulted in the reporting of an exception by the practitioner if that condition or event had existed during the period covered by the report. However, the practitioner has no responsibility to perform any procedure to detect such conditions or events.

## Establishing an Understanding With the Client

**.28** In accordance with paragraph .10 of AT section 201, the practitioner should establish an understanding with the client regarding the services to be performed. Such an understanding reduces the risk that the client may misinterpret the objectives and limitations of an agreed-upon procedures engagement performed to meet the regulatory requirements of the law. Such an understanding also reduces the risk that the client will misunderstand its responsibilities and the responsibilities of the practitioner. The practitioner should document the understanding in the working papers, preferably through a written

communication with the client (an *engagement letter*). The communication should be addressed to the client. Matters that might be included in such an understanding are the following:

- A statement confirming that an agreed-upon procedures engagement is to be performed to meet the requirements of Section 1410(b)(5) of the law
- A statement identifying the procedures to be performed as those set forth in this SOP
- A statement identifying the client as the specified party to the agreed-upon procedures report
- A statement acknowledging the client's responsibility for the sufficiency of the procedures in the SOP
- A statement acknowledging that the practitioner makes no representation regarding the sufficiency of the procedures in the SOP
- A statement describing the responsibilities of the practitioner, including but not limited to the responsibility to perform the agreed-upon procedures and to provide the client with a report, and the circumstances under which the practitioner may decline to issue a report
- A statement indicating that the engagement will be conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants (AICPA)
- A statement indicating that an agreed-upon procedures engagement does not constitute an examination, the objective of which would be the expression of an opinion on the internal control over derivative transactions, and that if an examination were performed, other matters might come to the practitioner's attention
- A statement indicating that the practitioner will not express an opinion or any other form of assurance
- A statement describing the client's responsibility to comply with the law and the client's responsibility for the design and operation of effective internal control over derivative transactions
- A statement describing the client's responsibility for providing accurate and complete information to the practitioner
- A statement indicating that the practitioner has no responsibility for the completeness or accuracy of the information provided to the practitioner
- A statement restricting the use of the report to the client
- A statement describing any arrangements to involve a specialist

## Management Representations

.29 Although AT section 201 does not require a practitioner to obtain a representation letter from management in an agreed-upon procedures engagement, when performing the engagement described in this SOP, it is recommended that the practitioner obtain such a letter signed by the appropriate members of management, including the highest ranking officer responsible for internal control over derivative transactions. Management's refusal to furnish written representations that the practitioner has determined to be appropriate

for the engagement constitutes a limitation on the performance of the engagement that requires either modification of the report or withdrawal from the engagement. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.30** The representations that a practitioner deems appropriate will depend on the specific nature of the engagement; however, they generally include the following representations from management:

- A statement acknowledging responsibility for establishing and maintaining effective internal control over derivative transactions
- A statement that there have been no errors or fraud that might indicate a weakness in the internal control over derivative transactions
- A statement that management has disclosed to the practitioner all significant deficiencies in the design or operation of the internal control over derivative transactions
- A statement that management has disclosed to the practitioner any communications from regulatory agencies, internal auditors, and other practitioners or consultants relating to the internal control over derivative transactions
- A statement that management has made available to the practitioner all information they believe is relevant to the internal control over derivative transactions
- A statement that management has responded fully to all inquiries made by the practitioner during the engagement
- A statement that no events have occurred subsequent to the date as of which the procedures were applied that would require adjustment to or modification to responses to the agreed-upon procedures

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.31** An illustrative representation letter is presented in appendix C, "Illustrative Management Representation Letter" (paragraph .38), of this SOP. For additional information regarding management's representations in an agreed-upon procedures engagement, see paragraphs .37–.39 of AT section 201.

## Restriction on the Performance of Procedures

**.32** As previously stated, a practitioner should not agree to do either of the following.

- a. Eliminate any of the procedures presented in appendix B (paragraph .37) of this SOP, unless a section is not applicable because the insurance company did not enter into derivative transactions addressed by the section.
- b. Reduce the extent of the tests in an applicable section.

**.33** If circumstances impose restrictions on the performance of the agreed-upon procedures presented in appendix B (paragraph .37) of this SOP, the practitioner should describe the restriction(s) in his or her report or withdraw from the engagement.

## Dating the Report

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

## Effective Date

**.35** This SOP is effective upon issuance and is applicable only to agreed-upon procedures engagements that address internal control over derivative transactions required by the law.

.36

## Appendix A—Illustrative Agreed-Upon Procedures Report

The following is an illustrative agreed-upon procedures report based on the guidance in AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*).

### Independent Accountant's Report on Applying Agreed-Upon Procedures

To the Management of ABC Insurance Company:

We have performed the applicable procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position (SOP), 01-3, *Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*, which were agreed to by ABC Insurance Company, solely to assist you in complying with the requirements of Section 1410 (b)(5) of the New York State Insurance Law, as amended (the law), which addresses the assessment of internal control over derivative transactions as defined in Section 1401(a) of the law, and Section 178.5 of Regulation No. 163 during the year ended December 31, 20XX. Management of ABC Insurance Company is responsible for maintaining effective internal control over derivative transactions. 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 ABC Insurance Company. Consequently, we make no representation regarding the sufficiency of the procedures described in the attached appendix either for the purpose for which this report has been requested or for any other purpose.

The procedures performed and the findings are included in the attached appendix.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on the internal control over derivative transactions of ABC Insurance Company for the year ended December 31, 20XX. 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 management and Board of Directors of ABC Insurance Company and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

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## Appendix B—Agreed-Upon Procedures for Testing Internal Control Over Derivative Transactions

The following table lists the types of derivative transactions permitted by the New York Derivative Law (the law). We inquired of management of the insurance company as to whether the insurance company used the type of derivative addressed by each section, and marked the column entitled "Is the Section Applicable?" either *Yes* or *No* based on management's response to the inquiry. For each type of derivative with a *Yes* response, we performed the procedures in the applicable section and attached the section to the report. For each type of derivative with a *No* response, we did not perform procedures nor did we attach the applicable section to the report. We compared the types of derivative reported by the insurance company in its "Schedule of Derivative Transactions" included in the Annual Statement with the types of derivatives listed in the following table and found that the types of derivatives included in the schedule were marked *Yes* in the table.

### Attachments to the Report

#### Section of the Agreed-Upon Procedures    Is the Section Applicable?

<u>No.</u>	<u>Type of Derivative</u>	<u>Yes or No</u>
1	All Derivative Types	Yes
2	Cap Contracts	
3	Collar Contracts	
4	Floor Contracts	
5	Forward Contracts	
6	Future Contracts	
7	Option Contracts	
8	Swap Contracts	
9	Swaption Contracts	
10	Warrant Contracts	

## Section 1—All Derivative Types

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
<p>The following procedures were performed to test controls applicable to all derivative transactions. The procedures were applied to the internal control over derivative transactions in existence during the year ended December 31, 20XX</p>			
<b>Documentation of Controls, Policies, and Procedures</b>			
1. Read the insurance company's derivative use plan (DUP), amendments thereto, and its documentation of controls, policies, and procedures that describe internal control over derivative transactions and found that the DUP and the documentation of controls, policies, and procedures include a description of controls that address the following:			
a. Systems or processes for the periodic valuation of derivative transactions including mechanisms for compensating for any lack of independence in valuing derivative positions (Valuation)	_____	_____	_____
b. Systems or processes for determining whether a derivative instrument used for hedging or replication has been effective (Effectiveness)	_____	_____	_____
c. Credit risk management systems or processes for over-the-counter (OTC) derivative transactions that measure credit risk exposure using the counterparty exposure amount and policies for the establishment of collateral arrangements with counterparties (Credit Risk Management)	_____	_____	_____
d. Management assessment of the adequacy and technical expertise of personnel associated with derivative transactions and systems to implement and control investment practices involving derivatives (Professional Competence)	_____	_____	_____
e. Systems or processes for regular reports to management, segregation of duties, and internal review procedures (Reporting)	_____	_____	_____
f. Procedures for conducting initial and ongoing legal reviews of derivative transactions including assessments of contract enforceability (Legal Reviews)	_____	_____	_____
<b>Nontransaction-Specific Procedures</b>			
2. Read the minutes of meetings of the board of directors and found an indication that the board of directors of the insurance company approved the DUP and any amendments thereto.	_____	_____	_____
3. Inquired of management as to whether the DUP and any amendments thereto were approved by the New York State Insurance Department and was advised that the DUP and any amendments thereto were approved.	_____	_____	_____
4. Read the minutes of meetings of the board of directors and found an indication that the board of directors of the insurance company approved the commitment of financial resources determined by management to be sufficient to accomplish the objectives of the insurance company's DUP.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
<p><i>This procedure does not provide an assessment of or assurance about the adequacy of the resources determined by management to be sufficient to accomplish the objectives of the DUP.</i></p> <p><i>In performing the following procedures, the practitioner frequently will find that management has designated and will have in place limits, controls, or procedures that are more restrictive than those approved for use in the DUP</i></p>			
5. For the year ended December 31, 20XX, inquired of management and was advised that—			
a. There was monitoring of derivative transactions by a control staff, such as internal audit or other internal review group, that is independent of derivatives trading activities.	_____	_____	_____
b. There were procedures in place for derivative personnel to obtain, prior to exceeding limits prescribed by management, at least oral approval from members of senior management who are independent of derivatives trading activities.	_____	_____	_____
c. There were procedures in place for senior management to address excesses related to management-established limits and divergences from management-approved derivative strategies, and that such management has authority to grant exceptions to derivatives limits.	_____	_____	_____
d. There were procedures in place requiring that management be informed when limits prescribed in the DUP were exceeded and for management to approve corrective action(s) in such circumstances.	_____	_____	_____
e. There were procedures in place for the accurate transmittal of derivatives positions to the risk measurement systems when management had implemented risk management systems.	_____	_____	_____
f. There were procedures in place for the performance of appropriate reconciliations to ensure data integrity across the full range of derivatives, including any new or existing derivatives that may be monitored apart from the main processing networks.	_____	_____	_____
g. There were procedures in place for risk managers and senior management to define constraints on derivative activities to ensure compliance with the DUP and to justify excesses with respect to specified management limits.	_____	_____	_____
h. There were procedures in place for senior management, an independent group, or an individual that management designated to perform at least an annual assessment of the identified controls and financial results of the derivative activities to determine that controls were effectively implemented and that the insurance company's business objectives and strategies were achieved.	_____	_____	_____
i. There were procedures in place for a review of limits in the context of changes in strategy, risk tolerance of the insurance company, and market conditions.	_____	_____	_____

(continued)

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
<b>Reporting to the Board of Directors or Committee Thereof</b>			
The law contains provisions regarding management oversight of derivative and replication transactions.			
6. Read the minutes of the board of directors meetings or committees thereof and found an indication that the board of directors or committee thereof received, at least quarterly, a report regarding derivative and replication transactions.	-----	-----	-----
7. Read one quarterly report referred to in procedure 6 and found that the report contained—			
a. A list, or appropriate summaries, of the following:			
(1) Derivative transactions during the period			
(2) Derivative transactions outstanding at the end of the period	-----	-----	-----
(3) Unrealized gains or losses on open derivative positions	-----	-----	-----
(4) Derivative transactions closed during the period	-----	-----	-----
b. A summary of the performance of the derivatives in comparison to the objective of the derivative transactions	-----	-----	-----
c. An evaluation of the risks and benefits of the derivative transactions	-----	-----	-----
d. A summary of the amount, type, and performance of replication transactions	-----	-----	-----
8. If the report referred to in the preceding procedure was received, reviewed, and approved by a committee of the board of directors, read the minutes of the board of directors meeting and found an indication that a report of such committee was reviewed at the next board of directors meeting.	-----	-----	-----
9. Read the board of directors minutes and found an indication that the board of directors received a report during the year describing the level of knowledge and experience of individuals conducting, monitoring, controlling, and auditing derivative and replication transactions.	-----	-----	-----

**Derivative and Replication Limitations**

The law contains limits on hedging and replication transactions. An insurance company may enter into hedging or replication transactions if, as a result of and after giving effect to the transaction, the derivative investments and replication investments do not exceed certain specified percentages of admitted assets. The following procedures were performed using one analysis per quarter prepared by the insurance company to monitor compliance with the limitations.

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
10. Obtained and read the insurance company's analysis used to test limitations on investments in derivatives and replication transactions and found that the amounts shown in the analysis indicated that—			
a. The aggregate statement value of options, swaptions, caps, floors, and warrants purchased was not in excess of seven and one-half percent of the insurance company's admitted assets, per the last annual statement.	_____	_____	_____
b. The aggregate statement value of options, swaptions, caps, and floors written was not in excess of three percent of admitted assets.	_____	_____	_____
c. The aggregate potential exposure of collars, swaps, forwards, and futures entered into and options, swaptions, caps, and floors written was not in excess of six and one-half percent of admitted assets.	_____	_____	_____
d. The aggregate statement value of all assets being replicated did not exceed ten percent of the insurance company's admitted assets.	_____	_____	_____
e. The extent of derivative transactions did not exceed the insurance company's internal limitations or that any excess had been specifically authorized by management.	_____	_____	_____
11. Inquired of the preparer of the analysis read in procedure 10 and was advised that the analysis excluded transactions entered into to hedge the currency risk of investments denominated in a currency other than United States dollars.	_____	_____	_____
12. Obtained and read the insurance company's analysis used to test limitations on counterparty exposure, as defined in section 178.3 (e) of the Regulation, and found that the report indicated that—			
a. The counterparty exposure under one or more derivative transactions for any single counterparty, other than a "qualified counterparty," was not in excess of one percent of the insurance company's admitted assets.	_____	_____	_____
b. The counterparty exposure under one or more derivative transactions for all counterparties, other than qualified counterparties, was not in excess of three percent of the insurance company's admitted assets.	_____	_____	_____
13. If the insurance company required collateral arrangements with the counterparties, obtained and read the insurance company's analysis used to monitor the adequacy of the collateral held in accordance with the terms of the arrangement and found that the amount of the collateral held as shown on the analysis was equal to or in excess of the amount to be held.	_____	_____	_____

**Description of Exceptions if Any**

Procedure Number

Description of Exception


**Section 2—Cap Contracts**

<u>Procedures</u>	<i>Findings</i>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
<p>Performed the following procedures on selected cap contracts to test internal control over cap transactions. Selected five percent of each type of cap transaction (that is, purchases [premium disbursements], sales [premium receipts], and closeouts [closings and settlements of the position]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.</p>			
<b>Reporting</b>			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into cap contracts.	-----	-----	-----
2. For each cap selected for testing, read management's documentation describing the intended use of the cap and performed the following procedures, as applicable.	-----	-----	-----
For caps used as a hedge—			
3. Determined that the documentation described the following:			
a. The risk hedged	-----	-----	-----
b. How the hedge was consistent with the overall risk management strategy	-----	-----	-----
c. How the cap was expected to be effective in offsetting the exposure	-----	-----	-----
d. The approach in assessing the effectiveness of the hedge	-----	-----	-----
4. Determined that the following items were documented:			
a. The purpose(s) of the cap as a hedge	-----	-----	-----
b. The terms of the cap, the name of the counterparty, and the counterparty exposure amount	-----	-----	-----
c. The assets or liabilities (or portion thereof) that the cap hedged	-----	-----	-----
d. Evidence that the cap continued to be an effective hedge	-----	-----	-----
e. Evidence that the cap was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount or underlying	-----	-----	-----
If the cap was an exact offset to an outstanding cap—			
5. Read documentation indicating that the cap offset an outstanding cap previously purchased or sold by the insurance company and that the cap was an exact offset of the market risk of the cap being offset.	-----	-----	-----

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
For caps used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____
c. How the cap was expected to be effective in replicating the investment characteristics of the replicated investment	_____	_____	_____
d. The approach for assessing the effectiveness of the replication transaction	_____	_____	_____
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____
b. The terms of the cap, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
For all selected caps including those that are a part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize cap transactions. Compared the name of the individual who authorized the cap transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount or strike price exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	_____	_____	_____
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the cap transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	_____	_____	_____
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	_____	_____	_____

(continued)

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
12. Obtained a list of individuals authorized by the board of directors or a committee thereof to trade cap contracts. Compared the name of the individual who executed the purchase, sale, or closeout of the cap with the names on the list and found the name of the individual on the list.	_____	_____	_____
13. Obtained a list of individuals authorized to approve payments relating to caps. Compared the name of the individual who approved any payment relating to the cap with the names on the list and found the name of the individual on the list.	_____	_____	_____
14. Compared the name of the individual who approved any payment relating to the cap with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
15. Compared the name of the individual who received cash or other consideration in connection with the cap with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____
16. Obtained the deal ticket and confirmation for the purchase, sale, or closeout of the cap and found that the purchase, sale, or closeout was confirmed by the counterparty.	_____	_____	_____
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade caps and found that the name was not on the list.	_____	_____	_____
18. Compared the terms of the cap contract, as stated on the deal ticket and confirmation, with the terms of the cap contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
19. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company determined that its accounting records for caps tested in procedure 18, agreed with or reconciled to the related control account; for example, the subsidiary ledger to the general ledger.	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the cap agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____
21. Compared the terms of the cap agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the cap agreement and found them to be in agreement.	_____	_____	_____
22. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company physically inventoried the cap agreements.	_____	_____	_____
23. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the cap agreement with the names of individuals authorized to execute purchases, sales, or closeouts of cap contracts and found that the name of the individual was not on the list.	_____	_____	_____

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
24. Compared information regarding the cap, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	-----	-----	-----
25. If the cap should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the cap, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	-----	-----	-----
26. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to the cap tested, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	-----	-----	-----

**Effectiveness of Caps Used As Hedges and in Replication Transactions**

27. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the cap as a hedge or replication in accordance with the policies regarding effectiveness.	-----	-----	-----
28. If the cap was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	-----	-----	-----

**Legal Review**

29. Read documentation indicating that the legal department reviewed the cap agreement to assess contract compliance with the DUP and enforceability.	-----	-----	-----
30. Read documentation indicating that the legal department updated its assessment of agreement enforceability at least annually.	-----	-----	-----

**Valuation**

31. Obtained the insurance company's policies and procedures for valuing caps and found that the insurance company determined the fair value of the cap in accordance with the policy described in the insurance company's procedures for the valuation of caps.	-----	-----	-----
32. Read documentation supporting the fair value of the cap and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized person.	-----	-----	-----

**Description of Exceptions if Any**

<i><b>Procedure Number</b></i>	<i><b>Description of Exception</b></i>

**Section 3—Collar Contracts**

	<i>Findings</i>		
	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
<b><u>Procedures</u></b>			
<p>Performed the following procedures on selected collar contracts to test internal control over collar transactions. Selected five percent of each type of collar transaction (that is, executions [entering into a collar transaction in which the net position at inception may result in either no cash outlay, cash received, or cash disbursed] and closeouts [closings and settlements of the position]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.</p>			
<b>Reporting</b>			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into collar contracts.	_____	_____	_____
2. For each collar selected for testing, read management's documentation describing the intended use of the collar and performed the following procedures, as applicable.	_____	_____	_____
For collars used as a hedge—			
3. Determined that the documentation described the following:			
a. The risk hedged	_____	_____	_____
b. How the hedge was consistent with the overall risk management strategy	_____	_____	_____
c. How the collar was expected to be effective in offsetting the exposure	_____	_____	_____
d. The approach in assessing the effectiveness of the hedge	_____	_____	_____
4. Determined that the following items were documented:			
a. The purpose(s) of the collar as a hedge	_____	_____	_____
b. The terms of the collar, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
c. The assets or liabilities (or portion thereof) that the collar hedged	_____	_____	_____
d. Evidence that the collar continued to be an effective hedge	_____	_____	_____
e. Evidence that the contract was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount or underlying	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
If the collar was an exact offset of an outstanding collar—			
5. Read documentation indicating that the collar offset an outstanding collar previously purchased or sold by the insurance company and that the collar was an exact offset of the market risk of the collar being offset.	-----	-----	-----
For collars used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	-----	-----	-----
b. How the replication was consistent with the overall management investment strategy	-----	-----	-----
c. How the collar was expected to be effective in replicating the investment characteristics of the replicated investment	-----	-----	-----
d. The approach in assessing the effectiveness of the replication transaction	-----	-----	-----
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	-----	-----	-----
b. The terms of the collar, the name of the counterparty, and the counterparty exposure amount	-----	-----	-----
For all selected collars including those that are a part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize collar transactions. Compared the name of the individual who authorized the collar transaction with the names on the list and found the name of the individual on the list.	-----	-----	-----
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount or strike price exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	-----	-----	-----
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the collar transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	-----	-----	-----

(continued)

<i>Procedures</i>	<i>Findings</i>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	-----	-----	-----
12. Obtained a list of individuals authorized by the board of directors or a committee thereof to trade collar contracts. Compared the name of the individual who executed the execution or closeout of the collar contract with the names on the list and found the name of the individual on the list.	-----	-----	-----
13. Obtained a list of individuals authorized to approve payments relating to collars. Compared the name of the individual who approved any payment relating to the collar with the names on the list and found the name of the individual on the list.	-----	-----	-----
14. Compared the name of the individual who approved any payment relating to the collar with the name of the individual who approved entering into the contract and found that the names were different.	-----	-----	-----
15. Compared the name of the individual who received cash or other consideration in connection with the collar with the name of the individual who entered into the contract and found that the names of the individuals were different.	-----	-----	-----
16. Obtained the deal ticket and confirmation for the execution or closeout of the collar and found that the execution or closeout was confirmed by the counterparty.	-----	-----	-----
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade collars and found that the name was not on the list.	-----	-----	-----
18. Compared the terms of the collar contract, as stated on the deal ticket and confirmation, with the terms of the collar contract recorded in the insurance company's accounting records and found them to be in agreement.	-----	-----	-----
19. Obtained documentation for one reporting period (for example, monthly or quarterly) indicating that the insurance company determined that its accounting records for collars, tested in procedure 18, agreed with or reconciled to the related control account; for example, the subsidiary ledger to the general ledger.	-----	-----	-----
20. Obtained the accounting record documenting modifications, if any, to the collar agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	-----	-----	-----
21. Compared the terms of the collar agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the collar agreement and found them to be in agreement.	-----	-----	-----
22. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company physically inventoried the collar agreement.	-----	-----	-----

<b><i>Procedures</i></b>	<b><i>Findings</i></b>		
	<b><i>No Exception</i></b>	<b><i>Exception</i></b>	<b><i>N/A</i></b>
23. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the collar contracts with the names of individuals authorized to enter into trades, executions, or closeouts of collar contracts and found that the name of the individual was not on the list.	-----	-----	-----
24. Compared information regarding the collar, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	-----	-----	-----
25. If the collar should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the collar, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	-----	-----	-----
26. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to the collar tested, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	-----	-----	-----

**Effectiveness of Collars Used As Hedges and in Replication Transactions**

27. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the collar as a hedge or replication in accordance with the policies regarding effectiveness.	-----	-----	-----
28. If the collar was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	-----	-----	-----

**Legal Review**

29. Read documentation indicating that the legal department reviewed the collar agreement to assess contract compliance with the DUP and enforceability.	-----	-----	-----
30. Read documentation indicating that the legal department updated its assessment of agreement enforceability at least annually.	-----	-----	-----

**Valuation**

31. Obtained the insurance company's policies and procedures for valuing collars and found that the insurance company determined the fair value of the collar in accordance with the policy described in the insurance company's procedures for the valuation of collars.	-----	-----	-----
32. Read documentation supporting the fair value of the collar and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.	-----	-----	-----

**Description of Exceptions if Any**

<b><i>Procedure Number</i></b>	<b><i>Description of Exception</i></b>

**Section 4—Floor Contracts**

	<i>Findings</i>		
	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
<b><u>Procedures</u></b>			
<p>Performed the following procedures on selected floor contracts to test internal control over floor transactions. Selected five percent of each type of floor transaction (that is, purchases [premium disbursements], sales [premium receipts], and closeouts [closings and settlements of the position]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.</p>			
<b>Reporting</b>			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into floor contracts.	_____	_____	_____
2. For each floor selected for testing, read management's documentation describing the intended use of the floor and performed the following procedures, as applicable.	_____	_____	_____
For floors used as a hedge—			
3. Determined that the documentation described the following:			
a. The risk hedged	_____	_____	_____
b. How the hedge was consistent with the overall risk management strategy	_____	_____	_____
c. How the floor was expected to be effective in offsetting the exposure	_____	_____	_____
d. The approach in assessing the effectiveness of the hedge	_____	_____	_____
4. Determined that the following items were documented:			
a. The purpose(s) of the floor as a hedge	_____	_____	_____
b. The terms of the floor, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
c. The assets or liabilities (or portion thereof) that the floor hedged	_____	_____	_____
d. Evidence that the floor continued to be an effective hedge	_____	_____	_____
e. Evidence that the floor was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures for entering into hedge transactions; for example, the notional amount or underlying	_____	_____	_____
If the floor was an exact offset of an outstanding floor—			
5. Read documentation indicating that the floor offset an outstanding floor previously purchased or sold by the insurance company and that the floor was an exact offset of the market risk of the floor being offset.	_____	_____	_____

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
For floors used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	-----	-----	-----
b. How the replication was consistent with the overall management investment strategy	-----	-----	-----
c. How the floor was expected to be effective in replicating the investment characteristics of the replicated investment	-----	-----	-----
d. The approach in assessing the effectiveness of the replication transaction	-----	-----	-----
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	-----	-----	-----
b. The terms of the floor, the name of the counterparty, and the counterparty exposure amount	-----	-----	-----
For all selected floors including those that are a part of a replication transaction—			
8. Obtained a list of individuals approved by the board of directors or a committee thereof who had the authority to authorize floor transactions. Compared the name of the individual who authorized the floor transaction with the names on the list and found the name of the individual on the list.	-----	-----	-----
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount or strike price exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	-----	-----	-----
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the floor transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	-----	-----	-----
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	-----	-----	-----

(continued)

<i>Procedures</i>	<i>Findings</i>		
	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
12. Obtained a list of individuals authorized by the board of directors or a committee thereof to trade floor contracts. Compared the name of the individual who executed the purchase, sale, or closeout of the floor with the names on the list and found the name of the individual on the list.	_____	_____	_____
13. Obtained a list of individuals authorized to approve payments relating to floors. Compared the name of the individual who approved any payment relating to the floor with the names on the list and found the name of the individual on the list.	_____	_____	_____
14. Compared the name of the individual who approved any payment relating to the floor with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
15. Compared the name of the individual who received cash or other consideration in connection with the floor with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____
16. Obtained the deal ticket and confirmation for the purchase, sale, or closeout of the floor and found that the purchase, sale, or closeout was confirmed by the counterparty.	_____	_____	_____
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade floors and found that the name was not on the list.	_____	_____	_____
18. Compared the terms of the floor contract, as stated on the deal ticket and confirmation, with the terms of the floor contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
19. Obtained documentation for one reporting period (for example, monthly or quarterly), that the insurance company determined that its accounting records for floors, tested in procedure 18, agreed with or reconciled to the related control account; for example, the subsidiary ledger to the general ledger.	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the floor agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____
21. Compared the terms of the floor agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the floor agreement and found them to be in agreement.	_____	_____	_____
22. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company physically inventoried the floor agreements.	_____	_____	_____
23. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the floor agreement with the names of individuals authorized to execute purchases, sales, or closeouts of floor contracts and found that the name was not on the list.	_____	_____	_____

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
24. Compared information regarding the floor, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	-----	-----	-----
25. If the floor should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the floor, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	-----	-----	-----
26. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to the floor tested, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	-----	-----	-----

**Effectiveness of Floors Used As Hedges and in Replication Transactions**

27. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the floor as a hedge or replication in accordance with the policies regarding effectiveness.	-----	-----	-----
28. If the floor was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	-----	-----	-----

**Legal Review**

29. Read documentation indicating that the legal department reviewed the floor agreement to assess contract compliance with the DUP and enforceability.	-----	-----	-----
30. Read documentation indicating that the legal department updated its assessment of agreement enforceability at least annually.	-----	-----	-----

**Valuation**

31. Obtained the insurance company's policies and procedures for valuing floors and found that the insurance company determined the fair value of the floor in accordance with the policy described in the insurance company's procedures for the valuation of floors.	-----	-----	-----
32. Read documentation supporting the fair value of the floor and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.	-----	-----	-----

**Description of Exceptions if Any**

<i><b>Procedure Number</b></i>	<i><b>Description of Exception</b></i>

**Section 5—Forward Contracts**

*Findings*

**Procedures**

Performed the following procedures on selected forward contracts to test internal control over forward transactions. Selected five percent of each type of forward transaction, with the selections distributed throughout the year. These are, (1) forward contracts entered into to make delivery, (2) forward contracts entered into to take delivery, (3) forward contracts settled by making delivery, (4) forward contracts settled by taking delivery, (5) forward contracts settled by cash. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.

<u>No</u>	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
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**Reporting**

1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into forward contracts.
2. For each forward selected for testing, read management's documentation describing the intended use of the forward and performed the following procedures, as applicable.

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For forward contracts used as a hedge—

3. Determined that the documentation describes the following:
  - a. The risk hedged
  - b. How the hedge was consistent with the overall risk management strategy
  - c. How the forward was expected to be effective in offsetting the exposure
  - d. The approach in assessing the effectiveness of the hedge
4. Determined that the following items were documented:
  - a. The purpose(s) of the forward as a hedge
  - b. The terms of the forward, the name of the counterparty, and the counterparty exposure amount
  - c. The assets or liabilities (or portion thereof) that the forward hedged
  - d. The specific forward contract used in the hedge
  - e. Evidence that the forward continued to be an effective hedge
  - f. Evidence that the forward was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount or underlying

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<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
If the forward was an exact offset of an outstanding forward—			
5. Read documentation indicating that the forward offset an outstanding forward previously purchased or sold by the insurance company and that the forward was an exact offset of the market risk of the forward being offset.	-----	-----	-----
For forwards used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	-----	-----	-----
b. How the replication was consistent with the overall management investment strategy	-----	-----	-----
c. How the forward was expected to be effective in replicating the investment characteristic of the replicated investment	-----	-----	-----
d. The approach for assessing the effectiveness of the replication transaction	-----	-----	-----
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	-----	-----	-----
b. The terms of the forward contract, the name of the counterparty, and the counterparty exposure amount	-----	-----	-----
For all selected forwards, including those that are a part of the replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof who had the authority to authorize forward transactions. Compared the name of the individual who authorized the forward transaction with the names on the list and found the name of the individual on the list.	-----	-----	-----
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	-----	-----	-----
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the forward transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	-----	-----	-----

(continued)

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	-----	-----	-----
12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade forward contracts. Compared the name of the individual who executed the purchase or sale of the forward with the names on the list and found the name of the individual on the list.	-----	-----	-----
13. Obtained a list of individuals authorized to approve settlements or payments related to forward contracts. For the purchase and any transaction subsequent to purchase, compared the name of the individual who approved any payment or settlement of funds in connection with the forward contract with the names on the list and found the name of the individual on the list.	-----	-----	-----
14. Compared the name of the individual who approved any settlement or payment relating to the forward with the name of the individual who approved entering into the contract and found that the names were different.	-----	-----	-----
15. Compared the name of the individual who received cash or other consideration in connection with the forward with the name of the individual who entered into the contract and found that the names of the individuals were different.	-----	-----	-----
16. Obtained the deal ticket and confirmation for the purchase or sale of the forward contract and found that the purchase or sale was confirmed by the counterparty.	-----	-----	-----
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade forwards and found that the name was not on the list.	-----	-----	-----
18. Compared the terms of the forward contract, as stated on the deal ticket and confirmation, with the terms of the forward contract recorded in the insurance company's accounting records and found them to be in agreement.	-----	-----	-----
19. Obtained documentation for one reporting period, (for example, monthly or quarterly), that the insurance company determined that its accounting records for forwards, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	-----	-----	-----
20. Obtained the accounting record documenting modifications, if any, to the forward contract. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	-----	-----	-----
21. For one reporting period, (for example, monthly or quarterly), obtained the insurance company's documentation of the existence of the forward contract and found that the insurance company either (a) obtained a statement from the custodian confirming the existence of the forward contract, (b) physically inventoried the forward contract, or (c) obtained a statement from the counterparty acknowledging the existence of the forward contract.	-----	-----	-----

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the forward with the names of individuals authorized to execute purchases and sales of forwards and found that the name was not on the list.	-----	-----	-----
23. Compared information regarding the forward, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	-----	-----	-----
24. If the forward should have been included in the monitoring analysis separately tested in step 10 within section 1, "All Derivative Types," compared information regarding the forward, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	-----	-----	-----

**Effectiveness of Forward Contracts Used As Hedges and in Replication Transactions**

25. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the forward as a hedge or replication in accordance with the policies regarding effectiveness.	-----	-----	-----
26. If the forward was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	-----	-----	-----

**Legal Review**

27. Read documentation indicating that the legal department reviewed the forward contract to assess contract compliance with the DUP and enforceability.	-----	-----	-----
28. Read documentation indicating that the legal department updated its assessment of contract enforceability at least annually.	-----	-----	-----

**Valuation**

29. Obtained the insurance company's policies and procedures for valuing forwards and found that the insurance company determined the fair value of the forward in accordance with the policy described in the insurance company's procedures for valuation of forwards.	-----	-----	-----
30. Read documentation supporting the fair value of the forward contract and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.	-----	-----	-----

**Description of Exceptions if Any**

<i><b>Procedure Number</b></i>	<i><b>Description of Exception</b></i>

**Section 6—Futures Contracts**

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
<p>Performed the following procedures on selected futures contracts to test internal control over futures transactions. Selected five percent of each type of futures transaction, with the selections distributed throughout the year. These are purchases, sales, and cash settlements (closeouts of a position). If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.</p>			
<b>Reporting</b>			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to trade futures.	-----	-----	-----
2. For each futures transaction selected for testing, read management's documentation describing the intended use of the futures and performed the following procedures, as applicable.	-----	-----	-----
For futures used as a hedge—			
3. Determined that the documentation describes the following:			
a. The risk hedged	-----	-----	-----
b. How the hedge was consistent with the overall risk management strategy	-----	-----	-----
c. How the futures position was expected to be effective in offsetting the exposure	-----	-----	-----
d. The approach in assessing the effectiveness of the hedge	-----	-----	-----
4. Determined that the following items were documented:			
a. The purpose(s) of the futures as a hedge	-----	-----	-----
b. The terms of the futures transaction and the name of the exchange and firm(s) handling the trade	-----	-----	-----
c. The assets or liabilities (or portion thereof) that the futures transaction hedged	-----	-----	-----
d. Evidence that the futures contract continued to be an effective hedge	-----	-----	-----
e. Evidence that the futures position was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures for futures transactions; for example, the notional amount or underlying	-----	-----	-----
For futures transactions that were an exact offset of an outstanding futures transaction—			
5. Read documentation indicating that the futures transaction offset an outstanding futures position previously purchased or sold by the insurer and that the futures transaction was an exact offset of the market risk of the futures position being offset.	-----	-----	-----

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
For futures used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____
c. How the futures position was expected to be effective in replicating the investment characteristics of the replicated investment	_____	_____	_____
d. The approach in assessing the effectiveness of the replication transaction	_____	_____	_____
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____
b. The terms of the futures transaction and the name of the exchange and the firm(s) handling the trade	_____	_____	_____
c. The specific futures contract used in the replication	_____	_____	_____
For all selected futures including those that are a part of the replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize futures trades. Compared the name of the individual who authorized the futures transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	_____	_____	_____
10. Obtained a list of individuals authorized by the board of directors or committee thereof to trade futures contracts. Compared the name of the individual who executed the purchase or sale of the futures contract with the names on the list and found the name of the individual on the list.	_____	_____	_____
11. Obtained a list of individuals authorized to approve settlements or disbursements related to futures transactions. For purchases and transactions subsequent to purchase or sale of the futures contract, compared the name of the individual who approved any settlement of funds relating to the futures with the names on the list and found the name of the individual on the list.	_____	_____	_____

(continued)

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
12. Compared the name of the individual who approved any payment relating to the futures with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
13. Compared the name of the individual who received cash or other consideration in connection with the futures with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____
14. Obtained the deal ticket and confirmation for the purchase, expiration, or sale of the futures contracts and found that the purchase, sale, or expiration of the futures contract was confirmed by the deal ticket and confirmation.	_____	_____	_____
15. Compared the terms of the futures transaction, as stated on the deal ticket and confirmation, with the terms of the transaction recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
16. Obtained documentation for one reporting period, (for example, monthly or quarterly), that the insurance company determined that its accounting records for futures, tested in procedure 15, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	_____	_____	_____
17. For one reporting period, (for example, monthly or quarterly), obtained the insurance company's documentation of the existence of the futures contracts and found that the insurance company obtained statements from the futures counterparty(ies) or broker(s) confirming the futures transactions and positions.	_____	_____	_____
18. Compared information regarding the futures contract, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____
19. If the futures position should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the futures contract, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____
<b>Effectiveness of Futures Used As Hedges and in Replication Transactions</b>			
20. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the futures position as a hedge or replication in accordance with the policies regarding effectiveness.	_____	_____	_____
21. If the futures position was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the company policies and procedures and found that the action taken was consistent with the accounting policy.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
<b>Valuation</b>			
22. Obtained the insurance company's policies and procedures for valuing positions and found that the insurance company determined the valuation of the futures contract in accordance with the policy described in the insurance company's procedures for valuation of futures.	-----	-----	-----
23. Read documentation supporting the market price of the futures contract and found that the market price was obtained from an independent source.	-----	-----	-----

**Description of Exceptions if Any**

<u>Procedure Number</u>	<u>Description of Exception</u>

**Section 7—Option Contracts**

	<i>Findings</i>		
	<u>No</u>		
<u>Procedures</u>	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
<p>Performed the following procedures on selected option contracts to test internal control over option transactions. Selected five percent of each type of option transaction (that is, purchases, sales, expirations, and exercises), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.</p>			
<b>Reporting</b>			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to trade or enter into option contracts.	_____	_____	_____
2. For each option selected for testing, read management's documentation describing the intended use of the option and performed the following procedures, as applicable.	_____	_____	_____
For options used as a hedge—			
3. Determined that the documentation described the following:			
a. The risk hedged	_____	_____	_____
b. How the hedge was consistent with the overall risk management strategy	_____	_____	_____
c. How the option was expected to be effective in offsetting the exposure	_____	_____	_____
d. The approach in assessing the effectiveness of the hedge	_____	_____	_____
4. Determined that the following items were documented:			
a. The purpose(s) of the option as a hedge	_____	_____	_____
b. For over-the-counter (OTC) options, the terms of the option, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
c. For exchange-traded options, the term of the option, the name of the exchange, and the name of the firm(s) handling the trade	_____	_____	_____
d. The assets or liabilities (or portion thereof) that the option hedged	_____	_____	_____
e. For OTC and exchange-traded options, the specific option used in the hedge	_____	_____	_____
f. Evidence that the option continued to be an effective hedge	_____	_____	_____
g. Evidence that the option was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount, or underlying	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
If the option transaction was (a) for income generation and was for the sale of a call option on securities or (b) an exact offset to an outstanding option—			
5. Read the documentation supporting the transaction which indicated that the insurance company was holding or could immediately acquire through the exercise of options, warrants, or conversion rights already owned, the underlying securities during the entire period the option was outstanding.	_____	_____	_____
6. Read documentation indicating that the option offset an outstanding option previously purchased or sold by the insurance company and that the option was an exact offset to the market risk of the option being offset.	_____	_____	_____
For options used in a replication transaction—			
7. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____
c. How the option was expected to be effective in replicating the investment characteristics of the replicated investment	_____	_____	_____
d. The approach in assessing the effectiveness of the replication transaction	_____	_____	_____
8. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____
b. The specific option used in the replication	_____	_____	_____
c. For OTC options, the terms of the option, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
d. For exchange-traded options, the name of the exchange and the firm(s) handling the trade	_____	_____	_____
For all selected options, including those that are a part of a replication transaction—			
9. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize option transactions. Compared the name of the individual who authorized the option transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____
10. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	_____	_____	_____

<b><i>Procedures</i></b>	<b><i>Findings</i></b>		
	<b><i>No Exception</i></b>	<b><i>Exception</i></b>	<b><i>N/A</i></b>
11. Obtained a list of <i>qualified and nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the option transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	-----	-----	-----
12. For OTC options, determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 11.	-----	-----	-----
13. Obtained a list of individuals authorized by the board of directors or committee thereof to trade option contracts. Compared the name of the individual who executed the purchase, sale, or exercise of the option with the names on the list and found the name of the individual on the list.	-----	-----	-----
14. Obtained a list of individuals authorized to approve payments relating to options contracts. Compared the name of the individual who approved any payment relating to the option with the names on the list and found the name of the individual on the list.	-----	-----	-----
15. Compared the name of the individual who approved any payment relating to the option with the name of the individual who approved entering into the contract and found that the names were different.	-----	-----	-----
16. Compared the name of the individual who received cash or other consideration in connection with the option with the name of the individual who entered into the contract and found that the names of the individuals were different.	-----	-----	-----
17. Obtained the deal ticket and confirmation for the purchase, sale, or exercise of the option and found that the purchase, sale, or exercise of the option was confirmed by the counterparty or firm handling the transaction.	-----	-----	-----
18. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade options and found that the name was not on the list.	-----	-----	-----
19. Compared the terms of the option contract, as stated on the deal ticket and confirmation, with the terms of the option contract recorded in the insurance company's accounting records and found them to be in agreement.	-----	-----	-----
20. Obtained documentation for one reporting period, (for example, monthly or quarterly), indicating that the insurance company determined whether its accounting records for options, tested in procedure 19, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	-----	-----	-----

<i>Procedures</i>	<i>Findings</i>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
21. Obtained the accounting record documenting modifications, if any, to the option transaction. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	-----	-----	-----
22. Obtained documentation for one reporting period, (for example, monthly or quarterly), indicating that the insurance company obtained a statement from the counterparty confirming the existence of the option position.	-----	-----	-----
23. Using the list of authorized traders obtained in procedure 13, compared the name of the individual who had custody of or access to the option documentation with the names of individuals authorized to purchase, sell, or exercise the option and found that the name was not on the list.	-----	-----	-----
24. Compared information regarding the option, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	-----	-----	-----
25. If the option should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the option, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	-----	-----	-----
<b>Effectiveness of Options Used As Hedges and in Replication Transactions</b>			
26. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the option as a hedge or replication in accordance with the policies regarding effectiveness.	-----	-----	-----
27. If the option was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	-----	-----	-----
<b>Legal Review</b>			
28. Read documentation indicating that the legal department reviewed the option agreement to assess contract compliance with the DUP and enforceability.	-----	-----	-----
29. Read documentation indicating that the legal department updated its assessment of legal enforceability of the OTC option agreement at least annually.	-----	-----	-----

(continued)

<u>Procedures</u>	<u>Findings</u>		
	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
<b>Valuation</b>			
30. Obtained the insurance company's policies and procedures for valuing options and found that the insurance company determined the fair value of OTC options and the market price of exchange-traded options, in accordance with the policy described in the insurance company's procedures for the valuation of options.	-----	-----	-----
31. Read documentation supporting the fair value for OTC options and the market price of exchange-traded options and found that the fair value or market value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.	-----	-----	-----

**Description of Exceptions if Any**

<u>Procedure Number</u>	<u>Description of Exception</u>



<i>Procedures</i>	<i>Findings</i>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
For swaps that were an exact offset of an outstanding swap—			
5. Read documentation that indicated that the swap offset a swap previously purchased or sold, and that the swap was an exact offset to the market risk of the swap being offset.	-----	-----	-----
For swaps used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	-----	-----	-----
b. How the replication was consistent with the overall management investment strategy	-----	-----	-----
c. How the swap was expected to be effective in replicating the investment characteristic of the replicated investment	-----	-----	-----
d. The approach in assessing the effectiveness of the replication transaction	-----	-----	-----
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	-----	-----	-----
b. The terms of the swap, the name of the counterparty, and the counterparty exposure amount	-----	-----	-----
For all selected swaps including those that are a part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof who had the authority to authorize swap transactions. Compared the name of the individual who authorized the swap transaction with the names on the list and found the name of the individual on the list.	-----	-----	-----
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transactions tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	-----	-----	-----
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the swap agreement with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	-----	-----	-----

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	-----	-----	-----
12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade swap contracts. Compared the name of the individual who executed the swap with the names on the list and found the name of the individual on the list.	-----	-----	-----
13. Obtained a list of individuals authorized to approve settlements or disbursements related to swaps. For purchases and any interim settlements or closeouts of the swap subsequent to purchase, compared the name of the individual who approved any settlement of funds relating to the swap with the names on the list and found the name of the individual on the list.	-----	-----	-----
14. Compared the name of the individual who approved any payment relating to the swap with the name of the individual who approved entering into the contract and found that the names were different.	-----	-----	-----
15. Compared the name of the individual who received cash or other consideration in connection with the swap with the name of the individual who entered into the contract and found that the names of the individuals were different.	-----	-----	-----
16. Obtained the deal ticket and confirmation for the purchase, execution, or closeout of the swap and found that the purchase, execution, or closeout of the swap was confirmed by the counterparty.	-----	-----	-----
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade swaps and found that the name was not on the list.	-----	-----	-----
18. Compared the terms of the swap contract, as stated on the deal ticket and confirmation, with the terms of the swap contract recorded in the insurance company's accounting records and found them to be in agreement.	-----	-----	-----
19. Obtained documentation for one reporting period (for example, monthly, or quarterly), that the insurance company determined whether its accounting records for swaps, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	-----	-----	-----
20. Obtained the accounting record documenting modifications, if any, to the swap agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	-----	-----	-----
21. Compared the terms of the swap agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the swap agreement and found them to be in agreement.	-----	-----	-----

(continued)

<i>Procedures</i>	<i>Findings</i>		
	<i>No Exception</i>	<i>Exception</i>	<i>N/A</i>
22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the swap agreement with the names of individuals authorized to execute swap agreements and found that the name was not on the list.	_____	_____	_____
23. Compared information regarding the swap, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____
24. If the swap should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the swap, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____
25. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to swap transactions, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	_____	_____	_____
<b>Effectiveness of Swaps Used As Hedges and in Replication Transactions</b>			
26. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the swap as a hedge or replication in accordance with the policies regarding effectiveness.	_____	_____	_____
27. If the swap was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	_____	_____	_____
<b>Legal Review</b>			
28. Read documentation indicating that the legal department reviewed the swap agreement to assess contract compliance with the DUP and enforceability.	_____	_____	_____
29. Read documentation indicating that the legal department updated its assessment of the enforceability of the swap agreement at least annually.	_____	_____	_____
<b>Valuation</b>			
30. Obtained the insurance company's policies and procedures for valuing swaps and found that the insurance company determined the fair value of the swap in accordance with the policy described in the insurance company's procedures for valuation of swaps.	_____	_____	_____
31. Read documentation supporting the fair value of the swap and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.	_____	_____	_____

**Description of Exceptions if Any**

<i>Procedure Number</i>	<i>Description of Exception</i>
_____	_____
_____	_____
_____	_____

**Section 9—Swaption Contracts**

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
<p>Performed the following procedures on selected swaption contracts to test internal control over swaption transactions. Selected five percent of each type of swaption transaction with the selections distributed throughout the year. These are executions (purchases) and closeouts (sales). If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.</p>			
<b>Reporting</b>			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to buy or sell swaptions.	-----	-----	-----
2. For each swaption contract selected for testing, read management's documentation describing the intended use of the swaption and performed the following procedures, as applicable.	-----	-----	-----
For swaptions used as a hedge—			
3. Determined that the documentation describes the following:			
a. The risk hedged	-----	-----	-----
b. How the hedge was consistent with the overall risk management strategy	-----	-----	-----
c. How the swaption was expected to be effective in offsetting the exposure	-----	-----	-----
d. The approach in assessing the effectiveness of the hedge	-----	-----	-----
4. Determined that the following items were documented:			
a. The purpose(s) of the swaption as a hedge	-----	-----	-----
b. The terms of the swaption, the name of the counterparty, and the counterparty exposure amount	-----	-----	-----
c. The assets or liabilities (or portion thereof) that the swaption hedged	-----	-----	-----
d. Evidence that the swaption continued to be an effective hedge	-----	-----	-----
e. Evidence that the swaption was consistent with the insurance company's parameters, as specified in the DUP or applicable policies and procedures, for entering into swaption agreements; for example, the notional amount or underlying	-----	-----	-----

(continued)

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
For swaptions that were an exact offset of an outstanding swaption—			
5. Read documentation indicating that the swaption offset an outstanding swaption and that the swaption was an exact offset of the market risk of the swaption being offset.	-----	-----	-----
For swaptions used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	-----	-----	-----
b. How the replication was consistent with the overall management investment strategy	-----	-----	-----
c. How the swaption was expected to be effective in replicating the investment characteristic of the replicated investment	-----	-----	-----
d. The approach in assessing the effectiveness of the replication transaction	-----	-----	-----
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	-----	-----	-----
b. The terms of the swaption, the name of the counterparty, and the counterparty exposure amount	-----	-----	-----
For all selected swaptions including those that are a part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize swaptions. Compared the name of the individual who authorized the swaption transaction with the names on the list and found the name of the individual on the list.	-----	-----	-----
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transactions tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	-----	-----	-----
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the swaption transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	-----	-----	-----

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	_____	_____	_____
12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade swaption contracts. Compared the name of the individual who executed the swaption with the names on the list and found the name of the individual on the list.	_____	_____	_____
13. Obtained a list of individuals authorized to approve settlements or disbursements related to swaption agreements. Compared the name of the individual who approved settlements and disbursements relating to the swaption with the names on the list and found the name on the list.	_____	_____	_____
14. Compared the name of the individual who approved any payment relating to the swaption with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
15. Compared the name of the individual who received cash or other consideration in connection with the swaption with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____
16. Obtained the deal ticket and confirmation for the purchase, sale, modification, or closeout of the swaption and found that the purchase, sale, modification, or closeout was confirmed by the counterparty.	_____	_____	_____
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade swaptions and found that the name was not on the list.	_____	_____	_____
18. Compared the terms of the swaption contract, as stated on the deal ticket and confirmation, with the terms of the swaption contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
19. Obtained documentation for one reporting period (for example, monthly or quarterly), that the insurance company determined whether its accounting records for swaptions, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the swaption agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____
21. Compared the terms of the swaption agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the swaption agreement and found them to be in agreement.	_____	_____	_____

(continued)

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the swaption agreement with the names of individuals authorized to execute swaption agreements and found that the name was not on the list.	-----	-----	-----
23. Compared information regarding the swaption, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	-----	-----	-----
24. If the swaption should have been included in the monitoring analysis separately tested in procedure 10 within section 1, " All Derivative Types," compared information regarding the swaption, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	-----	-----	-----

**Effectiveness of Swaptions Used As Hedges and in Replication Transactions**

25. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the swaption as a hedge or replication in accordance with the policies regarding effectiveness.	-----	-----	-----
26. If the swaption was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	-----	-----	-----

**Legal Review**

27. Read documentation indicating that the legal department reviewed the swaption agreement to assess contract compliance with the DUP and enforceability.	-----	-----	-----
28. Read documentation indicating that the legal department updated its assessment of the enforceability of the swaption agreement at least annually.	-----	-----	-----

**Valuation**

29. Obtained the insurance company's policies and procedures for valuing swaptions and found that the insurance company determined the fair value of the swaption in accordance with the policy described in the insurance company's procedures for valuation of swaptions.	-----	-----	-----
30. Read documentation supporting the fair value of the swaption and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.	-----	-----	-----

**Description of Exceptions if Any**

<i><b>Procedure Number</b></i>	<i><b>Description of Exception</b></i>
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## Section 10—Warrant Contracts

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
<p>Performed the following procedures on selected warrant contracts to test internal control over warrant transactions. Selected five percent of each type of warrant transaction (that is, purchases, sales, expirations, and exercises), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.</p>			
<b>Reporting</b>			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to trade or enter into warrant contracts.	-----	-----	-----
2. For each warrant selected for testing, read management's documentation describing the intended use of the warrant and performed the following procedures, as applicable.	-----	-----	-----
For warrants used as a hedge—			
3. Determined that the documentation described the following:			
a. The risk hedged	-----	-----	-----
b. How the hedge was consistent with the overall risk management strategy	-----	-----	-----
c. How the warrant was expected to be effective in offsetting the exposure	-----	-----	-----
d. The approach in assessing the effectiveness of the hedge	-----	-----	-----
Determined that the following items were documented:			
4. a. The purpose(s) of the warrant as a hedge	-----	-----	-----
b. For exchange-traded warrants, the term of the warrant, the name of the exchange, and the name of the firm(s) handling the trade	-----	-----	-----
c. For over-the-counter (OTC) warrants, the terms of the warrant, the name of the counterparty, and the counterparty exposure amount	-----	-----	-----
d. The assets or liabilities (or portion thereof) that the warrant hedged	-----	-----	-----
e. Evidence that the warrant continued to be an effective hedge	-----	-----	-----
f. Evidence that the warrant was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures for entering into hedge transactions; for example, the notional amount or underlying	-----	-----	-----

<b><i>Procedures</i></b>	<b><i>Findings</i></b>		
	<b><i>No Exception</i></b>	<b><i>Exception</i></b>	<b><i>N/A</i></b>
If the warrant transaction was an exact offset of an outstanding warrant—			
5. Read documentation indicating that the warrant transaction offset an outstanding warrant previously purchased or sold by the insurance company and that the warrant was an exact offset of the market risk of the warrant being offset	-----	-----	-----
For warrants used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	-----	-----	-----
b. How the replication was consistent with the overall management investment strategy	-----	-----	-----
c. How the warrant was expected to be effective in replicating the investment characteristics of the replicated investment	-----	-----	-----
d. The approach in assessing the effectiveness of the replication transaction	-----	-----	-----
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	-----	-----	-----
b. The specific warrant used in the replication	-----	-----	-----
c. For exchange-traded warrants, the name of the exchange and the firm(s) handling the trade	-----	-----	-----
d. For OTC warrants, the terms of the warrant, the name of the counterparty, and the counterparty exposure amount	-----	-----	-----
For all selected warrants including those that are part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof who had the authority to authorize warrant transactions. Compared the name of the individual who authorized the warrant transaction with the names on the list and found the name of the individual on the list.	-----	-----	-----
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support, and found evidence of approval of the transaction tested.	-----	-----	-----

<i>Procedures</i>	<i>Findings</i>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the warrant transaction with names on the list, and found the name of the counterparty on the respective qualified or nonqualified list.	-----	-----	-----
11. For OTC warrants, determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure, consistent with the classification in the listing obtained in procedure 10.	-----	-----	-----
12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade warrant contracts. Compared the name of the individual who executed the purchase, sale, or exercise of the warrant with the names on the list and found the name of the individual on the list.	-----	-----	-----
13. Obtained a list of individuals authorized to approve payments related to warrant contracts. Compared the name of the individual who approved any payment relating to the warrant with the names on the list, and found the name of the individual on the list.	-----	-----	-----
14. Compared the name of the individual who approved any payment relating to the warrant with the name of the individual who approved entering into the contract and found that the names were different.	-----	-----	-----
15. Compared the name of the individual who received cash or other consideration in connection with the warrant with the name of the individual who entered into the contract and found that the names of the individuals were different.	-----	-----	-----
16. Obtained the deal ticket and confirmation for the purchase, sale, or exercise of an exchange-traded warrant and found that the purchase, sale, or exercise was confirmed by the firm handling the transaction.	-----	-----	-----
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade warrants and found that the name was not on the list.	-----	-----	-----
18. Compared the terms of the warrant contract, as stated on the deal ticket and confirmation, with the terms of the warrant contract recorded in the insurance company's accounting records and found them to be in agreement.	-----	-----	-----
19. Obtained documentation for one reporting period, (for example, monthly or quarterly), that the insurance company determined whether its accounting records for warrants, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	-----	-----	-----
20. Obtained the accounting record documenting modifications, if any, to the warrant transaction. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	-----	-----	-----

(continued)

<i><b>Procedures</b></i>	<i><b>Findings</b></i>		
	<i><b>No Exception</b></i>	<i><b>Exception</b></i>	<i><b>N/A</b></i>
21. For one reporting period, (for example, monthly or quarterly), obtained the insurance company's documentation of the existence of the warrant contract and found that the insurance company either (a) obtained statements from the custodian confirming the existence of the warrant contracts or (b) physically inventoried the warrant contracts.	_____	_____	_____
22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody of or access to the warrant contracts with the names of individuals authorized to execute purchases, sales, or exercises of warrants and found that the name was not on the list.	_____	_____	_____
23. Compared information regarding the warrant, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____
24. If the warrant position should have been included in the monitoring analysis separately tested in procedure 10 of section 1, "All Derivative Types," compared information regarding the warrant, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____
<b>Effectiveness of Warrants Used As Hedges and in Replication Transactions</b>			
25. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the warrant as a hedge or replication in accordance with the policies regarding effectiveness.	_____	_____	_____
26. If the warrant was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	_____	_____	_____
<b>Legal Review</b>			
27. Read documentation indicating that the legal department reviewed a nonexchange traded warrant agreement to assess contract compliance with the DUP and enforceability.	_____	_____	_____
28. Read documentation indicating that the legal department updated its assessment of enforceability of the nonexchange traded warrant agreement at least annually.	_____	_____	_____
<b>Valuation</b>			
29. Obtained the insurance company's policies and procedures for valuing warrants and found that the insurance company determined the fair value of the warrant in accordance with the policy described in the insurance company's procedures for the valuation of warrants	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
30. Read documentation supporting the fair value of warrants and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.	-----	-----	-----

**Description of Exceptions if Any**

<u>Procedure Number</u>	<u>Description of Exception</u>

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Appendix C—Illustrative Management Representation Letter

[Responsible Party's Letterhead]

[Date]

[CPA Firm's Name and Address]

In connection with your engagement to apply the agreed-upon procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position 01-03, *Performing Agreed-Upon Procedures Engagements that Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*, which were agreed to by management of ABC Insurance Company, solely to assist us in complying with the requirements of Section 1410 (b)(5) of the New York State Insurance Law, as amended (the law), which addresses the assessment of internal control over derivative transactions as defined in Section 1401 (a) of the law and Section 178.5 of Regulation No. 163 during the year ended December 31, 20XX, we confirm, to the best of our knowledge and belief, the following representations made to you during your engagement:

1. We are responsible for establishing and maintaining effective internal control over derivative transactions in accordance with the law.
2. During the year ended December 31, 20XX, the internal control over derivative transactions was functioning in accordance with the policies and procedures set forth in the Company's derivative use plan (DUP) and related accounting policies and procedures. There have been no errors or fraud that would indicate a weakness in the internal control over derivative transactions.
3. We have disclosed to you all significant deficiencies in the design or operation of the internal control over derivative transactions that would adversely affect the Company's ability to function in accordance with the Company's DUP.
4. There have been no communications from regulatory agencies, internal auditors, or other practitioners or consultants relating to the internal control over derivative transactions, including communications received between December 31, 20XX and the date of this letter.
5. We have made available to you all information that we believe is relevant to the internal control over derivative transactions.
6. We have responded fully to all inquiries made to us by you during the engagement.

To the best of our knowledge and belief, no events have occurred subsequent to December 31, 20XX and through the date of this letter that would require adjustment to or modification of the findings of the agreed-upon procedures.

[Signature]

[Title]

[Signature]

[Title]

**Reporting on Controls Over Derivative  
Transactions at Insurance Entities Task Force**

ALBERT J. REZNICEK, *Chair*  
EDWARD F. BADER  
DARRYL BRILEY  
BEN B. KORBLY  
EDWARD J. METZGER

DAVID A. NACHMAN  
PAULA C. PANIK  
ROBERT M. SOLITRO  
MARY TODD STOCKER  
DEBORAH H. WHITMORE

The AICPA is grateful to Jean Connolly, James S. Gerson, Laurel A. Hammer, Jay Matalon, and James M. Yanosy for their technical assistance with this document and also to Michael Moriarty of the New York State Department of Insurance for reviewing this document and providing recommendations.

**AICPA Staff**

CHARLES E. LANDES  
*Director*  
*Audit and Attest Standards*

JUDITH M. SHERINSKY  
*Technical Manager*  
*Audit and Attest Standards*

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## AUD Section 30

# ***Statement of Position 02-1 Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code***

May 23, 2002

### NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA New Jersey Annual Claims Prompt Payment Reports Task Force of the AICPA Auditing Standards Board (ASB) to provide guidance regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to agreed-upon procedures engagements performed to comply with the requirements of New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1 (NJAC 11:22-1 or the Code), which establishes Department of Banking and Insurance (department) standards for the payment of claims relating to health benefits plans and dental plans and contains requirements for carriers to file certain reports with the department relating to the timeliness of claims payments and the reasons for denial and late payment of claims in a format prescribed by the department. The department has approved the use of the agreed-upon procedures outlined in this SOP to comply with the reporting requirements of the Code.

This SOP is recognized as an attestation interpretation as defined in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Attestation interpretations are recommendations on the application of SSAEs in specific circumstances, including engagements for entities in specialized industries. Attestation interpretations are issued under the authority of the ASB. The members of the ASB have found this SOP to be consistent with existing SSAEs.

A practitioner should be aware of and consider attestation interpretations applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions of this SOP.

## Introduction and Background

.01 New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1 (NJAC 11:22-1 or the Code), establishes Department of Banking and Insurance (department) standards for the payment of claims relating to health benefits

plans and dental plans and contains requirements for carriers to file certain reports with the department relating to the timeliness of claims payments and the reasons for denial and late payment of claims in a format prescribed by the department.

**.02** NJAC 11:22-1 applies to any insurance company, health service corporation, medical service corporation, hospital service corporation, health maintenance organization, dental service corporation, and dental plan organization that issues health benefits plans or dental plans in the state of New Jersey and to any agent, employee, or other representative of such entity that processes claims for such entity.

**.03** Among other things, the Code requires carriers to report:

- Quarterly to the department on the timeliness of claims payments in the format set forth in Appendix A (claims payment exhibit report) of NJAC 11:22-1, and
- Quarterly and annually on late payments of claims and the reasons for any denials (claims prompt payment report) in the format set forth in Appendix B of NJAC 11:22-1.

**.04** Furthermore, the Code requires that the annual claims prompt payment report, which is due to be filed with the department on or before March 31, pursuant to NJAC 11:22-1.9(a), be accompanied by the report of a private auditing firm, which may be a Certified Public Accountant (CPA) or a firm of CPAs. However, for calendar year 2001, the report of the private auditing firm may be filed with the department on or before July 1, 2002. The department has specified, in Bulletin No. 02-07, that the work shall be conducted, and the report shall be prepared, in accordance with agreed-upon procedures acceptable to the department.

## Applicability

**.05** This Statement of Position (SOP) was developed to provide practitioners with guidance on performing agreed-upon procedures engagements that address annual claims prompt payment reports as required by the New Jersey Administrative Code. The engagement described in this SOP is designed only to satisfy the requirements of the Code. The procedures, as set forth in this SOP, are not necessarily appropriate for use in any other engagement. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## The Code

### Definitions

**.06** The following definitions are reprinted from the Code and are applicable when performing the agreed-upon procedures engagement described in this SOP.

*Agent*—Any entity, including a subsidiary of a carrier, or an organized delivery system as defined by N.J.S.A. 17:48H-1, with which a carrier has contracted to perform claims processing or claims payment services.

*Carrier*—An insurance company, health service corporation, hospital service corporation, medical service corporation or health maintenance organization authorized to issue health benefits plans in this State and a dental service

corporation or dental plan organization authorized to issue dental plans in this State.

*Claim*—A request by a covered person, a participating health care provider, or a nonparticipating health care provider who has received an assignment of benefits from the covered person, for payment relating to health care services or supplies or dental services or supplies covered under a health benefits plan or dental plan issued by a carrier.

*Clean claim*—

1. The claim is for a service or supply covered by the health benefits plan or dental plan;
2. The claim is submitted with all the information requested by the carrier on the claim form or in other instructions distributed to the provider or covered person;
3. The person to whom the service or supply was provided was covered by the carrier's health benefits or dental plan on the date of service;
4. The carrier does not reasonably believe that the claim has been submitted fraudulently; and
5. The claim does not require special treatment. For the purposes of this subchapter, special treatment means that unusual claim processing is required to determine whether a service or supply is covered, such as claims involving experimental treatments or newly approved medications. The circumstances requiring special treatment should be documented in the claim file.

*Covered person*—A person on whose behalf a carrier offering the plan is obligated to pay benefits or provide services pursuant to the health benefits or dental plan.

*Covered service or supply*—A service or supply provided to a covered person under a health benefits or dental plan for which the carrier is obligated to pay benefits or provides services or supplies.

*Dental plan*—A benefits plan which pays dental expense benefits or provides dental services and supplies and is delivered or issued for delivery in this State by or through any carrier in this State.

*Department*—The Department of Banking and Insurance.

*Health benefits plan*—A benefits plan that pays hospital and medical expense benefits or provides hospital and medical services, and is delivered or issued for delivery in this State by or through a carrier. Health benefits plan includes, but is not limited to, Medicare supplement coverage and risk contracts to the extent not otherwise prohibited by Federal law. For the purposes of this chapter, health benefits plan shall not include the following plans, policies or contracts: accident only, credit, disability, long-term care, CHAMPUS supplement coverage, coverage arising out of a workers' compensation or similar law, automobile medical payment insurance, personal injury protection insurance issued pursuant to P.L. 1972, c.70 (N.J.S.A. 39:6A-1 et seq.) or hospital confinement indemnity coverage.

*Health care provider or provider*—An individual or entity which, acting within the scope of its license or certification, provides a covered service or supply as defined by the health benefits or dental plan. Health care provider includes, but is not limited to, a physician, dentist and other health care professional

licensed pursuant to Title 45 of the Revised Statutes and a hospital and other health care facilities licensed pursuant to Title 26 of the Revised Statutes.

## Reporting Requirements

**.07** The Code requires a carrier and its agent to remit payment of clean claims pursuant to specified time frames. The Code further requires that if a carrier or its agent denies or disputes a claim, in full or in part, the carrier or its agent must, within a specified time frame, notify both the covered person when he or she will have increased responsibility for payment, and the provider, of the basis for its decision to deny or dispute the claim.

**.08** The Code requires a carrier to report to the department quarterly on the timeliness of claims payments in the format prescribed in NJAC 11:22-1, Appendix A, "New Jersey Claims Payment Exhibit." This quarterly report is not required to be subjected to an agreed-upon procedures engagement, nor is an annual claims payment exhibit report required to be filed with the department.

**.09** The Code also requires a carrier to report to the department on a quarterly and annual basis on the late payment of claims and the reasons for denial of claims in the format prescribed in NJAC 11:22-1, Appendix B, "Quarterly (Annual) Claims Prompt Payment Report." The Code requires that the annual claims prompt payment report be accompanied by a report of a private auditing firm, which may be a CPA or a firm of CPAs.

**.10** The department has indicated, in Bulletin No. 02-07, that an agreed-upon procedures engagement pursuant to this SOP may be used to satisfy the requirement that an annual claims prompt payment report be accompanied by the report of a private auditing firm. Furthermore, in Bulletin No. 02-12, issued in May 2002, the department has indicated that it agrees to the sufficiency of the procedures included in this SOP for its purposes.

## Related Professional Standards

### AT Section 201, *Agreed-Upon Procedures Engagements*

**.11** Agreed-upon procedures engagements performed to meet the requirements of the Code are to be performed in accordance with AT section 201, *Agreed-Upon Procedures Engagements (AICPA, Professional Standards)*. As described in paragraph .03 of AT section 201, an agreed-upon procedures engagement is one in which a practitioner is engaged by a client to issue a report of findings based on specific procedures performed on the subject matter. Not all of the provisions of AT section 201 are discussed herein. Rather, this SOP includes guidance to assist practitioners in the application of selected aspects of AT section 201.

**.12** Paragraph .06 of AT section 201 states, in part, that the practitioner may perform an agreed-upon procedures engagement provided that, ". . . (c) the practitioner and the specified parties agree upon the procedures performed or to be performed by the practitioner; and (d) the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes."

**.13** As previously stated, Bulletin No. 02-07 from the department states that an agreed-upon procedures engagement may be used to meet the requirement for an independent private auditing firm to report on the annual claims prompt payment reports as required by the New Jersey Administrative Code. Furthermore, the department has approved the use of the agreed-upon procedures outlined in this SOP to comply with the reporting requirements of the

Code. Accordingly, practitioners should not eliminate any of the procedures presented in appendix B (paragraph .28), "Agreed-Upon Procedures That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code," of this SOP or reduce the extent of the tests. The department or the carrier may request that additional procedures be performed and the practitioner may agree to perform such procedures. In those circumstances, it would be expected that the additional procedures would be performed in the context of a separate agreed-upon procedures engagement.

## Procedures to Be Performed

**.14** The agreed-upon procedures to be performed are applied to the carrier's annual claims prompt payment report, which reports on the late payment of claims and reasons for denial of claims in the format prescribed in NJAC 11:22-1, Appendix B.

**.15** The procedures to be performed in the agreed-upon procedures engagement described in this SOP are presented in appendix B (paragraph .28) of this SOP. The procedures have been designed so that the findings resulting from the application of the procedures can be recorded in a tabular format. The three options available to the practitioner for expressing the findings for each procedure are *No Exception*, *Exception*, or *N/A* (not applicable). If a procedure is not applicable to a particular carrier, the procedure should be marked N/A rather than deleted from the report. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.16** If any portion of a procedure results in an exception, the findings for that entire procedure should be recorded as an exception and described in the section "Description of Exceptions If Any." The practitioner should provide a brief factual explanation for each exception that will enable the specified parties to understand the nature of the findings resulting in the exception. If management informs the practitioner that the condition giving rise to the exception was corrected by the date of the practitioner's report, the practitioner's explanation of the exception may include that information; for example, "Management has advised us that the condition resulting in the exception was corrected on Month X, 20XX. We have performed no procedures with respect to management's assertion."

**.17** A practitioner may perform significant portions of the agreed-upon procedures engagement before the end of the period covered by the report. If, during that time, the practitioner identifies conditions that result in an exception in one or more agreed-upon procedures, he or she should report the exception in the findings section of the agreed-upon procedures report, even if management corrects the condition prior to the end of the period.

**.18** Paragraph .40 of AT section 201 states the following:

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

**.19** A practitioner has no obligation to perform procedures beyond the agreed-upon procedures included in appendix B (paragraph .28) of this SOP.

However, if information that contradicts the information in the carrier's annual claims prompt payment report comes to the practitioner's attention by other means, such information should be included in the practitioner's report. This also would apply to conditions or events occurring during the subsequent-events period (subsequent to the period covered by the practitioner's report but prior to the date of the practitioner's report) that either contradict the findings in the report or that would have resulted in the reporting of an exception by the practitioner if that condition or event had existed during the period covered by the report. However, the practitioner has no responsibility to perform any procedure to detect such conditions or events.

## Establishing an Understanding With the Client

.20 In accordance with paragraph .10 of AT section 201, the practitioner should establish an understanding with the client regarding the services to be performed. Such an understanding reduces the risk that the client may misinterpret the objectives and limitations of an agreed-upon procedures engagement performed to meet the regulatory requirements of the Code. Such an understanding also reduces the risk that the client will misunderstand its responsibilities and the responsibilities of the practitioner. The practitioner should document the understanding in the working papers, preferably through a written communication with the client (an engagement letter). The communication should be addressed to the client. Matters that might be included in such an understanding are the following:

- A statement confirming that an agreed-upon procedures engagement is to be performed to meet the requirements of NJAC 11:22-1
- A statement identifying the procedures to be performed as those set forth in SOP 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*
- A statement identifying the client and the department as the specified parties to the agreed-upon procedures report
- A statement acknowledging the client's responsibility for the sufficiency of the procedures in the SOP and referring to Bulletin No. 02-12, which acknowledges the department's responsibility for the sufficiency of the procedures in the SOP
- A statement acknowledging that the practitioner makes no representation regarding the sufficiency of the procedures in the SOP
- A statement describing the responsibilities of the practitioner, including but not limited to the responsibility to perform the agreed-upon procedures and to provide the client with a report, and the circumstances under which the practitioner may decline to issue a report
- A statement indicating that the engagement will be conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants (AICPA)
- A statement indicating that an agreed-upon procedures engagement does not constitute an examination, the objective of which would be the expression of an opinion on the carrier's compliance with the requirements of NJAC 11:22-1, and that if an examination were performed, other matters might come to the practitioner's attention

- A statement indicating that the practitioner will not express an opinion or any other form of assurance
- A statement describing the client's responsibility to comply with the requirements of NJAC 11:22-1 and the client's responsibility for the information in the carrier's annual claims prompt payment report
- A statement describing the client's responsibility for providing accurate and complete information to the practitioner
- A statement indicating that the practitioner has no responsibility for the completeness or accuracy of the information provided to the practitioner
- A statement restricting the use of the report to the client and the department
- A statement describing any arrangements to involve a specialist

## Management Representations

**.21** Although AT section 201 does not require a practitioner to obtain a representation letter from management in an agreed-upon procedures engagement, when performing the engagement described in this SOP, it is recommended that the practitioner obtain such a letter, and that it generally be signed by the appropriate members of management including the highest-ranking officer responsible for the carrier's compliance with the requirements of NJAC 11:22-1. Management's refusal to furnish written representations that the practitioner has determined to be appropriate for the engagement constitutes a limitation on the performance of the engagement that requires either modification of the report or withdrawal from the engagement. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.22** The representations that a practitioner deems appropriate will depend on the specific nature of the engagement; however, they ordinarily include the following representations from management:

- A statement acknowledging responsibility for compliance with the requirements of NJAC 11:22-1 and responsibility for the information in the carrier's annual claims prompt payment report
- A statement that there have been no errors or fraud that might indicate that the carrier is not in compliance with the requirements of NJAC 11:22-1 and that there are no known matters (or that management has disclosed to the practitioner all known matters) that contradict the information in the carrier's annual claims prompt payment report
- A statement that management has disclosed to the practitioner any communications from regulatory agencies relating to the carrier's annual claims prompt payment report
- A statement that management has made available to the practitioner all information it believes is relevant to the carrier's annual claims prompt payment report
- A statement that management has responded fully to all inquiries made by the practitioner during the engagement

- A statement that no events have occurred subsequent to the date as of which the procedures were applied that would require modification of the findings of the agreed-upon procedures

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.23** An illustrative representation letter is presented in appendix C (paragraph .29), "Illustrative Management Representation Letter," of this SOP. For additional information regarding management's written representations in an agreed-upon procedures engagement, see paragraphs .37–.39 of AT section 201.

## Restriction on the Performance of Procedures

**.24** As previously stated, a practitioner should not agree to eliminate any of the procedures presented in appendix B (paragraph .28) of this SOP. If circumstances impose restrictions on the performance of the agreed-upon procedures, the practitioner should attempt to obtain agreement from the specified users for modification of the agreed-upon procedures presented in appendix B (paragraph .28) of this SOP. When such agreement cannot be obtained, the practitioner should describe the restriction(s) on the performance of procedures in his or her report or withdraw from the engagement.

## Dating the Report

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

## Effective Date

**.26** This SOP is effective upon issuance and is applicable only to agreed-upon procedures engagements that report on annual claims prompt payment reports as required by the NJAC.

## Appendix A—Illustrative Agreed-Upon Procedures Report

The following is an illustrative agreed-upon procedures report based on the guidance in AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*).

### Independent Accountant's Report on Applying Agreed-Upon Procedures

To the Management of ABC Carrier:

We have performed the applicable procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position (SOP) 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*, which were agreed to by ABC Carrier and the New Jersey Department of Banking and Insurance (the department), solely to assist you in complying with the reporting requirements of New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1.9 (NJAC 11:22-1.9) for Appendix B 20XX Annual Report (Exhibit I) for the year ended December 31, 20XX. Management of ABC Carrier is responsible for compliance with the requirements of NJAC 11:22-1. 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 ABC Carrier and the department. Consequently, we make no representation regarding the sufficiency of the procedures described in the attached Appendix either for the purpose for which this report has been requested or for any other purpose.

The procedures performed and the findings are included in the attached Appendix.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on ABC Carrier's compliance with the requirements of NJAC 11:22-1 for the year ended December 31, 20XX. 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 management of ABC Carrier and the State of New Jersey Department of Banking and Insurance, and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

## Appendix B—Agreed-Upon Procedures That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code

<i>Procedures</i>	<i>Findings</i>		
	<i>No Exception</i>	<i>Exception</i>	<i>N/A</i>
<p>The following procedures were applied to the ABC Carrier's 20XX Appendix B annual claims prompt payment report.</p> <p>We obtained supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report, and for each of the five categories (physician, dental, other health care professional, hospital, or other health care facilities), where applicable, compared the number of claims and the amount of claims for each quarter and the annual period from the supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report to the following columns of the report:</p> <ul style="list-style-type: none"> <li>• Total claims</li> <li>• Denied ineligible</li> <li>• Denied document</li> <li>• Denied coding/enrollment</li> <li>• Denied for amount</li> <li>• Time limit special</li> <li>• Time limit other</li> <li>• Denied referred fraud</li> <li>• Interest paid</li> <li>• Interest amount paid</li> <li>• Total paid</li> </ul> <p>We selected 10 percent of the claims from ABC Carrier's supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report, with the selections distributed throughout the year. If 10 percent of the claims exceeded 50, then the number of items selected was limited to 50. If 10 percent of the claims resulted in less than 10 claims, then the number of items selected was 10, and for each item selected we:</p> <p>1. Compared the following information to ABC Carrier's claim payment system:</p> <ul style="list-style-type: none"> <li>• Paid amount</li> <li>• Claim finalization or payment date</li> <li>• Claim received date</li> <li>• Denial code</li> </ul>			

*Findings*

***Procedures***

***No  
Exception    Exception    N/A***

- Claim category (physician, dental, other health care professional, hospital, or other health care facilities)

2. Compared the following information to the original claim information submissions:

- Date received
- Amount billed
- Category (physician, dental, other health care professional, hospital, or other health care facilities)

3. Noted whether, per ABC Carrier's member records, original claim information submission, or both, the claim related to a policy issued in the state of New Jersey

4. If a selected claim was denied, compared denial reason indicated in ABC Carrier's claims system records to supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report

5. If a selected claim is a "clean claim," as defined in NJAC 11:22-1.2, and as determined by ABC Carrier, recalculated the amount of interest paid on the selected claim in accordance with the requirements of NJAC 11:22-1.5

We selected 10 claims from ABC Carrier's primary claims system, with the selections distributed throughout the year, and for each item selected, traced the selected claims covered under New Jersey contracts to the supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report.

We proved the arithmetic accuracy of ABC Carrier's 20XX Appendix B annual claims prompt payment report.

**Description of Exceptions if Any**

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## Appendix C—Illustrative Management Representation Letter

[ABC Carrier's Letterhead]

[Date]

[CPA Firm's Name and Address]

In connection with your engagement to apply the agreed-upon procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position (SOP) 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*, which were agreed to by ABC Carrier and the New Jersey Department of Banking and Insurance, solely to assist us in complying with the requirements of New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1 (NJAC 11:22-1.9), for Appendix B 20XX Annual Report (Exhibit I) for the period from January 1, 20XX through December 31, 20XX, we confirm, to the best of our knowledge and belief, the following representations made to you during your engagement:

1. We are responsible for compliance with the requirements of NJAC 11:22-1 and for the information in ABC Carrier's annual claims prompt payment report.
2. During the year ended December 31, 20XX, there have been no errors or fraud that would indicate that ABC Carrier is not in compliance with the requirements of NJAC 11:22-1.
3. We have disclosed to you all known matters contradicting the information in ABC Carrier's annual claims prompt payment report.
4. There have been no communications from regulatory agencies relating to ABC Carrier's annual claims prompt payment report, including communications received between December 31, 20XX, and the date of this letter.
5. We have made available to you all information that we believe is relevant to ABC Carrier's annual claims prompt payment report.
6. We have responded fully to all inquiries made to us by you during the engagement.

To the best of our knowledge and belief, no events have occurred subsequent to December 31, 20XX, and through the date of this letter that would require adjustment to or modification of the findings of the agreed-upon procedures.

[Signature]

[Title]

[Signature]

[Title]

**New Jersey Annual Claims**

**Prompt Payment Reports Task Force**

JEFF MUZIO, *Chair*  
CRAIG C. ANDERSON  
JOHN D. HARRIS  
JOHN LANGIONE

NANCY LOFREDO  
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The AICPA is grateful to Jean Connolly, James S. Gerson, and Kim Hekker, for their technical assistance with this document.

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## AUD Section 35

# Statement of Position 04-1 Auditing the Statement of Social Insurance

November 22, 2004

### NOTICE TO READERS

This AICPA Statement of Position (SOP) is currently undergoing significant revision by a task force of the Auditing Standards Board to

- reflect the provisions of Statement of Federal Financial Accounting Standards (SFFAS) 36, *Reporting Comprehensive Long-Term Fiscal Projections for the U.S. Government*, which requires that a financial projection be presented as required supplemental information in the consolidated financial report of the U.S. Government for years 2010, 2011, and 2012, after which time the financial projection becomes a basic financial statement;
- reflect the requirements and guidance in AT section 301, *Financial Forecasts and Projections* (AICPA, *Professional Standards*); and
- expand the scope of the SOP to include the projection required by SFFAS 36 and perhaps other long-term projections.

As part of this revision, the task force is also reflecting the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 122–126. The revisions to this SOP will be reflected in a subsequent update of AICPA *Technical Practice Aids*.

### NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA Social Insurance Task Force to provide guidance regarding the audits of statements of social insurance prepared in accordance with the standards of the Federal Accounting Standards Advisory Board (FASAB). Audits of federal government agencies are also governed by *Government Auditing Standards* (the Yellow Book) and applicable Office of Management and Budget (OMB) guidance.

This SOP is recognized as an interpretive publication as defined in AUC section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications

*(continued)*

are recommendations on the application of generally accepted auditing standards (GAAS) in specific circumstances, including engagements for entities in specialized industries.

An interpretive publication is issued under the authority of the AICPA Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. The members of the ASB have found this SOP to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

## Introduction

**.01** The Federal Accounting Standards Advisory Board (FASAB) establishes accounting standards for reporting information about the following social insurance programs:

- a. Old-Age Survivors and Disability Insurance (OASDI or Social Security)
- b. Medicare ([Hospital Insurance [HI] and Medicare Supplementary Medical Insurance [SMI])
- c. Railroad Retirement benefits
- d. Black Lung benefits
- e. Unemployment Insurance

**.02** FASAB standards require the financial statements of the federal agencies responsible for the Social Security, Medicare, Railroad Retirement, and Black Lung programs and the financial statements of the federal government-wide entity to present a statement of social insurance as a basic financial statement. FASAB standards require these agencies and the government-wide entity to report:

- a. The estimated present value of the income to be received from or on behalf of the following groups during a projection<sup>1</sup> period sufficient to illustrate the long-term sustainability of the social insurance programs:
  - (1) Current participants who have not yet attained retirement age
  - (2) Current participants who have attained retirement age

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<sup>1</sup> The AICPA Guide *Prospective Financial Information* (guide) defines the term *projection* and differentiates it from the term *forecast*. In this Statement of Position (SOP), the term *projection* is used in its generic sense, as it is used in standards issued by the Financial Accounting Standards Advisory Board (FASAB) and the federal agencies that administer social insurance programs. The use of the term *projection* in this SOP is not intended to suggest that information presented in the statement of social insurance is a projection as defined in the guide or that the provisions of the guide would apply to the audit of the statement of social insurance.

- (3) Individuals expected to become participants
- b. The estimated present value of the benefit payments to be made during that same period to or on behalf of the groups listed in item *a*
- c. The estimated net present value of the cash flows during the projection period (the income described in item *a* over the expenditures described in item *b*, or the expenditures described in item *b* over the income described in item *a*)
- d. In notes to the statement of social insurance:
- (1) The accumulated excess of all past cash receipts, including interest on investments, over all past cash disbursements within the social insurance program represented by the fund balance at the valuation date
  - (2) An explanation of how the net present value referred to in item *c* is calculated for the closed group<sup>2</sup> (Paragraph 27(3)(i) of Statement of Federal Financial Accounting Standards [SFFAS] No. 17, *Accounting for Social Insurance*, identifies the information to be included in this explanation.)
  - (3) Comparative financial information for items *a*, *b*, *c*, and *d(1)* for the current year and for each of the four preceding years
  - (4) The significant assumptions used in preparing the estimates

**.03** The income, expenditures, and net present value of cash flows recognized in the statement of social insurance differ from traditional concepts of income and expenditures for retirement and health benefit programs. Financial reporting for social insurance programs includes estimates of income and expenditures not only for current program participants but also for individuals expected to become participants in social insurance programs in the future. In paragraphs 26–28 of the basis for conclusions section of SFFAS No. 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*, FASAB acknowledges this difference and explains why the recognition of such amounts is essential to the fair presentation of federal financial statements:

26. The Board believes that the SOSI [statement of social insurance] should be treated as a basic financial statement because it is essential to fair presentation and is important to achieve the objectives of federal financial reporting. The related stewardship objectives include helping users to assess the impact on the country of the Government's activities, determine whether the Government's financial position improved or deteriorated over the period, and predict whether future budgetary resources will likely be sufficient to sustain public services and meet obligations as they come due. In that regard, the multi-trillion dollar obligations associated with Social Insurance over the next 75 years could significantly exceed the largest liabilities currently recognized in the U.S. Government Balance Sheet.

27. The Board acknowledges that there is great uncertainty inherent in long term projections, but believes that if the uncertainty is suitably disclosed—as is required by SFFAS 17—it need not preclude designating the information as

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<sup>2</sup> The *closed group* is defined as those persons who, as of a valuation date, are participants in a social insurance program as beneficiaries, covered workers, or payers of earmarked taxes or premiums.

a basic financial statement, essential for fair presentation in conformity with GAAP...

28. Even within the context of historical financial reporting, the Board notes that accrual-basis "historical" financial statements include many measurements that involve assumptions about the future. The distinction between reporting on the financial effects of events that have occurred and the effects of future events depends, obviously, upon the definition of the event. The information required by SFFAS 17 reports on the financial effects of existing law and demographic conditions and assumptions, just as the pension obligation at a point in time is based on existing conditions. In that sense, Social Insurance information can be viewed as reflecting events that have occurred and, therefore, as "historical."

## Applicability

.04 This Statement of Position (SOP) provides guidance to auditors in auditing the statement of social insurance for the following social insurance programs:

- a. Old-Age Survivors and Disability Insurance (OASDI or Social Security)
- b. Medicare (Hospital Insurance [HI] and Medicare Supplementary Medical Insurance [SMI])
- c. Railroad Retirement benefits
- d. Black Lung benefits

As permitted by AU section 543, *Part of Audit Performed by Other Independent Auditors*, a principal auditor may fulfill the requirements of this SOP by using work that other independent auditors have performed in conformity with the provisions of this SOP. For example, for the OASDI program, the auditor of the federal government-wide financial statements may use the work and report of the auditor of the Social Security Administration's statement of social insurance.

## Management's Responsibilities

.05 The agency's management (management) is responsible for preparing the statement of social insurance and the estimates underlying it in conformity with generally accepted accounting principles. In doing so, management must determine its best estimate<sup>3</sup> of the economic and demographic conditions that will exist in the future. Because estimates in the statement of social insurance are based on subjective as well as objective factors, management must use judgment to estimate amounts included in the statement of social insurance. Management's judgment ordinarily is based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist. Management is responsible for the accuracy and completeness of the statement of social insurance.

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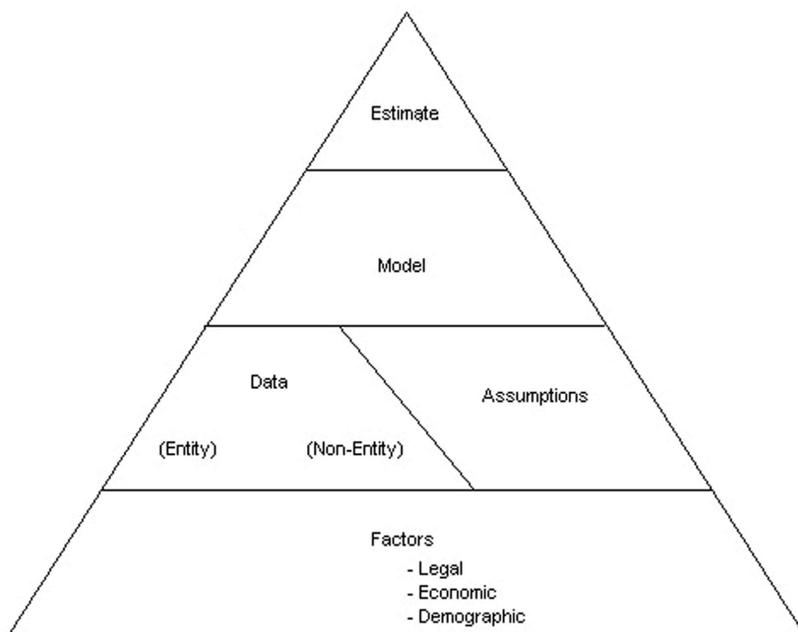
<sup>3</sup> Paragraph 25 of FASAB Statement of Federal Financial Accounting Standards (SFFAS) No. 17, *Accounting for Social Insurance*, states, in part, "The projections and estimates used should be based on the entity's best estimates of demographic and economic assumptions, taking each factor individually and incorporating future changes mandated by current law." Certain agencies prepare social insurance information using assumptions prepared by a board of trustees. Auditors should consider such assumptions to represent the agency's "best estimates" if the trustees have characterized them as such, and agency management has determined them to be reasonable. With respect to these assumptions, the auditor should perform audit procedures that are consistent with the guidance in paragraphs .09–.35 of this SOP.

## Preparing Social Insurance Estimates

**.06** Management is responsible for preparing the estimates underlying the statement of social insurance. That process ordinarily consists of:

- a. Identifying the relevant factors that may affect the estimates
- b. Developing assumptions that represent management's best estimate of circumstances and events with respect to the relevant factors
- c. Accumulating relevant, sufficient, and reliable data on which to base the estimates
- d. Determining the estimated amounts based on assumptions and other relevant factors
- e. Determining that the estimates are presented in conformity with generally accepted accounting principles and that disclosure is adequate

## Conceptual Model



**Figure 1: Elements of the Process of Developing Social Insurance Estimates**

**.07** Figure 1, "Elements of the Process of Developing Social Insurance Estimates," is a conceptual model depicting the elements of the process that results in the statement of social insurance. It is not intended to depict the<sup>4</sup> actual

<sup>4</sup> Office of Management and Budget (OMB) Circular No. A-123, *Management Accountability and Control*, section II, "Establishing Management Controls," states, in part, "...documentation for transactions, management controls, and other significant events must be clear and readily available for examination."

process used by an organization to develop the statement of social insurance. With the assistance of internal and external specialists, management considers, identifies, and documents factors, assumptions, and data that serve as input to a model for developing estimates. The factors, data, assumptions, and models used to develop the statement of social insurance are closely interrelated and may not be separable. Following are definitions of the terms used in figure 1:

- a. *Factors.* The elements or variables that affect income or expenditures for a program and for which data must be gathered and assumptions must be generated, for example, legal, economic, and demographic factors. An example of a factor is the number of individuals reaching age 65 in a specific year.
- b. *Assumptions.* Expectations about what will happen in the future. An example of an assumption is that there will be a 1 percent increase in the number of women working outside the home in each of the next five years. An assumption is expressed as a value or direction assigned to a factor.
- c. *Data.* Organized factual information used for analysis or to make decisions. An example is census data and classifications of that data, such as the population classified by sex or age. Data may be developed within the entity that prepares the statement of social insurance or it may come from sources outside the entity.
- d. *Models.* Methods or formulas for mathematically expressing how the assumptions and data relate to each other. For example, a model might indicate that a 1 percent decline in the birth rate in a given year will result in a 0.2 percent decrease in social insurance income and benefit payments 10 years later. A model is a set of coded instructions, rules, or procedures used to perform a desired sequence of events or to obtain a result. Typically, models are developed by using various computer applications.
- e. *Estimates.* The amounts or valuations that result after processing the factors, data, and assumptions in a model. These estimates will be used in preparing the statement of social insurance.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Designing and Implementing Internal Control Related to Estimates

**.08** Controls that are designed and implemented in a manner consistent with Standards for Internal Control in the Federal Government issued by the Government Accountability Office help ensure the accuracy and completeness of the statement of social insurance. An entity's internal control may reduce the likelihood of material misstatements of financial statement assertions involving estimates. Among the aspects of internal control that are relevant to the process of developing estimates are the following:

- a. Management communication of the need for proper estimates
- b. Accumulation of relevant, sufficient, and reliable data on which to base accounting estimates
- c. Preparation of the estimates by qualified personnel
- d. Adequate review and approval of the estimates by appropriate levels of authority, for example:
  - (1) Review of the sources of the relevant factors

- (2) Review of the process used to develop assumptions
  - (3) Review of the reasonableness of the assumptions and resulting estimates
  - (4) Consideration of the need to use the work of specialists
  - (5) Consideration of changes in previously established methods for developing estimates
- e. Comparison of prior estimates with actual subsequent results to assess the reliability of the process and models used to develop the estimates
  - f. Appropriate general and application controls related to computer-based models used in the calculation of estimates included in the statement of social insurance

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## The Auditor's Responsibility

**.09** Paragraph .10 of AU section 342, *Auditing Accounting Estimates*, states that the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches to evaluate the reasonableness of an estimate:

- a. Review and test the process used by management to develop the estimate.
- b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- c. Review subsequent events or transactions occurring prior to the date of the auditor's report.

In auditing the statement of social insurance, if controls over the estimation process are effective, the most practicable and efficient approach may be to review and test the process used by management. However, if the auditor finds that controls over the estimation process are ineffective, the auditor should consider whether it is practicable to:

- Develop an independent expectation of the estimate, or portions of the estimate, to corroborate management's estimate
- or
- Obtain sufficient appropriate audit evidence from outside the audited agency's process that would support the assertions in the statement of social insurance.

If it is not practicable to mitigate the effects of the ineffective controls through substantive procedures such as these, the auditor's report on the statement of social insurance should be modified. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.10** The auditor's objective when auditing the statement of social insurance is to obtain sufficient appropriate audit evidence to provide reasonable assurance that:

- a. The estimates presented in the statement of social insurance are reasonable in the circumstances.

- b. The statement of social insurance is presented fairly, in all material respects, in conformity with generally accepted accounting principles, including adequate disclosure.

Paragraphs .11–.43 of this SOP describe how the auditor achieves this objective. As discussed in footnote 9 of paragraph .19, if the auditor does not possess the level of competence in actuarial science to qualify as an actuary, it is necessary for the auditor to obtain the services of an independent actuary<sup>5</sup> to assist the auditor in planning and performing auditing procedures. Generally, the auditor will need the assistance of an independent actuary in performing various procedures during all phases of the audit and related to all elements of the estimates. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Obtaining an Understanding of the Entity and Its Environment, Including Its Internal Control

.11 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires the auditor to 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. [Paragraph added, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.12 The procedures the auditor performs to obtain the required understanding are known as *risk assessment procedures*. In an audit of the statement of social insurance, the auditor's risk assessment procedures should include

- a. obtaining knowledge about the agency and its environment including the following matters:
  - (1) The agency's program and its operations including relevant laws and regulations governing the program that have a direct and material effect on the statement of social insurance (paragraphs .13–.14)
  - (2) The agency's process for developing, evaluating, and incorporating estimates in the statement of social insurance (paragraph .15)
  - (3) The work performed by the agency's actuary (paragraphs .16–.20)
  - (4) The work performed and findings reported by any external review groups that have been commissioned by the

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<sup>5</sup> The actuary can either be under contract with the audit firm or employed by the audit firm. In either case, the actuary performing services for the audit firm would need to meet the independence standards of generally accepted governmental auditing standards (GAGAS), which are applicable to audits of statements of social insurance. For example, for actuaries under contract with the audit firm, the auditor should determine whether the actuary's firm is independent of the agency being audited and then assess the actuary's ability to impartially perform the work and report results. In conducting this assessment, the auditor should provide the actuary with the GAGAS independence requirements and obtain representations from the actuary regarding his or her independence from the audited entity. For actuaries employed by the audit firm, the independence requirements are the same as those for auditors. Paragraphs 3.06–.18 of chapter 3, "General Standards," *Government Auditing Standards: 2003 Revision* (GAO-03-673G) describe applicable independence requirements.

- agency, an appropriate advisory board, or the trustees<sup>6</sup> (paragraph .21).
- b. considering materiality (paragraphs .22–.23).
  - c. obtaining an understanding of the agency's internal control as it relates to the preparation of the statement of social insurance (paragraphs .24–.27).
  - d. assessing the risk of material misstatement of the financial statements (paragraphs .28–.29).<sup>7</sup>
  - e. performing further audit procedures (paragraphs .30–.35).

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

### ***Obtaining Knowledge About the Agency's Program and Its Operations***

**.13** Relevant knowledge about the program and its operations includes the following:

- a. The nature of the program's activities
- b. The source of its funding
- c. Who the beneficiaries are

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.14** An important aspect of the program and its operations are the laws and regulations governing the program that may have a direct and material effect on amounts reported as social insurance income and expenditures. To obtain the laws and regulations governing the operation of the social insurance program, the auditor may request them from agency management. Through inquiry of management, the auditor may obtain information about

- a. the laws and regulations that significantly affect the determination of amounts included in the statement of social insurance and
- b. how management has given effect to changes in laws and to new regulations published in final form in determining future social insurance income and expenditures.

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

### ***Obtaining Knowledge About the Agency's Process for Developing, Evaluating, and Incorporating Estimates in the Statement of Social Insurance***

**.15** The auditor should obtain knowledge about the agency's process for developing, evaluating, and incorporating estimates in the statement of social

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<sup>6</sup> Certain social insurance programs are overseen by a board of trustees. For example, the Social Security Act establishes a board of trustees to oversee the financial operations of the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund. The board is composed of six members, four of whom serve automatically by virtue of their positions in the federal government: the Secretary of the Treasury (the managing trustee), the Secretary of Labor, the Secretary of Health and Human Services, and the Commissioner of Social Security. The other two members are appointed by the President and confirmed by the Senate to serve as public representatives.

<sup>7</sup> The auditor generally would conclude that inherent risk is high for assertions about estimates in the statement of social insurance because of the complexity of such estimates and the need for significant judgment in preparing them. Other factors that may affect inherent risk in auditing the statement of social insurance include the political climate surrounding social insurance programs, budget limitations, and economic conditions.

insurance. Procedures the auditor may perform to obtain that knowledge include the following:

- a. Making inquiries of management; individuals responsible for initiating, processing, or recording estimates; and internal and external specialists with expertise in relevant subject matter, such as actuarial science, economics, and law.
- b. Reading entity or nonentity documents and records used to prepare the statement of social insurance, as well as the agency's documentation of the process for preparing the statement of social insurance.
- c. Observing entity activities and operations used to prepare the statement of social insurance, such as transferring data from a tabulation report to a computerized application.

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

### ***Obtaining Knowledge About the Work Performed by the Agency's Actuary***

**.16** Information presented in the statement of social insurance ordinarily is determined on the basis of an actuarial valuation of the program performed or reviewed by the agency's actuary, using data received from sources inside and outside the agency, and actuarial techniques. Paragraph .12 of AU section 336, *Using the Work of a Specialist*, states the following:

The auditor should (a) obtain an understanding of the methods and assumptions used by the specialist, (b) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (c) evaluate whether the specialist's findings support the related assertions in the financial statements.

[Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.17** The auditor's qualifications do not encompass actuarial science or the complexities of probability and longevity associated with social insurance income and expenditures. The auditor may have a general awareness and understanding of actuarial concepts and practices; however, he or she does not purport to act in the capacity of an actuary. The auditor, therefore, should follow the guidance in AU section 336 to obtain assurance regarding the work of an actuary on such matters as program income and benefit payments. [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.18** An audit of the statement of social insurance requires cooperation and coordination between the auditor and the actuary. The auditor uses the work of the actuary as an audit procedure to obtain sufficient appropriate audit evidence; the auditor does not merely rely on the report of an actuary. Although the appropriateness and reasonableness of the methods and assumptions used, as well as their application, are within the expertise of the actuary, the auditor does not divide responsibility with the actuary for his or her opinion on the financial statements taken as a whole. Thus, the auditor should satisfy himself or herself as to the professional qualifications and reputation of the actuary as well as the actuary's objectivity, and should obtain an understanding of the actuary's methods and assumptions, test data provided to the actuary, and consider whether the actuary's findings support the related representations in the financial statements. [Paragraph renumbered and revised, June 2009, to

reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.19** If the actuary who has prepared or reviewed the actuarial valuation of the social insurance program was engaged by the agency administering that program, it is necessary for the auditor to obtain the services of an independent actuary<sup>8</sup> to assist the auditor in performing auditing procedures that assess the agency actuary's methods, assumptions, and estimates, and aid the auditor in determining whether the agency actuary's findings are not unreasonable in the circumstances.<sup>9</sup> *Government Auditing Standards*, which are applicable to audits of statements of social insurance, provide independence requirements and examples of personal, external, and organizational impairments to independence. [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.20** The auditor should document (a) the specific audit procedures that were performed with the assistance of an independent actuary, and the related findings and conclusions, (b) the relationship between the procedures performed with the assistance of an independent actuary and the auditor's assessments of audit risk and materiality, and (c) all other significant matters related to the objectives and scope of the independent actuary's work, including any limitations on the independent actuary's procedures. [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

### ***Obtaining Knowledge About the Work Performed by External Review Groups***

**.21** In some cases, the agency responsible for the preparation of the statement of social insurance or the program's trustees may commission the services of an external review group comprising technical experts in relevant fields to review the factors, assumptions, data, estimates, and models used to prepare the statement of social insurance. In many instances, individuals assigned to perform these reviews are recognized authorities in their respective fields of study. Because of the nature of these external review groups and the qualifications of the individuals typically assigned to them, information about the work performed by the external review group, how its findings are communicated to the agency, and how the agency has responded to these findings are relevant to an audit of the statement of social insurance.<sup>10</sup> See paragraph A-18c of the appendix of this SOP, entitled "Illustrative Controls and Audit Procedures," for examples of inquiries the auditor may make of management to obtain knowledge about the work performed by external review groups. [Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

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<sup>8</sup> See footnote 5.

<sup>9</sup> Although paragraph .11 of AU section 336, *Using the Work of a Specialist*, does not preclude the auditor from using the work of a specialist who is related to the client, because of the significance of the estimates of income and expenditures to the statement of social insurance, and the complexity and subjectivity involved in developing such estimates, auditing estimates in the statement of social insurance requires the use of an outside actuary, that is, an actuary who is not employed or managed by the agency. If the auditor has the requisite knowledge and experience in actuarial science, the auditor may serve as the actuary. If the auditor does not possess the level of competence in actuarial science to qualify as an actuary, the auditor should use the work of an independent outside actuary.

<sup>10</sup> Although reviews by external review groups may not be conducted annually, in auditing the statement of social insurance the auditor should obtain and review the most recent report of such external review groups.

### **Considering Materiality**

**.22** The auditor's determination 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. Auditors should design audit procedures to obtain reasonable assurance of detecting misstatements that, either individually or when aggregated with other misstatements, could be material to the financial statements taken as a whole. Auditors should exercise due professional care when setting the materiality base, carefully assessing the information gained from risk assessment procedures and the needs of users of the financial statements. [Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.23** For certain federal agencies, amounts reported in the statement of social insurance may vary significantly from the amounts reported in the other basic financial statements, or may differ significantly on a qualitative basis. In such cases, it may not be appropriate to establish a single materiality threshold for the entire set of financial statements. Instead, the auditor should consider using a separate materiality level when planning and performing the audit of the statement of social insurance and related disclosures. [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

### **Obtaining an Understanding of the Agency's Internal Control**

**.24** AU section 314 defines internal control as a process—effected by those charged with governance, an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of the entity's objectives with regard to (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations. [Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.25** In auditing the statement of social insurance, the auditor should obtain a sufficient understanding of the agency's internal control by performing risk assessment procedures to evaluate the design of the agency's controls relevant to an audit of the statement of social insurance and to determine whether those controls have been implemented. The auditor should use this knowledge to

- a. identify types of potential misstatements.
- b. consider factors that affect the risks of material misstatement.
- c. design tests of controls, when applicable, and substantive procedures.

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**[.26]** [Paragraph renumbered and deleted, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.27** Internal control consists of the following five interrelated components:

- a. *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.

- b. 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.
- c. *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.
- d. *Control activities* are the policies and procedures that help ensure that management directives are carried out.
- e. *Monitoring* is a process that assesses the quality of internal control performance over time.

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. [Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

### **Assessing the Risks of Material Misstatement**

**.28** Using the information gained from the auditor's risk assessment procedures, the auditor should identify and assess the risks of material misstatement for assertions in the statement of social insurance. [Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.29** The risk of material misstatement of estimates ordinarily varies with the complexity and subjectivity of the process, the availability and reliability of the relevant data, the number and significance of assumptions that are made, and the degree of uncertainty associated with the assumptions. [Paragraph added, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

### **Performing Further Audit Procedures**

**.30** The auditor should design further audit procedures, including tests of the operating effectiveness of controls, where relevant or necessary, and substantive procedures, whose nature, timing, and extent are responsive to the assessed risks of material misstatement at both the financial statement and the relevant assertion level. [Paragraph added, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.[31]** [Paragraph renumbered and deleted, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.32** AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, states that the auditor should perform tests of controls when the auditor's risk assessment 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. However, when auditing the statement of social insurance, the complexity and subjectivity of the estimates, the volume of data involved, and the importance of controls ordinarily would make performing only substantive tests an ineffective strategy.<sup>11</sup> [Paragraph renumbered and

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<sup>11</sup> OMB Bulletin No. 01-02 states that "For those internal controls that have been properly designed and placed in operation, the auditor shall perform sufficient tests to support a low assessed level of control risk."

revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[.33] [Paragraph renumbered and deleted, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[.34] [Paragraph renumbered and deleted, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.35 As indicated in paragraph .09 of this SOP, in evaluating the reasonableness of the estimates in the statement of social insurance, the auditor primarily reviews and tests the process used by management. The appendix of this SOP contains examples of

- a. procedures the auditor performs to obtain knowledge about the agency's process for developing, evaluating, and incorporating estimates in the statement of social insurance.
- b. controls that are relevant to an agency's preparation of the statement of social insurance. (The auditor should obtain an understanding of the design of such controls and determine whether they have been placed in operation.)
- c. procedures the auditor performs to test controls, assess control risk, and test assertions in the statement of social insurance.

[Paragraph added, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

### **Testing the Work of the Agency's Actuary**

.36 When auditing estimates and considering the related factors, assumptions, data, and models, the auditor should obtain the services of an actuary in accordance with AU section 336.<sup>12</sup> [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.37 With respect to the actuarial present value of amounts reported in the statement of social insurance, the auditor, in following the guidance in AU section 336, should

- a. read the agency actuary's actuarial report.
- b. evaluate the professional qualifications, competence, and objectivity of the agency's actuary. Examples of factors that should be considered are the actuary's membership in a recognized professional organization and the opinion of other actuaries, whom the auditor knows to be qualified, regarding the actuary's professional qualifications.
- c. obtain an understanding of the actuary's objectives, scope of work, methods, and assumptions, and their consistency of application. The Actuarial Standards Board establishes Actuarial Standards of Practice (ASOPs) that identify what the actuary should consider, document, and disclose when performing an actuarial assignment. The auditor may consult the ASOPs in obtaining an understanding of the methods and assumptions used in the valuation of the social insurance program.<sup>13</sup> Management, not the actuary, is responsible for the assumptions made and methods used.

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<sup>12</sup> See footnote 9.

<sup>13</sup> Relevant standards include Actuarial Standards of Practice No. 21, *The Actuary's Responsibility to the Auditor*, No. 23, *Data Quality*, and No. 32, *Social Insurance*.

- d. test the reliability and completeness of the data provided by the agency and used by the actuary in the actuarial valuation. (See paragraphs A-11–A-14 in the appendix to this SOP.) For example, laws or regulations governing program operations can affect the determination of the data or methods to be used in the actuarial calculations. In testing the reliability and completeness of the data, the auditor may inquire as to whether the actuarial valuation considers all pertinent provisions of laws and regulations governing program operations, including any changes in laws or regulations affecting the actuarial calculations since the date of the latest statement of social insurance. In the event that data provided to the actuary are significantly incomplete, the auditor may inquire of the actuary about the treatment of the incomplete data and determine whether the method used by the actuary to give effect to the missing data in his or her valuation is reasonable in the circumstances.
- e. assess the nature and significance of any reservations concerning assumptions or data that the actuary has stated in his or her report.

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

### **Testing the Fund Balance**

.38 Paragraph 27(3)(h) of SFFAS No. 17 requires the agency to report "the accumulated excess of all past cash receipts, including interest on investments, over all past cash disbursements within the social insurance program represented by the fund balance at the valuation date." As noted in paragraph 26 of SFFAS No. 17, the valuation date for the statement of social insurance may differ from the valuation date for the other financial statements. Accordingly, the auditor should conduct appropriate testing of the accumulated cash receipts over the accumulated cash disbursements, as of the social insurance valuation date. The nature and extent of testing is a matter of professional judgment. Examples of procedures the auditor may perform are confirmation testing or roll-forward testing. [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

### **Obtaining Management's Representations**

.39 AU section 333, *Management Representations*, requires the auditor to obtain a representation letter from management confirming representations given to the auditor during the engagement, for example, a representation regarding the completeness of the information provided to the auditor. In an audit of the statement of social insurance, the representation letter should include, as applicable, the following representations:

- a. The actuarial assumptions and methods used to measure amounts in the statement of social insurance for financial accounting and disclosure purposes represent management's best estimates regarding future events based on demographic and economic assumptions, and future changes mandated by law.
- b. There were no material omissions from the data provided to the agency's actuary for the purpose of determining the actuarial present value of the estimated future income to be received, and estimated future expenditures to be paid during a projection period sufficient to illustrate the long-term sustainability of the

[name of the social insurance program] as of [dates of statements of social insurance presented].

- c. Management is responsible for the assumptions and methods used in the preparation of the statement of social insurance. Management of the agency agrees with the actuarial methods and assumptions used by the agency's actuary and has no knowledge or belief that would make such methods or assumptions inappropriate in the circumstances. Management did not give any instructions, nor cause any instructions to be given to the agency's actuary with respect to values or amounts derived, and is not aware of any matters that have affected the objectivity of the agency's actuary. Management believes that the actuarial assumptions and methods used to measure amounts in the statement of social insurance for financial accounting purposes are appropriate in the circumstances.
- d. The statement of social insurance covers a projection period sufficient to illustrate long-term sustainability of the social insurance program.
- e. Management has provided the auditor with all the reports developed by external review groups appointed by the agency or the program's trustees related to estimates in the statement of social insurance.
- f. The following matters relating to the statement of social insurance have been disclosed properly in the notes to the financial statements:
  - (1) The accumulated excess of all past cash receipts, including interest on investments, over all past cash disbursements within the social insurance program represented by the fund balance at the valuation date
  - (2) An explanation of how the net present value is calculated for the closed group<sup>14</sup> (Paragraph 27(3)(i) of SFFAS No. 17 identifies the information to be included in this explanation.)
  - (3) Comparative financial information for the items in paragraphs .02a, .02b, .02c, and .02d(1) of this SOP, for the current year and for each of the four preceding years
  - (4) Significant assumptions used in preparing the estimates
- g. There have been no changes in [or, Changes in the following have been properly recorded or disclosed in the financial statements]:
  - (1) The actuarial methods or assumptions used to calculate amounts recorded or disclosed in the financial statements between the valuation dates (that is, January 1, 20X8, and January 1, 20X7) or changes in the method of collecting data.
  - (2) The actuarial methods or assumptions used to calculate amounts recorded or disclosed in the financial statements between the valuation date and the financial reporting date (that is, January 1, 20X8, and September 30, 20X8) or changes in the method of collecting data.

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<sup>14</sup> The *closed group* is defined as those persons who, as of a valuation date, are participants in a social insurance program as beneficiaries, covered workers, or payers of earmarked taxes or premiums.

- h. There have been no changes in [or, Changes in the following have been properly recorded or disclosed in the financial statements]:
  - (1) Laws and regulations affecting social insurance program income and benefits between the valuation dates (January 1, 20X8, and January 1, 20X7).
  - (2) Laws and regulations affecting social insurance program income and benefits between the valuation date and the financial reporting date (that is, January 1, 20X8, and September 30, 20X8).
- i. Accounting estimates applicable to the financial information of the agency included in the statement of social insurance are based on management's best estimate, after considering past and current events and assumptions about future events.

[Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Reporting

.40 Because FASAB has defined the statement of social insurance as a basic financial statement, the auditor should report on it as a part of his or her report on the other basic financial statements. In addition to following the requirements of AU section 508, *Reports on Audited Financial Statements*, the auditor's report on a federal agency's financial statements that present a statement of social insurance should include the following elements:

- a. An opinion as to whether the statement of social insurance presents fairly, in all material respects, the financial condition<sup>15</sup> of the agency's social insurance program(s) as of the valuation date in conformity with generally accepted accounting principles.
- b. An explanatory paragraph following the opinion paragraph, describing that (i) the statement of social insurance presents the actuarial present value of the agency's estimated future income to be received from or on behalf of the participants and estimated future expenditures to be paid to or on behalf of participants during a projection period sufficient to illustrate long-term sustainability of the social insurance program; (ii) in preparing the statement of social insurance, management considers and selects assumptions and data that it believes provide a reasonable basis for the

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<sup>15</sup> In Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, the FASAB articulates a concept of *financial condition*, as distinct from *financial position*. Financial condition is broader and more forward-looking than financial position. Presenting information on financial condition is consistent with FASAB's financial reporting objective of stewardship. In illustrating how the stewardship objective aligns with the needs of users of federal financial statements, FASAB observes that,

All users need information on earmarked revenues recorded in trust funds. They want to know, for example, whether the Social Security Trust funds are likely, in the foreseeable future, to need infusions of new taxes to pay benefits. Citizens need to know the implications of investing trust fund revenues in government securities.

In reporting the actuarial present value of the estimated future income to be received, estimated future expenditures to be paid, and excess of income over expenditures during a projection period sufficient to illustrate the long-term sustainability of an agency's social insurance programs, and in disclosing in the notes to the financial statements comparative financial information for the five most recent years, the statement of social insurance presents the financial condition of the programs. Thus, in reporting on the statement of social insurance, the auditor refers to the financial condition of the agency's social insurance programs.

assertions in the statement; and (iii) because of the large number of factors that affect the statement of social insurance and the fact that future events and circumstances cannot be known with certainty, there will be differences between the estimates in the statement of social insurance and the actual results, and those differences may be material.

- c. Reference to any standards or regulations in addition to generally accepted auditing standards, such as *Government Auditing Standards*, that apply to audits of federal financial statements and any additional elements of the auditor's report that those standards or regulations require.

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.41 The following is an illustrative auditor's report for a statement of social insurance.

#### Independent Auditor's Report<sup>16</sup>

We have audited the accompanying consolidated balance sheets of XYZ Social Insurance Agency, as of September 30, 20X8 and 20X7, the related consolidated statements of net cost, of changes in net position and of financing; the combined statements of budgetary resources for the years then ended; and statements of social insurance as of January 1, 20X8, 20X7, 20X6, 20X5, and 20X4.<sup>17</sup> These financial statements are the responsibility of XYZ Social Insurance Agency'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; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. 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 previously present fairly, in all material respects, the financial position of XYZ Social Insurance Agency as of September 30, 20X8 and 20X7; its net cost of operations; changes in net position, budgetary resources, and financing for the year then ended; and the financial condition of its social insurance programs as of January 1, 20X8, 20X7, 20X6, 20X5, and 20X4, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, the statements of social insurance present the actuarial present value of the Agency's estimated future

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<sup>16</sup> Paragraphs .65–.74 of AU section 508, *Reports on Audited Financial Statements*, provide guidance on reporting on comparative financial statements, including guidance on reporting when there has been a change in auditors.

<sup>17</sup> The auditor's report on the statement of social insurance covers a period of five years (see paragraph 27(3)(j) of SFFAS No. 17); whereas, the auditor's report on the other financial statements covers a period of two years. In the first year's audit of the statement of social insurance, the auditor would only express an opinion on one year; in year two, the auditor would express an opinion on two years, and so on, until all five years were covered.

income to be received from or on behalf of the participants and estimated future expenditures to be paid to or on behalf of participants during a projection period sufficient to illustrate long-term sustainability of the social insurance program. In preparing the statements of social insurance, management considers and selects assumptions and data that it believes provide a reasonable basis for the assertions in the statements. However, because of the large number of factors that affect the statement of social insurance and the fact that future events and circumstances cannot be known with certainty, there will be differences between the estimates in the statement of social insurance and the actual results, and those differences may be material.

Accounting principles generally accepted in the United States of America require that Management's Discussion and Analysis (MD&A) and the Required Supplementary Information (RSI) be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Federal Accounting Standards Advisory Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the MD&A and RSI in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the MD&A and RSI because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

In accordance with *Government Auditing Standards*, we have also issued a report dated [report date] on our consideration of the agency's internal control and a report dated [report date] on its compliance with laws and regulations. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

[Signature]

[Date]

[Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120.]

**.42** The statement of social insurance does not articulate with the other basic financial statements. For that reason, the portion of the auditor's report that addresses the statement of social insurance ordinarily will not affect the auditor's report on the balance sheet or the statements of net costs, changes in net position, financing, or budgetary resources. The following illustrates a report in which the auditor disclaims an opinion on the statement of social insurance but expresses an unqualified opinion on the other financial statements.

#### Independent Auditor's Report

We have audited the accompanying consolidated balance sheets of XYZ Social Insurance Agency, as of September 30, 20X8 and 20X7, the related consolidated statements of net cost, of changes in net position and of financing, and the combined statements of budgetary resources for the years then ended, and we were engaged to audit the statements of social insurance as of January 1, 20X8, 20X7, 20X6, 20X5, and 20X4. These financial statements are the responsibility of XYZ Social Insurance Agency'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; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. 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.

*[Insert paragraph describing limitation on scope of the audits of the statements of social insurance.]*

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 statements of social insurance as of January 1, 20X8, 20X7, 20X6, 20X5, and 20X4.

In our opinion, the financial statements referred to previously present fairly, in all material respects, the financial position of XYZ Social Insurance Agency as of September 30, 20X8 and 20X7, its net cost of operations, changes in net position, budgetary resources, and financing for the year then ended in conformity with accounting principles generally accepted in the United States of America.

*[Omit explanatory paragraph required by paragraph .40(b) of this SOP.]*

*[Modify the paragraph reporting on Management's Discussion and Analysis and Required Supplementary Information for the effects of the scope limitations regarding the statement of social insurance on that information, considering the guidance in AU section 550, Other Information in Documents Containing Audited Financial Statements, AU section 551, Supplementary Information in Relation to the Financial Statements as a Whole, and AU section 552, Reporting on Condensed Financial Statements and Selected Financial Data.]*

*[Reference to reports on internal control and compliance with laws and regulations in accordance with the Government Auditing Standards is the same as in the illustration in paragraph .41 of this SOP.]*

*[Signature]*

*[Date]*

[Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120.]

**.43** If the agency that operates a social insurance program issues financial statements that purport to present financial position, net cost of operations, changes in net position, budgetary resources, and financing for the years then ended, but omits the related statements of social insurance, the auditor ordinarily will conclude that the omission requires qualification of the auditor's opinion in the following manner.

#### Independent Auditor's Report

We have audited the accompanying consolidated balance sheets of XYZ Social Insurance Agency, as of September 30, 20X8 and 20X7, the related consolidated statements of net cost, of changes in net position and of financing, and the

combined statements of budgetary resources for the years then ended. These financial statements are the responsibility of XYZ Social Insurance Agency's management. Our responsibility is to express an opinion on these financial statements based on our audits.

*[Same second paragraph as the standard report]*

The agency declined to present statements of social insurance as of January 1, 20X8, 20X7, 20X6, 20X5, and 20X4. Presentation of such statements describing the financial condition of its social insurance programs is required by accounting principles generally accepted in the United States of America.

In our opinion, except that the omission of the statements of social insurance results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to previously present fairly, in all material respects, the financial position of XYZ Social Insurance Agency as of September 30, 20X8 and 20X7; its net cost of operations; and changes in net position, budgetary resources, and financing for the year then ended in conformity with accounting principles generally accepted in the United States of America.

*[Omit explanatory paragraph required by paragraph .40(b) of this SOP.]*

*[Modify, in accordance with the guidance in paragraph .09 of AU section 558, Required Supplementary Information, the paragraph regarding Management's Discussion and Analysis and the Required Supplementary Information (RSI) for the omission of the RSI.]*

*[Reference to reports on internal control and compliance with laws and regulations in accordance with Government Auditing Standards is the same as in the illustration in paragraph .41 of this SOP.]*

*[Signature]*

*[Date]*

[Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120.]

## Effective Date and Transition

.44 This SOP is effective for audits of statements of social insurance for periods beginning after September 30, 2005. SFFAS No. 17 (subparagraph 27(3)(a-h)) requires disclosure of the information for the current year and for each of the four preceding years. Comparative information in the statement of social insurance that has not been audited should be marked as unaudited. Earlier implementation of the provisions of this SOP is permitted. [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Appendix

### Illustrative Controls and Audit Procedures

- A-1.** This appendix contains examples of:
- Procedures the auditor performs to obtain knowledge about the agency's process for developing, evaluating, and incorporating estimates in the statement of social insurance
  - Controls that are relevant to the agency's preparation of the statement of social insurance (The auditor should obtain an understanding of the design of such controls and determine whether they have been implemented.)
  - Procedures the auditor performs to tests controls and assertions in the statement of social insurance
- A-2.** The appendix is divided into the following five sections:
- Factors (paragraphs A-3–A-5)
  - Assumptions (paragraphs A-6–A-10)
  - Data (paragraphs A-11–A-14)
  - Models (paragraphs A-15–A-17)
  - Estimates (paragraphs A-18–A-20)

Each of these sections includes examples of the items described in paragraph A-1. The procedures and controls included in this appendix are illustrative and do not represent a complete list of procedures and controls.

#### Factors

- A-3.** In evaluating the reasonableness of an accounting estimate, the auditor ordinarily concentrates on key factors that are significant to the estimate, sensitive to variation, deviations from historical patterns, and subjective and susceptible to misstatement and bias. The following are examples of procedures the auditor performs to obtain knowledge about how the agency generates, evaluates, selects, and reviews factors to be included in estimates in the statement of social insurance:
- Identifying the individuals involved in generating, evaluating, selecting, and reviewing factors to be included in estimates in the statement of social insurance
  - Determining how factors affecting social insurance estimates are generated, evaluated, selected, and reviewed, and how that process is documented<sup>1</sup>
  - Reading documentation of the process for generating, evaluating, selecting, and reviewing estimates to be included in the statement of social insurance

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<sup>1</sup> Office of Management and Budget (OMB) Circular No. A-123, *Management and Accountability Control*, and No. A-127, *Financial Management Systems*, outline documentation requirements for manual and automated financial related transactions and systems.

- A-4.** The auditor should obtain a sufficient understanding of the entity's internal control 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. The following are examples of controls related to factors:
- a.* Management's process for monitoring the environment to determine the effect that change in the environment (for example, legal, political, health, immigration) might have on the factors considered
  - b.* Procedures to prevent or detect and correct the inadvertent omission of factors that should be considered in developing the estimate (an example of such a control would be comparing factors considered and selected in the current period with those of prior periods)
  - c.* Hiring procedures to ensure that individuals responsible for generating, evaluating, selecting, and reviewing factors have the appropriate education and experience
- A-5.** The following are examples of procedures the auditor performs to test controls and financial statement assertions related to factors:
- a.* Reviewing documentation of the factors considered in developing the estimate
  - b.* Evaluating whether the factors that have been considered are relevant and sufficient for the purpose of preparing the statement of social insurance
  - c.* Considering whether there are additional key factors that management has not addressed

### Assumptions

- A-6.** In evaluating the reasonableness of an accounting estimate, the auditor ordinarily concentrates on assumptions that are significant to the accounting estimate, sensitive to variation, deviations from historical patterns, and subjective and susceptible to misstatement and bias.
- A-7.** The following are examples of matters the auditor inquires about in discussions with management and other knowledgeable personnel to determine how the agency generates, evaluates, selects, and reviews assumptions to be included in estimates in the statement of social insurance:
- a.* The source of the assumptions for significant estimates<sup>2</sup>

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<sup>2</sup> For some agencies, the assumptions are established by an external board of trustees and provided to the agency. For example, for the Social Security program, the Social Security Act establishes a board of trustees to oversee the financial operations of the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund. The board is composed of six members, four of whom serve automatically by virtue of their positions in the federal government. They are the Secretary of the Treasury (the managing trustee), the Secretary of Labor, the Secretary of Health and Human Services, and the Commissioner of Social Security. The other two members are appointed by the President and confirmed by the Senate to serve as public representatives. In such circumstances, the auditor's procedures generally would focus on testing the work performed by the agency's actuary in reviewing the assumptions developed by the board of trustees. The agency's actuary reports on whether (a) the techniques and methodology used to evaluate the financial and actuarial status of the program is based upon sound principles of actuarial practice and are generally accepted within the actuarial profession; and (b) the assumptions used and the resulting actuarial estimates are, individually and in the aggregate, reasonable for the purpose of evaluating the financial and actuarial status of the trust funds, taking into consideration the past experience and future expectations for the population, the economy, and the program.

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- b.* How the assumptions underlying the estimates are documented
  - c.* The process for determining the best estimate (for example, intermediate) assumptions (possible outcomes)
  - d.* How management considers and determines the effect that variation in the underlying assumptions will have on the estimates
- A-8.** The following are examples of controls related to assumptions:
  - a.* The agency's documentation of the process used to generate, evaluate, select, and review assumptions
  - b.* How management monitors the environment for possible changes that might affect the assumptions used to develop estimates, for example, the need to consider alternative assumptions
  - c.* Comparing assumptions made in the current period with those of prior periods and reconciling differences
  - d.* Hiring procedures to ensure that personnel have the appropriate education and experience to meet job description requirements
- A-9.** The following are examples of procedures the auditor performs to test controls and financial statement assertions related to assumptions:
  - a.* Identifying the assumptions used and evaluating the reasonableness of those assumptions
  - b.* Determining whether data and other related information support the assumptions
  - c.* Evaluating whether interrelated assumptions are consistent with each other
  - d.* Comparing assumptions made by the entity to the range of assumptions made by entities in other industries, for example, insurance companies, financial institutions, or other government agencies, and evaluating the implications of significant differences
  - e.* Considering whether there are alternative assumptions about the factors
  - f.* Evaluating whether the assumptions selected are consistent with supporting data, relevant historical data, and industry data
  - g.* Reviewing available documentation of the assumptions used in developing the estimates
  - h.* Evaluating whether facts and informed judgment about past and future events or circumstances support the underlying assumptions
  - i.* Evaluating whether any of the significant assumptions are so subjective that no reasonably objective basis could exist to support the use of the assumption
  - j.* Inquiring of program managers regarding the reasonableness of assumptions that are related to the manager's realm of responsibility

- k.* Evaluating whether the assumptions appear to be complete, that is, whether assumptions have been developed for each key factor
  - l.* Considering whether the assumptions appear to be relatively objective, that is, are not unduly optimistic or pessimistic
  - m.* Evaluating whether the assumptions are consistent with the laws and regulations governing the program
  - n.* Evaluating whether the assumptions, individually and in the aggregate, make sense in the context of the statement of social insurance taken as a whole
  - o.* Evaluating whether significant assumptions are appropriately disclosed in the statement of social insurance
- A-10.** Assumptions that have no material effect on the statement of social insurance may not have to be individually evaluated; however, the aggregate effect of individually insignificant assumptions should be considered in making an overall evaluation of whether the assumptions underlying the reported amounts are reasonable.

### Data

- A-11.** The following are examples of matters the auditor inquires about in discussions with management and other knowledgeable personnel, and reads about in agency documentation to determine how the agency generates, evaluates, selects, and reviews data to be included in estimates in the statement of social insurance:
- a.* The source of the data for significant estimates and whether the data are developed internally or by outside parties
  - b.* How data are collected, maintained, processed, and updated
  - c.* How the data underlying the estimates are documented
- A-12.** The following are examples of controls related to data:
- a.* Controls over the accuracy and completeness of internally prepared data, for example, review of the data for reasonableness and consistency with other data, and general and application controls over the data such as edit checks and batch totals
  - b.* Controls that prevent or detect and correct errors in the collection, maintenance, processing, and updating of the data, for example, manual controls to ensure that data are accurately entered and uploaded to a computerized system
  - c.* Controls over the reliability of external sources of data, for example, confirming and verifying data by tracing and agreeing it to census information in reports prepared by the United States Census Bureau
  - d.* Procedures to identify and document authorized users of the system and to restrict access to the system, for example, the use of unique user passwords and periodic changes to those passwords

- e.* Preparation and review of a risk assessment on a regular basis or when a significant change occurs in either the internal or external physical environment
- f.* Preventive maintenance agreements or procedures for key system hardware components
- g.* On a regular basis, backing up software and data that are stored offsite
- h.* Restricting access to utility programs that can read, add, change, or delete data or programs to authorized individuals
- i.* Establishing procedures to ensure that original source documents are retained or are reproducible by the agency for an adequate amount of time to facilitate the retrieval or reconstruction of data

**A-13.** The following are examples of procedures the auditor performs to test controls and financial statement assertions related to data:

- a.* Evaluating whether the data used to develop the estimates are relevant, reliable, and sufficient for the purpose
- b.* Identifying the source of the data, that is, whether the data were developed by the agency or by an outside entity
- c.* Reviewing documentation of the data used to develop estimates
- d.* Determining whether data used to develop estimates are consistent with supporting data, historical data, and other related information. An example would be determining whether a positive or negative correlation exists between sets of data if such a correlation would be expected to exist
- e.* Evaluating the accuracy and completeness of internally prepared data
- f.* Tracing and agreeing internally prepared data to system output reports generated by the agency

**A-14.** In determining the extent of the procedures to be performed on data obtained from an external source, a factor to consider is whether the data are widely disseminated and used, or whether the data were developed for limited use. An example of data that are widely disseminated and used is a report prepared by the U.S. Census Bureau. For such data, the auditor may trace and agree the information to reports prepared by the U.S. Census Bureau. If management has made adjustments to data obtained from a widely disseminated and used external source, the auditor should evaluate:

- a.* Management's reason for adjusting the data
- b.* The accuracy and completeness of the adjustments to the externally obtained data
- c.* Management's documentation supporting the adjustment

For data meant for limited use, all other factors being equal, the auditor should confirm or otherwise verify data obtained from other federal agencies and other external sources that were used in the actuarial valuation. If management has made adjustments to data developed for limited use, the auditor should evaluate:

- a.* Management's reason for adjusting the data

- b. The accuracy and completeness of the adjustments to the externally obtained data
- c. Management's documentation supporting the adjustment

## Models

- A-15.** The following are examples of procedures the auditor performs to obtain knowledge about how the agency generates, evaluates, selects, and reviews models used to develop estimates included in the statement of social insurance:
- a. Inquiring of management and other knowledgeable personnel about how they design or select the model used for the development of estimates and how they document that model
  - b. Inquiring of management and other knowledgeable personnel about how they determine the effect that variations in the underlying assumptions have on the estimates
- A-16.** The following are examples of controls related to models:
- a. General and application controls related to the model, such as controls over input to the model and processing of that input
  - b. Controls that prevent or detect and correct errors in the development and processing of the model
  - c. Controls that prevent or detect and correct unauthorized access or changes to the model, for example, an access control table that is a component of the system and prohibits unauthorized users from accessing and changing the model. An example of a detective control is an audit log that tracks any changes made to the model
  - d. Controls designed to ensure that the information contained in the statement of social insurance and related disclosures conforms to generally accepted accounting principles
  - e. Designating responsibility for significant information resources within the agency (for example, data and programs) and establishing and maintaining security over such resources
  - f. Comparing existing system security features to documented system security requirements
  - g. Assigning responsibility to individuals in a manner that ensures that no single individual has the authority to read, add, change, or delete information without an independent review of that activity
  - h. Subjecting hardware and software acquisitions and implementations to extensive testing prior to acceptance in production
- A-17.** The following are examples of procedures the auditor performs to test controls and financial statement assertions related to models:
- a. Reviewing documentation that describes the instructions, rules, or procedures used in the model to calculate estimates
  - b. Reperforming calculations used in the model to translate the assumptions, data, and factors into the estimate

- c. Reviewing management's documentation of its sensitivity analysis and considering whether the results are consistent with the auditor's expectations
- d. If available, comparing the results of the model with the results of models used by other organizations for reasonableness

### Estimates

**A-18.** The following are examples of matters the auditor inquires about in discussions with management and other knowledgeable personnel to determine how the agency generates, evaluates, selects, and reviews estimates to be included in the statement of social insurance:

- a. How management obtains the expertise to develop and evaluate estimates in the statement of social insurance, including hiring procedures, professional development activities, and procedures for engaging outside specialists
- b. Who has final authority for reviewing and approving estimates
- c. The work performed by external review groups, their findings, and how those findings are used by the agency, for example:
  - (1) The scope and timing of the work performed by external review groups
  - (2) The composition of external review groups and the qualifications of the members
  - (3) Whether the external review groups are independent of the agency
  - (4) Whether the external review groups issued formal reports including findings or recommendations

**A-19.** The following are examples of controls related to estimates:

- a. Procedures related to the review and implementation of recommendations developed by external review groups
- b. General and application controls related to estimates, such as evidence of supervisory and management review of estimates and supporting documentation
- c. Controls intended to ensure that the information contained in the statement of social insurance and related notes conforms to Federal Accounting Standards Advisory Board (FASAB) guidance
- d. Controls related to the supervision of individuals who develop estimates, and the review of those estimates and supporting documentation
- e. Controls to regularly verify that personnel developing estimates are qualified to perform those tasks based on their education, training, and experience, as required

**A-20.** The following are examples of procedures the auditor performs to test controls and financial statement assertions related to estimates:

- a. Developing a trend analysis in which one period is compared to the next period

- b. Determining whether the information in the statement of social insurance, including related disclosure, is supported by sufficient, competent evidential matter
- c. Comparing the estimated future expenditures predicted by the actuarial model to actual expenditures for the previous fiscal year
- d. Evaluating the reasonableness of the time period covered by the statement of social insurance. FASAB standards require that the statement of social insurance cover a projection period sufficient to illustrate long-term sustainability of the social insurance program

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

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**AUD Section 40*****Statement of Position 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***

October 15, 2007

**NOTE**

This AICPA Statement of Position (SOP) has been developed by the AICPA Chief Compliance Officers Task Force of the AICPA Auditing Standards Board (ASB) to provide guidance regarding the application of Statements on Standards for Attestation Engagements (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 (including business development companies), investment advisers, or other service providers (user organizations). A practitioner's report on the suitability of the design and operating effectiveness of a service provider's controls in achieving specified compliance control objectives is used primarily by user organizations because aspects of a user organization's compliance or internal control over compliance with laws, regulations, and rules may be affected by or include controls at service providers.

This SOP is recognized as an attestation interpretation as defined in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Attestation interpretations are recommendations on the application of SSAEs in specific circumstances, including engagements for entities in specialized industries. Attestation interpretations are issued under the authority of the ASB. The members of the ASB have found this SOP to be consistent with existing SSAEs.

A practitioner should be aware of and consider attestation interpretations applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions of this SOP.

## Introduction and Background

.01 In December 2003, the Securities and Exchange Commission (SEC) adopted Rule 38a-1 under the Investment Company Act of 1940 and Rule 206(4)-7 under the Investment Advisers Act of 1940. The rules were adopted to protect investors by ensuring that (a) each investment company registered with the SEC under the Investment Company Act of 1940, and each business development company<sup>1</sup> (collectively, funds) has an internal program to enhance compliance with federal securities laws<sup>2</sup> and (b) each investment adviser registered with the SEC has an internal program to enhance compliance with the Investment Advisers Act of 1940, including SEC rules issued thereunder.

.02 Many operations of funds and, in some instances, operations of investment advisers are carried out by entities that provide services to the funds or investment advisers. In this Statement of Position (SOP), such entities are termed *service providers*. Service providers have their own compliance policies and procedures that may affect or be part of a fund's or investment adviser's compliance or internal control over compliance with federal securities laws, individual statutes or provisions thereof, or corresponding SEC rules (*federal securities laws or elements thereof*).<sup>3</sup> Rule 38a-1 requires each fund to adopt and implement written policies and procedures reasonably designed to prevent violation of federal securities laws by the fund or any of the following service providers named in the rule: investment advisers, principal underwriters, administrators, and transfer agents. Accordingly, a fund's compliance policies and procedures provide for oversight of the compliance procedures performed by the named service providers. Further, Rule 206(4)-7 requires an investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violation by the investment adviser and its supervised persons of the Investment Advisers Act of 1940 and SEC rules issued thereunder. In this SOP, the term *service providers* refers to the service providers named in Rule 38a-1 as well as other service providers, such as custodians. The term *user organization* generally refers to a fund or investment adviser that uses the services of a service provider. In some instances, a single entity may be a service provider *and* a user organization. For example, Administrator A, in its capacity as a service provider to a fund, may be responsible for monitoring whether the fund's registration statement filed with the SEC complies with SEC disclosure requirements, but may subcontract that function to Administrator B that specializes in that area. In this situation, Administrator A is also a user organization because it uses the services of Administrator B. In this SOP, Administrator B is referred to as a *subservice provider*. In applying the guidance in this SOP, a subservice provider is considered a service provider.

.03 Among other provisions, the rules mentioned in paragraph .01 require funds and investment advisers to

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<sup>1</sup> A business development company is a closed-end investment company that, among other requirements, has elected to be subject to the provisions of certain sections of the Investment Company Act of 1940.

<sup>2</sup> Rule 38a-1 defines *federal securities laws* to include the Securities Act of 1933, the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002, the Investment Company Act of 1940, the Investment Advisers Act of 1940, Title V of the Gramm-Leach-Bliley Act, any rules adopted by the Securities and Exchange Commission (SEC) under any of these statutes, the Bank Secrecy Act as it applies to funds, and any rules adopted thereunder by the SEC or the Department of the Treasury.

<sup>3</sup> In this Statement of Position (SOP), *federal securities laws or elements thereof* is defined as federal securities laws (see footnote 2), individual statutes or provisions thereof, or corresponding SEC rules.

- adopt and implement written policies and procedures<sup>4</sup> reasonably designed to prevent violation of, in the case of funds, federal securities laws and, in the case of investment advisers, the Investment Advisers Act of 1940, including SEC rules issued thereunder.
- review those policies and procedures at least annually for their adequacy and the effectiveness of their implementation.<sup>5</sup>
- designate a chief compliance officer (CCO) to be responsible for administering the policies and procedures (for funds, the CCO must report directly to the fund's board of directors).

.04 SEC Release Nos. IC-26299 and IA-2204 adopting the rules note that it may be impractical for a fund or its CCO to directly review all of its named service providers' policies and procedures, particularly if one or more of the service providers are not affiliated with the fund. In these circumstances, the SEC considers the fund to have satisfied the requirements of Rule 38a-1 if the fund's board of directors, in evaluating whether to approve the service provider's compliance program, uses a "third-party report" on the service provider's policies and procedures.<sup>6</sup> In the United States fund industry, in connection with the audit of a fund's financial statements, a number of service providers are accustomed to engaging an independent auditor to report on the suitability of the design and operating effectiveness of controls at the service provider that may be relevant to the fund's internal control over financial reporting. These engagements are performed under AT section 801, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*), and reports issued thereunder are used by the funds' independent auditor when auditing the fund's financial statements. Similarly, since the adoption of the rules in December 2003, service providers have received requests from funds and investment advisers for information and assurance regarding the suitability of the design and operating effectiveness of the service provider's controls in achieving compliance control objectives. Also, in some circumstances, subservice providers (service providers that provide services to other service providers, for example, a service organization that reports fund share balances and transactions of retirement plan participants, in aggregate, to a fund's transfer agent and maintains records thereof) have received similar requests from service providers. Such information assists funds and investment advisers in fulfilling their responsibilities to perform an annual review of specified compliance activities and assists service providers and subservice providers in their consideration of their own controls. [Revised, August 2011, to reflect conforming changes necessary due to the issuance of SSAE No. 16.]

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<sup>4</sup> Rule 38a-1 and Rule 206(4)-7 use the term *policies and procedures* to refer to the principles and activities an entity adopts and implements to prevent violation of federal securities laws or elements thereof. In this SOP, the term *controls* is used to refer to the policies and procedures an entity adopts and implements to achieve specified compliance control objectives.

<sup>5</sup> The annual review requirement is imposed upon the fund or investment adviser. Specifically, the rules do not require the fund or adviser to engage an independent accountant to attest to management's annual review or to perform a separate evaluation of any aspect of the fund's or investment adviser's compliance policies and procedures. Further, the rules do not require that the annual review employ a specific framework or methodology for evaluating the effectiveness of a fund's or investment adviser's compliance policies and procedures. Lastly, there is no requirement that annual or other compliance reports prepared by chief compliance officers of funds or investment advisers be filed with the SEC; however, the SEC may request such reports in connection with their inspection and examination programs of funds and investment advisers or in other circumstances.

<sup>6</sup> The SEC release states that the third party report must describe the service provider's compliance program as it relates to the types of services provided to the fund, discuss the types of compliance risks material to the fund, and assess the adequacy of the service provider's compliance controls. Information produced as a result of an engagement covered by this SOP may be used by the fund, in part, to meet these provisions. The report must be provided to the fund no less frequently than annually.

.05 Specific information about the rules is provided in "Compliance Programs of Investment Companies and Investment Advisers," which can be accessed at the United States SEC website at [www.sec.gov/rules/final/ia-2204.htm](http://www.sec.gov/rules/final/ia-2204.htm). The following is a table that briefly summarizes significant provisions of the rules. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

<b>SEC Rule and (Section Number)</b>	<b>Rule 38a-1 (§17 CFR 270.38a-1)</b>	<b>Rule 206(4)-7 (§17 CFR 275.206(4)-7) and Amendments to Rule 204-2 (§17 CFR 275.204-2)</b>
<b>Applicable entity</b>	<b>Investment companies and business development companies (funds) must:</b>	<b>Investment advisers must:</b>
<b>Nature of the policies and procedures to be adopted and implemented</b>	Adopt and implement written policies and procedures reasonably designed to prevent violation of federal securities laws by the fund, including policies and procedures that provide for oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent (named service providers) of the fund.	Adopt and implement written policies and procedures reasonably designed to prevent violation, by the investment adviser and persons supervised by the investment adviser, of the Investment Advisers Act of 1940 and the SEC rules issued thereunder.
<b>Board approval of policies and procedures</b>	Obtain approval by the fund's board of directors of the fund's policies and procedures and those of each of the named service providers.	
<b>Annual review of policies and procedures</b>	Review, no less frequently than annually, (1) the adequacy of the policies and procedures of the fund and each of the named service providers and (2) the effectiveness of their implementation.	Review, no less frequently than annually, (1) the adequacy of the policies and procedures established pursuant to the rule and (2) the effectiveness of their implementation.

<p><b>SEC Rule and (Section Number)</b></p>	<p><b>Rule 38a-1 (§17 CFR 270.38a-1)</b></p>	<p><b>Rule 206(4)-7 (§17 CFR 275.206(4)-7) and Amendments to Rule 204-2 (§17 CFR 275.204-2)</b></p>
<p><b>Applicable entity</b></p>	<p><b>Investment companies and business development companies (funds) must:</b></p>	<p><b>Investment advisers must:</b></p>
<p><b>Individual responsible for administering policies and procedures</b></p>	<p>Designate an individual to be the fund's chief compliance officer (CCO), responsible for administering the policies and procedures adopted under paragraph (a) (1) of the rule. The designation and compensation of the CCO must be approved by the fund's board of directors, and the CCO may be removed only by action and approval of the fund's board of directors.</p>	<p>Designate an individual (who is a supervised person) to be the adviser's CCO, responsible for administering the policies and procedures that are adopted under paragraph (a) of the rule.</p>
<p><b>Report to the board of directors</b></p>	<p>The CCO must provide a written report to the fund's board of directors, no less frequently than annually, that addresses at a minimum:</p> <ul style="list-style-type: none"> <li>• The operation of the fund's policies and procedures and those of each of the named service providers, any material changes made to those policies and procedures since the last report, and any material changes to the policies and procedures recommended as a result of the annual review.</li> </ul>	

*(continued)*

SEC Rule and (Section Number)	Rule 38a-1 (§17 CFR 270.38a-1)	Rule 206(4)-7 (§17 CFR 275.206(4)-7) and Amendments to Rule 204-2 (§17 CFR 275.204-2)
Applicable entity	Investment companies and business development companies (funds) must:	Investment advisers must:
	<ul style="list-style-type: none"> <li>• Each <i>material compliance matter</i><sup>7</sup> that occurred since the date of the last report.</li> </ul> <p>After the initial report, subsequent CCO reports are expected to cover the period since the date of the last report.</p>	

## Objective of the Examination Engagement

**.06** Because federal securities laws encompass a significantly comprehensive set of obligations and responsibilities, the compliance control objectives presented by management of the service provider ordinarily would not include all conceivable compliance control objectives related to federal securities laws or elements thereof. Also, although Rule 38a-1 requires a fund's CCO to include in the fund's annual compliance report information concerning any material compliance matter(s) that occurred during the relevant period, the objective of the examination engagement described in paragraphs .01–.33 of this SOP is not to identify and report any material compliance matter(s) that may have existed at the service provider during the period covered by the practitioner's report. Rather, the objective of the examination engagement described in paragraphs .01–.33 of this SOP is for the practitioner to report on the suitability of the design (at the end of a specified period) and the operating effectiveness (during the specified period) of the service provider's controls in achieving the compliance control objectives specified by management of the service provider.

**.07** AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), allows a practitioner to report on either management's assertion or on the subject matter to which it relates.<sup>8</sup> Paragraph .64 of AT section 101 indicates that

<sup>7</sup> SEC Rule 38a-1 defines a *material compliance matter* as any compliance matter about which the fund's board of directors would reasonably need to know to oversee fund compliance and that involves, without limitation, (a) a violation of federal securities laws (as defined in Rule 38a-1) by the fund, its investment adviser, principal underwriter, administrator, or transfer agent (or officers, directors, employees, or agents thereof); (b) a violation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator, or transfer agent; or (c) a weakness in the design or implementation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator, or transfer agent.

<sup>8</sup> When conditions exist that individually or in combination result in one or more material misstatements or deviations from the criteria, to most effectively communicate with the reader of the report, the practitioner should ordinarily express his or her conclusion directly on the subject matter, not on the assertion.

when the practitioner reports on an assertion, the assertion should either be (a) bound with or accompany the practitioner's report or (b) clearly stated in the practitioner's report. In view of the intended use of the information produced in connection with examination engagements covered by this SOP, practitioners are strongly encouraged to report on management's assertion rather than on the subject matter to ensure that management's assertion will be available to users of the report.

## Subject Matter of the Examination Engagement

.08 The examination engagement described in paragraphs .01–.33 of this SOP should be performed in accordance with AT section 101. AT section 101 enables a practitioner to design an engagement and report on subject matter (or an assertion thereon) other than financial statements. The subject matter of the engagement described in paragraphs .01–.33 of this SOP is the suitability of the design and operating effectiveness of a service provider's controls directed at achieving specified compliance control objectives. Use of the practitioner's examination report is restricted to the CCOs, management, boards of directors, and independent auditors of the service provider and of the entities that use the services of the service provider because these users would be expected to have the requisite knowledge and familiarity with the service provider's organization to understand the context of the examination report. [Revised, June 2009, to reflect conforming changes due to the issuance of recent authoritative literature.]

## Management's Responsibilities

.09 In an examination engagement in which the practitioner reports on the suitability of the design and operating effectiveness of controls to achieve specified compliance control objectives, management of the service provider is responsible for

- a. specifying compliance control objectives and related controls that are relevant to the services provided to user organizations and their internal control over compliance with federal securities laws or elements thereof.
- b. preparing and providing the practitioner with a written description of the specified compliance control objectives and related controls referred to in paragraph .09a (see appendix A-4 [paragraph .41] of this SOP, "Illustrative Service Provider's Description of Specified Compliance Control Objectives and Related Controls"). If applicable, the written description should include the applicable information described in paragraphs .16–.17 of this SOP concerning compliance control objectives and related controls of subservice providers.
- c. preparing and providing the practitioner with a written assertion regarding the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives<sup>9</sup> (see appendix A-3 (paragraph .40) of this SOP for an illustrative management assertion). The criteria management use in evaluating the suitability of the design and operating effectiveness of the controls included in management's description and in

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<sup>9</sup> Paragraph .09 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), states that a practitioner should ordinarily obtain a written assertion in an examination engagement, whether reporting on the subject matter or reporting on a written assertion.

making its assertion are the specified compliance control objectives.

- d. identifying and presenting a list of user control considerations if the application of controls by user organizations is necessary to achieve the specified compliance control objectives. In certain circumstances, a service provided by a service provider may be designed with the assumption that certain controls will be implemented by user organizations. For example, the service may be designed with the assumption that user organizations will have controls in place for authorizing transactions before they are sent to the service provider for processing. If such user controls are required to achieve the stated compliance control objectives, the service provider should describe them either in its written description or in a separate list accompanying the description.
- e. preparing and providing the practitioner with a representation letter that ordinarily includes the items listed in paragraph .26a-j of this SOP.

## Criteria

.10 Paragraph .23 of AT section 101 states, in part, that "The practitioner must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable...." Paragraph .24 of AT section 101, in turn, indicates that suitable criteria must have each of the following attributes: objectivity, measurability, completeness, and relevance. In the examination engagement covered by this SOP, the criteria to be used to evaluate the suitability of the design and operating effectiveness of the controls are the specified compliance control objectives. The practitioner should consider whether the language used by management to describe the specified compliance control objectives included in the written description is sufficiently precise to permit people having competence in and using the same measurement criterion to ordinarily obtain materially similar measurements (paragraph .29 of AT section 101). Consequently, practitioners should not perform an engagement covered by this SOP if the criteria are so subjective or vague that reasonably consistent measurements, qualitative or quantitative, of the subject matter cannot ordinarily be obtained. For example, the following compliance control objective ordinarily would be too subjective for evaluation:

Advertising and sales literature is frequently and properly reviewed.

The following revision of this control objective improves its objectivity and measurability:

At the end of each quarter, advertising and sales literature is reviewed by the service provider's compliance officer for conformity with the service provider's written policies.

Furthermore, although this SOP does not require all service providers to present identical compliance control objectives for similar business activities or services (for example, transfer agency and fund administration) included in the scope of the attestation engagement, compliance control objectives or elements thereof that pertain to those business activities or services and are relevant to user organizations should not be omitted if management of the service provider or the practitioner becomes aware of deficiencies in the suitability of the design or operating effectiveness of controls that would prevent the achievement of such objectives. See also related guidance in paragraphs .12b and .21–.22 of

this SOP. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Reference to Laws, Regulations, and Rules

.11 The written description of specified compliance control objectives and related controls prepared by management of the service provider should not include general or broad references<sup>10</sup> to federal securities laws or elements thereof that might imply that the specified compliance control objectives completely address or directly correspond to such laws or elements thereof. Such references may mislead user organizations and others because most laws, regulations, and rules contain numerous and detailed provisions, all of which may not be addressed by the compliance control objectives and related controls. Management of the service provider may, however, include a citation from such federal securities laws or elements thereof within the specified compliance control objective, in the written description, if the citation is sufficiently specific. An example is a citation containing the specific section or subsection of the law, regulation, or rule corresponding to the specified compliance control objective as in "For money market mutual funds, investments are monitored on a weekly basis for compliance with the portfolio maturity and quality provisions of SEC Rule 2a-7c.2 and 2a-7c.3, respectively."

## Practitioner's Responsibilities

.12 For the practitioner to express an opinion on the suitability of the design<sup>11</sup> and operating effectiveness of a service provider's controls in achieving specified compliance control objectives, the practitioner should

- a. obtain an understanding of the nature of the services provided by the service provider to user organizations and determine whether the specified compliance control objectives included in management's description are relevant to the services provided. Methods for obtaining an understanding of the services provided include
  - reading representative contracts between the service provider and user organizations, marketing or other material provided to user organizations, reports developed by internal auditors, and correspondence to and from regulatory authorities; and
  - making inquiries of management and other service provider personnel.
- b. obtain a written description prepared by management of the service provider of the specified compliance control objectives and related controls that are relevant to the services provided to user organizations and their internal control over compliance with federal securities laws or elements thereof (see appendix A-4 (paragraph .41) of this SOP, "Illustrative Service Provider's Description of Specified Compliance Control Objectives and Related

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<sup>10</sup> For example, the written description should not include a table that aligns the specified compliance control objectives with generally or broadly described federal securities laws or elements thereof. Such a presentation could cause readers to incorrectly conclude that the specified control objectives address all provisions of the federal securities laws or elements thereof referenced in the table.

<sup>11</sup> A control is suitably designed if individually, or in combination with other controls, it is likely to prevent or detect errors that could result in the nonachievement of specified compliance control objectives when the described controls are complied with satisfactorily.

Controls"). If the practitioner concludes that the description is materially misstated or misleading in the circumstances, the practitioner should inform the service provider's management and request that the description be amended. If management refuses to amend the description in a manner that addresses the practitioner's concerns, the practitioner should consider withdrawing from the engagement.

- c. consider the linkage between the controls and the specified compliance control objectives and the ability of the controls to prevent or detect errors related to the specified compliance control objectives.
- d. obtain sufficient appropriate evidence regarding the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives. Procedures to obtain evidence regarding the suitability of the design and implementation of relevant controls may include inquiry of appropriate service provider personnel, observation of the application of specific controls, inspection of documents and reports, and tracing transactions relevant to the subject matter of the engagement through the service provider's applicable information and communication systems. Inquiry alone is not sufficient to evaluate the design of a control relevant to an examination engagement and to determine whether it has been implemented. In testing the operating effectiveness of controls, the practitioner should obtain evidence about how the controls were applied at relevant times during the period under examination, the consistency with which they were applied, and by whom or what means they were applied. Tests of the operating effectiveness of controls ordinarily include the same types of procedures used to evaluate the design and implementation of controls, and may also include reperformance of the application of the control by the practitioner. Since inquiry alone is not sufficient, the practitioner should use a combination of procedures to obtain sufficient appropriate evidence regarding the operating effectiveness of controls.
- e. ordinarily, obtain a written assertion prepared by management of the service provider regarding the suitability of the design and operating effectiveness of the service provider's controls in achieving the specified compliance control objectives (see appendix A-3 [paragraph .40] of this SOP for an illustrative management assertion). As noted in paragraph .07 of this SOP, to ensure that management's assertion will be available to users of the report, practitioners are strongly encouraged to report on management's written assertion rather than on the subject matter, except when a deficiency or deficiencies in controls exist that, individually or in combination, result in the nonachievement of one or more specified compliance control objectives.
- f. obtain a representation letter from management that ordinarily would include the items in paragraph .26a-j of this SOP.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.13** Ordinarily, for the examination engagement described in this SOP, the relevant aspects of a service provider's internal control over compliance pertaining to its control environment, risk assessment, and monitoring would not be presented in the form of compliance control objectives; however, management

of the service provider is not precluded from doing so. The practitioner should perform tests of the relevant aspects of the service provider's control environment, risk assessment, and monitoring that relate to the services provided and should assess their effectiveness in establishing, enhancing, or mitigating the effectiveness of specific controls. If there are weaknesses in relevant aspects of the control environment, risk assessment, and monitoring the practitioner should consider an appropriate response. For example, modifying his or her procedures to obtain more persuasive evidence about the operating effectiveness of the controls and whether the specified compliance control objectives have been achieved. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Matters Addressed by the Compliance Control Objectives

**.14** As noted in paragraph .06, because federal securities laws encompass a significantly comprehensive set of obligations and responsibilities, management's description ordinarily would not include all conceivable compliance control objectives related to federal securities laws or elements thereof.

**.15** Unless the compliance control objectives have been designated by an outside party, such as a regulatory authority or a user group, management of the service provider is responsible for specifying the compliance control objectives and related controls that are the subject of the engagement. In establishing the compliance control objectives and related controls, management of the service provider should consider

- a. the nature of the services provided to user organizations.
- b. the service provider's contractual obligations to user organizations.
- c. the information and assurance needs of user organizations, including the relevancy of the compliance control objectives and related controls to the services provided to user organizations and their internal control over compliance with federal securities laws or elements thereof.<sup>12</sup>

Further, when circumstances permit, discussions between management of the service provider and user organizations are advisable in determining the compliance control objectives intended to address the needs of user organizations.

**.16** Service providers may have contractual or other arrangements with one or more subservice providers or other parties that perform administrative, computer operations, transaction processing, recordkeeping, or other activities on their behalf. In these circumstances, management of the service provider determines whether the subservice provider's relevant control objectives and related controls are to be included or excluded from its written description of specified compliance control objectives and related controls. Although the inclusive method provides more information to user organizations, it may not be appropriate or feasible in many or all instances. In determining which approach to use, management of the service provider should consider (a) the nature and extent of information about the subservice provider from which user organizations would derive benefit, (b) the degree of responsibility management would assume by including information about the subservice organization in its description

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<sup>12</sup> See SEC Release Nos. IC-26299 and IA-2204 adopting Rules 38a-1 and 206(4)-7, respectively (Section II.A., *Adoption and Implementation of Policies and Procedures*).

and accompanying written assertion, and (c) the practical difficulties entailed in implementing the inclusive method. Whether the subservice provider's relevant control objectives and related controls are included or excluded from the written description, the description should include a brief statement of the functions and nature of the services performed by the subservice provider. Ordinarily, disclosure of the identity of the subservice provider is not required. If, however, management of the service provider determines that the identity of the subservice provider would be relevant to user organizations, the name of the subservice provider may be included in the written description provided that there are no prohibitions against doing so, by contract or otherwise, and any necessary approvals have been obtained by the service provider. Also, when included, the written description should clearly differentiate between controls of the service provider and controls of the subservice provider.

**.17** If the subservice provider's relevant compliance control objectives and related controls are excluded, management of the service provider should state in the written description that the subservice provider's compliance control objectives and related controls are omitted from the description and, unless achievement of the compliance control objectives depends on controls at the subservice provider, that the compliance control objectives included in the written description include only those objectives that the service provider's controls are intended to achieve. Reporting guidance for situations in which the service provider excludes the subservice provider's compliance control objectives and related controls from the service provider's written description is presented in paragraph .31 of this SOP.

**.18** As noted in paragraph .13, ordinarily in the examination engagement described in this SOP, the relevant aspects of a service provider's internal control pertaining to its control environment, risk assessment, and monitoring would not be presented in the form of compliance control objectives; however, management of the service provider is not precluded from presenting those aspects in the form of compliance control objectives.

## Evaluating Deficiencies in Controls

**.19** Paragraph .24 of AT section 101 states, in part, that criteria are the standards or benchmarks against which the practitioner evaluates the subject matter. In this SOP, the criteria used by the practitioner to evaluate the suitability of the design and operating effectiveness of the controls included in management's description are the specified compliance control objectives. The practitioner should evaluate the results of the procedures he or she performed to obtain sufficient appropriate evidence about the suitability of the design and operating effectiveness of the controls and determine the significance of any identified deficiencies in controls, individually and in combination, to the achievement of the specified compliance control objectives. 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 always be met. A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**.20** The following are examples of factors that are relevant in evaluating the significance of identified deficiencies in controls:

- The existence of effective compensating controls that have been tested and evaluated and limit the severity of the deficiency
- The significance of the control(s) to achieving the compliance control objective
- The existence of multiple deficiencies in controls that, in combination, may be significant to the achievement of a compliance control objective, even if the deficiencies are individually insignificant to the achievement of the compliance control objective

The practitioner may conclude that the specified compliance control objective has been achieved even if a deficiency or deficiencies in controls have been identified. However, if, after performing his or her procedures, the practitioner concludes that the specified compliance control objective was not achieved, the practitioner should modify his or her report. See paragraph .29 of this SOP for related reporting guidance.

## User Organizations Affected by a Service Provider's Noncompliance With Federal Securities Laws or Elements Thereof

**.21** In the course of performing procedures at a service provider, a practitioner may become aware of a matter or matters constituting noncompliance with federal securities laws or elements thereof (including material compliance matters) that occurred during the period covered by the practitioner's report and relate to business activities or services included in the scope of the attestation engagement. Unless the instance(s) of noncompliance are clearly inconsequential, the practitioner should obtain an understanding of

- the nature of the noncompliance matter(s),
- the cause(s) of such,
- the period during which the noncompliance matter(s) existed or occurred, and
- the nature of any remediation activities taken to subsequently achieve compliance or the status of any remediation activities the service provider plans to take to achieve compliance.

**.22** Further, the practitioner should determine whether information about the noncompliance matter(s) has been communicated to affected user organizations. If management of the service provider has not communicated this information and is unwilling to do so, and the practitioner believes the nature of the noncompliance matter(s) could be significant to user organizations, the practitioner should inform management and those charged with governance of the service provider of the circumstances. If management and those charged with governance of the service provider do not respond in an appropriate manner, the practitioner should consider withdrawing from the engagement. The practitioner generally is not required to confirm with the user organizations that the service provider has communicated such information. If the user organizations have been notified in writing, the practitioner may request a copy from the service provider of the written communication. In all cases, judgment should be used by the practitioner in considering the effect, if any, of all information obtained about the noncompliance matter(s) on (a) the written assertion provided by management of the service provider regarding the suitability of the design and operating effectiveness of controls in achieving the specified compliance control objectives; and (b) the practitioner's procedures and report. [Revised,

June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Management Assertion

**.23** Paragraph .08 of AT section 101 defines an assertion as any declaration or set of declarations about whether the subject matter is based on or in conformity with the criteria selected. Paragraph .09 of AT section 101 provides the practitioner with additional information about a written assertion. For the examination engagement described in this SOP, whether reporting directly on the subject matter or on the assertion, the practitioner should ordinarily obtain a written assertion from management of the service provider regarding the suitability of the design and operating effectiveness of the service provider's controls in achieving the specified compliance control objectives. Appendix A-3 (paragraph .40) of this SOP contains an illustrative management assertion.

**.24** Management's assertion regarding the suitability of the design and operating effectiveness of the controls should specify the "as of" date and period covered by management's assertion. The determination of an appropriate period is at the discretion of management; however, to be useful to user organizations, the assertion and related practitioner's report ordinarily covers a minimum reporting period of six months. The following are examples of factors that are relevant in establishing the reporting period:

- The anticipated needs of users of the report
- The degree and frequency of changes in the service provider's controls related to the specified compliance control objectives
- The period needed to provide sufficient and appropriate evidence regarding the operating effectiveness of the controls

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Management Representations

**.25** Paragraphs .59–.60 of AT section 101 state, in part:

59. During an attest engagement, the responsible party makes many representations to the practitioner, both oral and written, in response to specific inquiries or through the presentation of subject matter or an assertion. Such representations from the responsible party are part of the evidential matter the practitioner obtains.

60. Written representations from the responsible party ordinarily confirm representations explicitly or implicitly given to the practitioner, 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. Accordingly, in an examination or a review engagement, a practitioner should consider obtaining a representation letter from the responsible party.

**.26** The representations that a practitioner considers appropriate generally will depend on the subject matter and circumstances of the engagement. In addition to obtaining management's written assertion about the suitability of the design and operating effectiveness of the service provider's controls in achieving the specified compliance control objectives, the practitioner ordinarily would obtain the following written representations from management of the

service provider in connection with the examination engagement described in paragraphs .01–.33 of this SOP:

- a. A statement acknowledging management's responsibility for
  - the subject matter of the examination engagement; namely, the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives.
  - selecting the criteria used and determining the appropriateness of such criteria for its purposes, including selecting and presenting compliance control objectives that are relevant to the services provided to user organizations and their internal control over compliance with federal securities laws or elements thereof (practitioners may wish to include in the representation letter the definition of the term *federal securities laws or elements thereof* found in footnotes 2 and 3 of this SOP).
  - its description of specified compliance control objectives and related controls.
  - its written assertion about the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives.
  - establishing and maintaining compliance and effective internal control over compliance with federal securities laws or elements thereof as they relate to the scope of the examination engagement, including establishing and maintaining controls that are suitably designed and operating effectively to achieve the specified compliance control objectives.
- b. A statement that management has disclosed to the practitioner all deficiencies of which it is aware in the design or operation of the service provider's internal control over compliance with federal securities laws or elements thereof, related to the scope of the attestation engagement, that existed during the period covered by the practitioner's report, including those for which management believes the cost of corrective action may exceed the benefits
- c. A statement that management has disclosed to the practitioner any significant changes in the service provider's controls related to the scope of the attestation engagement made since the service provider's last examination
- d. A statement that management has disclosed to the practitioner any instances of which it is aware of the service provider's noncompliance with federal securities laws or elements thereof, related to the scope of the attestation engagement, that existed during the period covered by the practitioner's report and that may affect one or more user organizations
- e. A statement that management has disclosed to the practitioner all instances of which it is aware when the service provider's controls have not operated with sufficient effectiveness during the period covered by the practitioner's report to achieve the specified compliance control objectives
- f. A statement that management has disclosed to the practitioner all known matters contradicting the assertion and any

communications from attorneys, regulatory agencies, internal auditors, consultants, other practitioners, or third parties related to the service provider's compliance, or internal control over compliance, with federal securities laws or elements thereof during the period covered by the practitioner's report that may affect one or more user organizations

- g.* A statement that management has made available to the practitioner all records and other information it believes are relevant to the service provider's compliance, or internal control over compliance, with federal securities laws or elements thereof, related to the scope of the attestation engagement and the period covered by the practitioner's report
- h.* A statement that management has responded fully to all inquiries made by the practitioner during the engagement
- i.* A statement that management has disclosed all events of which it is aware that occurred subsequent to the period being reported on that would have a material effect on the subject matter (or management's assertion) to which the practitioner's report relates
- j.* Statements regarding other matters the practitioner deems appropriate for inclusion in management's representations to the practitioner

**.27** If management refuses to furnish all the written representations that the practitioner deems necessary, the practitioner should consider the effects of such a refusal on his or her ability to express an opinion about the subject matter or assertion. If the practitioner believes that the representations are necessary to obtain sufficient appropriate evidence to express an opinion, management's refusal to furnish such evidence in the form of written representations constitutes a limitation on the scope of an examination sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause the practitioner to disclaim an opinion or withdraw from an examination engagement. However, based on the nature of the representations not obtained or the circumstances of the refusal, the practitioner may conclude, in an examination engagement, that a qualified opinion is appropriate. Further, the practitioner should consider the effects of the refusal on his or her ability to rely on other representations made by management of the service provider. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

## Reporting

**.28** Appendix A-1 (paragraph .38) of this SOP contains an illustrative practitioner's examination report on an assertion by management of a service provider regarding specified compliance control objectives and related controls. The illustrative report includes the required elements of a practitioner's unqualified report on an assertion that are listed in paragraph .86 of AT section 101. Paragraph .85 of AT section 101 presents the required elements of a practitioner's unqualified report on subject matter, and appendix A, "Examination Reports," of AT section 101 presents additional illustrative examination reports.

**.29** Paragraph .19 of this SOP notes that criteria are the standards or benchmarks against which a practitioner evaluates the subject matter, and in this SOP, the criteria for evaluating the suitability of the design and operating effectiveness of the controls are the specified compliance control objectives. If, after performing the procedures described in paragraphs .12–.13 and .19–.22 of this SOP, the practitioner concludes that the controls were not suitably

designed or operating with sufficient effectiveness to provide reasonable assurance that the specified compliance control objectives were achieved, the practitioner should modify his or her report and include a brief factual description that will enable users of the report to understand the nature of the deficiency or deficiencies in controls. The matter or matters pertaining to the suitability of the design or operating effectiveness of controls and giving rise to a qualified or adverse opinion in a report on the examination engagement described in this SOP should be referred to as a deficiency or deficiencies. Further, paragraph .66 of AT section 101 states, in part, that ". . . if conditions exist that, individually or in combination, result in one or more material misstatements or deviations from the criteria, the practitioner should modify the report and, to most effectively communicate with the reader of the report, should ordinarily express his or her conclusion directly on the subject matter, not on the assertion." Appendix B (paragraph .42) of this SOP contains an illustrative practitioner's examination report containing a qualified opinion on a service provider's controls in achieving the specified compliance control objectives. In that illustrative report, the practitioner reports on the subject matter rather than on the assertion.

**.30** As noted in paragraph .72 of AT section 101, a practitioner may have reservations about the engagement (for example, a restriction on the scope of the engagement), the subject matter, and, if applicable, the assertion. When a practitioner has such reservations, he or she should exercise professional judgment in determining the significance of those reservations and the type of report to be issued. Paragraphs .71–.74 and .76–.77 of AT section 101 provide guidance in this area.

**.31** If a subservice provider's compliance control objectives and related controls are excluded from the service provider's written description of specified compliance control objectives and related controls (see paragraph .17 of this SOP), the scope paragraph of the practitioner's report should be modified to

- refer to the disclosure in the written description regarding the service provider's use of a subservice provider and the functions and nature of the services performed by the subservice provider.
- state that the subservice provider's compliance control objectives and related controls are omitted from the written description and that the practitioner's examination did not extend to controls of the subservice provider.

Appendix A-2 (paragraph .39) of this SOP contains an illustrative practitioner's examination report on a service provider's specified compliance control objectives and related controls when the service provider uses a subservice provider and the subservice provider's control objectives and related controls are excluded from the description.

**.32** As noted in paragraph .17, situations may arise in which the service provider specifies compliance control objectives whose achievement depends on controls at a subservice provider. In those circumstances, if the service provider has excluded the subservice provider's controls from the written description, the practitioner should modify the scope and opinion paragraphs of his or her report to include the phrase "and subservice providers applied the controls contemplated in the design of the service provider's controls."

**.33** A practitioner may perform significant portions of the engagement before the end of the period covered by the report. If during that time the practitioner identifies compliance control objectives that have not been achieved, he or she should include a description of the condition in his or her report, even if management corrects the condition prior to the end of the period.

## Agreed-Upon Procedures

**.34** A practitioner may also perform agreed-upon procedures related to compliance control objectives and related controls. Such engagements are performed in accordance with AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*). In these engagements, the parties to the engagement (specified parties) and the practitioner agree upon the procedures to be performed. The practitioner performs these procedures and reports his or her findings. The specified parties assume responsibility for the sufficiency of the procedures because they best understand their own needs. In an agreed-upon procedures engagement, the practitioner does not perform an examination or review of an assertion or subject matter or express an opinion or negative assurance about the assertion or subject matter. The practitioner's report on agreed-upon procedures is in the form of procedures and findings. An illustrative agreed-upon procedures report is presented in appendix E (paragraph .45) of this SOP. Use of an agreed-upon procedures report is restricted to the specified parties that agree upon the procedures and accept responsibility for the sufficiency of the procedures for their purposes.

**.35** In accordance with paragraph .10 of AT section 201, a practitioner should establish an understanding with the client regarding the services to be performed. Such an understanding reduces the risk that the client may misinterpret the objectives and limitations of an agreed-upon procedures engagement and also reduces the risk that the client will misunderstand its responsibilities and the responsibilities of the practitioner. Paragraph .46 of AT section 101 provides further guidance on establishing an understanding with a client in an attestation engagement.

**.36** Paragraph .36 of AT section 201 enables a practitioner, after considering certain matters, to add a nonparticipant party as a specified party. If the practitioner agrees to add a specified party, he or she should obtain affirmative acknowledgement, normally in writing, from that party agreeing to the procedures performed and taking responsibility for the sufficiency of the procedures.

## Effective Date

**.37** This SOP is effective upon issuance.

## Appendix A-1—Illustrative Practitioner’s Examination Report on a Service Provider’s Assertion Regarding Specified Compliance Control Objectives and Related Controls

*Note: The compliance control objectives and related controls referenced in the following illustrative practitioner’s report are examples only and should not be viewed as representative of or a complete description of the compliance control objectives or related controls a service provider might be expected to (1) establish and implement to meet any contractual responsibilities to funds or any other clients, (2) monitor for investment compliance, or (3) include in its description of specified compliance control objectives and related controls in an examination engagement covered by this Statement of Position (SOP). Additionally, there may be other areas of responsibility (beyond investment compliance) that a service provider might assume on behalf of funds or any other clients that might result in the inclusion and presentation of different or additional compliance control objectives and related controls for engagements covered by this SOP.*

### Report of Independent Accountants

To the Management of XYZ Service Provider:

*[Introductory paragraph]*

We have examined the assertion made by the management of XYZ Service Provider pertaining to controls over investment compliance that XYZ Service Provider performs for user organizations. Management’s assertion is included in the accompanying document titled, "Management’s Assertion Regarding XYZ Service Provider’s Specified Compliance Control Objectives and Related Controls" and states that:

- The controls described in the accompanying document titled, "XYZ Service Provider’s Description of Specified Compliance Control Objectives and Related Controls" (management’s description), were suitably designed as of December 31, 20X1 to provide reasonable assurance that the compliance control objectives established by management and described therein would be achieved, if those controls were complied with satisfactorily *[and user organizations applied the controls contemplated in the design of XYZ Service Provider’s controls<sup>1</sup>]*; and
- The controls described in management’s description were operating with sufficient effectiveness to provide reasonable assurance that the specified compliance control objectives described therein were achieved during the period from January 1, 20X1 to December 31, 20X1.

Management of XYZ Service Provider is responsible for its assertion. Our responsibility is to express an opinion on management’s assertion based on our examination.

*[Scope paragraph]*

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<sup>1</sup> Refer to user controls only in situations in which the application of controls by the user organizations is necessary to achieve specified control objectives. Otherwise omit this reference.

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 and evaluating the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives, and examining, on a test basis, evidence supporting management's assertion 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 perform and did not perform an examination of XYZ Service Provider's or user organizations' compliance or internal control over compliance with Federal Securities Laws, as that term is defined by Securities and Exchange Commission (SEC) Rule 38a-1 under the Investment Company Act of 1940 ("Federal Securities Laws"). We also were not engaged to perform and did not perform an examination of XYZ Service Provider's compliance with its contractual obligations to its clients during the period from January 1, 20X1 to December 31, 20X1.

Our examination was limited to examining, for the purposes described above, management's assertion about the specified compliance control objectives and related controls included in management's description and did not consider any other compliance control objectives or controls that may be relevant to XYZ Service Provider's or user organizations' compliance or internal control over compliance with Federal Securities Laws. Further, the relative effectiveness and significance of specific controls at XYZ Service Provider, and their effect on user organizations' compliance or internal control over compliance with Federal Securities Laws 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 such controls or such other factors at individual user organizations.

The compliance control objectives and related controls set forth in management's description have been provided to enable user organizations, when performing their annual compliance reviews as required by SEC Rule 38a-1 under the Investment Company Act of 1940, to consider such information along with information about their own compliance or internal control over compliance with Federal Securities Laws, and any other relevant information.

*[Inherent limitations paragraph]*

Management's description is as of December 31, 20X1. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the system or controls in existence. The potential effectiveness of controls in achieving the specified compliance control objectives established by XYZ Service Provider is subject to inherent limitations and, accordingly, lack of compliance with controls and instances of errors or fraud may occur and not be detected. Furthermore, the projection of any evaluations, based on our findings, to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with such controls may deteriorate, or changes made to the system or controls, or the failure to make needed changes to the system or controls, may alter the validity of such evaluations.

*[Opinion paragraph]*

In our opinion, management's assertion referred to above is fairly stated, in all material respects, based on the specified compliance control objectives set forth in management's description.

*[Restricted use paragraph]*

**Attestation Engagements That Address Specified Compliance Control 1797**

This report is intended solely for the information and use of chief compliance officers, management, boards of directors, and the independent auditors of XYZ Service Provider and of the entities that use the services of XYZ Service Provider, and is not intended to be and should not be used by anyone other than these specified parties.

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*[Signature of Independent Accountant]*

March 31, 20X2

## Appendix A-2—Illustrative Practitioner’s Examination Report on a Service Provider’s Assertion Regarding Specified Compliance Control Objectives and Related Controls When the Service Provider Uses a Subservice Provider and the Subservice Provider’s Control Objectives and Related Controls are Excluded From the Description and the Scope of the Practitioner’s Engagement

*Note: The compliance control objectives and related controls referenced in the following illustrative practitioner’s report are examples only and should not be viewed as representative of or a complete description of the compliance control objectives or related controls a service provider might be expected to (1) establish and implement to meet any contractual responsibilities to funds or any other clients (2) monitor for investment compliance, or (3) include in its description of specified compliance control objectives and related controls in an examination engagement covered by this Statement of Position (SOP). Additionally, there may be other areas of responsibility (beyond investment compliance) that a service provider might assume on behalf of funds or any other clients that might result in the inclusion and presentation of different or additional compliance control objectives and related controls for engagements covered by this SOP.*

### Report of Independent Accountants

To the Management of XYZ Service Provider:

*[Introductory paragraph]*

We have examined the assertion made by the management of XYZ Service Provider pertaining to controls over investment compliance that XYZ Service Provider performs for user organizations. Management’s assertion is included in the accompanying document titled, “Management’s Assertion Regarding XYZ Service Provider’s Specified Compliance Control Objectives and Related Controls” and states that:

- The controls described in the accompanying document, “XYZ Service Provider’s Description of Specified Compliance Control Objectives and Related Controls” (management’s description), were suitably designed as of December 31, 20X1 to provide reasonable assurance that the compliance control objectives established by management and described therein would be achieved, if those controls were complied with satisfactorily *[and user organizations applied the controls contemplated in the design of XYZ Service Provider’s controls<sup>1</sup>]*:
- The controls described in management’s description were operating with sufficient effectiveness to provide reasonable assurance

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<sup>1</sup> Refer to user controls only in situations in which the application of controls by the user organizations is necessary to achieve the specified control objectives. Otherwise omit this reference. Also, if the application of controls by the subservice provider is necessary to achieve the specified compliance control objectives, and the subservice provider’s controls are excluded from the description, the practitioner’s report should be modified to include the phrase, “and the subservice provider applied the controls contemplated in the design of XYZ Service Provider’s controls.”

that the specified compliance control objectives described therein were achieved during the period from January 1, 20X1 to December 31, 20X1.

As stated in management's description, XYZ Service Provider uses a computer processing service provider for all of its computerized application processing. Management's description includes only those compliance control objectives and related controls of XYZ Service Provider, and does not include compliance control objectives and related controls of the computer processing service provider. Our examination did not extend to controls of the computer processing service provider.

Management of XYZ Service Provider is responsible for its assertion. Our responsibility is to express an opinion on management's assertion based on our examination.

*[Scope paragraph]*

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of and evaluating the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives; and examining, on a test basis, evidence supporting management's assertion 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 perform and did not perform an examination of XYZ Service Provider's or user organizations' compliance or internal control over compliance with Federal Securities Laws, as that term is defined by Securities and Exchange Commission (SEC) Rule 38a-1 under the Investment Company Act of 1940 ("Federal Securities Laws"). We also were not engaged to perform and did not perform an examination of XYZ Service Provider's compliance with its contractual obligations to its clients during the period from January 1, 20X1 to December 31, 20X1.

Our examination was limited to examining, for the purposes described above, management's assertion about the specified compliance control objectives and related controls included in management's description and did not consider any other compliance control objectives or controls that may be relevant to XYZ Service Provider's or user organizations' compliance or internal control over compliance with Federal Securities Laws. Further, the relative effectiveness and significance of specific controls at XYZ Service Provider, and their effect on user organizations' compliance or internal control over compliance with Federal Securities Laws are dependent on their interaction with the controls and other factors present at individual user organizations and at subservice providers. We have performed no procedures to evaluate the effectiveness of such controls or such other factors at individual user organizations or at subservice providers.

The compliance control objectives and related controls set forth in management's description have been provided to enable user organizations, when performing their annual compliance reviews as required by SEC Rule 38a-1 under the Investment Company Act of 1940, to consider such information along with information about their own compliance or internal control over compliance with Federal Securities Laws, and any other relevant information.

*[Inherent limitations paragraph]*

Management's description is as of December 31, 20X1. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the system or controls in existence. The potential effectiveness of controls in achieving the specified compliance control

objectives established by XYZ Service Provider is subject to inherent limitations and, accordingly, lack of compliance with controls and instances of errors or fraud may occur and not be detected. Furthermore, the projection of any evaluations, based on our findings, to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with such controls may deteriorate, or changes made to the system or controls, or the failure to make needed changes to the system or controls, may alter the validity of such evaluations.

*[Opinion paragraph]*

In our opinion, management's assertion referred to above is fairly stated, in all material respects, based on the specified compliance control objectives set forth in management's description.

*[Restricted use paragraph]*

This report is intended solely for the information and use of chief compliance officers, management, boards of directors, and the independent auditors of XYZ Service Provider and of the entities that use the services of XYZ Service Provider, and is not intended to be and should not be used by anyone other than these specified parties.

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*[Signature of Independent Accountant]*

March 31, 20X2

## Appendix A-3—Illustrative Management Assertion Regarding a Service Provider's Specified Compliance Control Objectives and Related Controls

### Management's Assertion Regarding XYZ Service Provider's Specified Compliance Control Objectives and Related Controls

XYZ Service Provider provides certain investment compliance services to funds (user organizations). XYZ Service Provider's description of specified compliance control objectives and related controls is presented in the accompanying document, "XYZ Service Provider's Description of Specified Compliance Control Objectives and Related Controls" (management's description). We, as members of management of XYZ Service Provider, are responsible for the description as well as for the suitability of the design and operating effectiveness of those controls.

Management's description is provided to enable user organizations, when performing their annual compliance review as required by Securities and Exchange Commission (SEC) Rule 38a-1 under the Investment Company Act of 1940, to consider such information, along with information about their own compliance and internal control over compliance with Federal Securities Laws, as that term is defined in Rule 38a-1, and any other relevant information. We have evaluated the suitability of the design and operating effectiveness of these controls in achieving the compliance control objectives included in management's description during the period from January 1, 20X1 through December 31, 20X1. The criteria against which the controls were evaluated are the specified compliance control objectives included in management's description. Based on our evaluation, we assert that:

- The controls included in management's description were suitably designed as of December 31, 20X1 to provide reasonable assurance that the compliance control objectives described therein would be achieved, if those controls were complied with satisfactorily [*and user organizations applied the controls contemplated in the design of XYZ Service Provider's controls*<sup>1</sup>].
- The controls set forth in management's description were operating with sufficient effectiveness to provide reasonable assurance that the specified compliance control objectives, included in management's description, were achieved during the period from January 1, 20X1 to December 31, 20X1.

By: \_\_\_\_\_

[Signature, name, and title of appropriate official]

By: \_\_\_\_\_

[Signature, name, and title of appropriate official]

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<sup>1</sup> Refer to user controls only in situations in which the application of controls by the user organizations is necessary to achieve the specified control objectives. Otherwise omit the reference. Also, if the application of controls by a subservice provider is necessary to achieve the specified compliance control objectives, and the subservice provider's controls are excluded from the description, the practitioner's report should be modified to include the phrase, "and the subservice provider applied the controls contemplated in the design of XYZ Service Provider's controls."

## Appendix A-4—Illustrative Service Provider's Description of Specified Compliance Control Objectives and Related Controls

### XYZ Service Provider's Description of Specified Compliance

#### Control Objectives and Related Controls

*Note: The following is an illustration of a description of investment compliance control objectives and related controls for an investment adviser (XYZ Service Provider) performing investment compliance-related services for funds.<sup>1</sup> This illustration is presented solely to provide an example of control objectives and related controls pertaining to investment-compliance related services and should not be viewed as representative of or a complete set of compliance control objectives or related controls that a service provider might be expected to (1) perform in these circumstances or similar circumstances, (2) establish and implement to meet any contractual responsibilities to funds or any other clients, or (3) include in its written description of specified compliance control objectives and related controls in an examination engagement covered by this Statement of Position (SOP). Additionally, there may be other areas of responsibility (beyond investment compliance) that a service provider might assume on behalf of funds or any other clients that might result in the inclusion and presentation of different or additional compliance control objectives and related controls for engagements covered by this SOP.*

#### **Monitoring Compliance with Fund Investment Guidelines and Restrictions**

*[XYZ Service Provider uses a computer processing service provider for all of its computerized application processing.<sup>2</sup> The accompanying description includes only those compliance control objectives and related controls of XYZ Service Provider, and does not include compliance control objectives and related controls of the computer processing service provider.]*

**Control Objective 1:** Controls provide reasonable assurance that securities trades for the fund and the fund's securities holdings comply with investment guidelines and restrictions included in the fund's investment advisory agreement, prospectus, and statement of additional information.

#### **Controls:**

1. Before any securities trading commences for a fund (a) XYZ Service Provider's trading desk representative enters information (coding) in the fund's securities trading order entry and compliance (STOEC) module to reflect all investment guidelines and

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<sup>1</sup> In this illustration, the investment adviser performs investment compliance-related services in addition to investment advisory services for funds. In other situations, investment compliance-related services may be performed, in whole or in part, by one or more other service providers or subservice providers.

<sup>2</sup> If the service provider uses a subservice provider, management's description should include a brief statement of the functions and nature of the services performed by the subservice provider. In addition, the description should indicate whether the subservice provider's compliance control objectives and related controls are included in or excluded from the description. See paragraphs .16–.17 of the Statement of Position for additional information about the information to be included in this disclosure.

restrictions included in the documents identified in Control Objective 1, and (b) a supervisor in XYZ Service Provider's fund services department compares, for completeness and accuracy, the information (coding) entered in the fund's STOEC module to the corresponding information included in the source documents referred to in Control Objective 1. Any discrepancies that appear to be the result of data entry errors (for example, entering the number 50% when the prospectus states 5%) are corrected upon identification by XYZ Service Provider. Any other discrepancies related to differences in interpretation or uncertainty about the meaning of information in the source documents, are communicated to the fund's treasurer or chief compliance officer for research, clarification, and resolution. Any subsequent changes to the original information (coding) entered by XYZ Service Provider must be approved by the fund's treasurer or chief compliance officer.

2. On a daily basis, a report of all deletions, modifications, and additions made to investment guidelines and restrictions in the fund's STOEC module is reviewed by a supervisor in XYZ Service Provider's fund services department. The supervisor compares each change made to a written authorization to effect the change submitted by the fund's treasurer or chief compliance officer.
3. Annually, a supervisor in XYZ Service Provider's fund services department compares, for completeness and accuracy, the current information (coding) in each fund's STOEC module to the corresponding source documents referred to in the Control Objective.
4. For all securities trades for which the functionality of a fund's STOEC module identifies an apparent or possible noncompliant securities trade order, the order is 'pending' until the fund's treasurer or chief compliance officer reviews the circumstances of the requested trade and determines whether it is permissible. If permissible, the 'pending' trade is released for processing upon written approval by either the fund's treasurer or chief compliance officer. If not permissible, the trade is cancelled. On the basis prescribed in the fund's compliance policies and procedures (daily, weekly, monthly, or quarterly), members of the compliance staff of XYZ Service Provider review reports generated by the STOEC module to ascertain that no violations of the fund's investment guidelines and restrictions have occurred. Any violations are researched, and XYZ Service Provider's compliance staff ascertains that corrective actions were approved by the fund's treasurer or chief compliance officer, and effected.

**Control Objective 2:** Controls provide reasonable assurance that the dollar-weighted average portfolio maturities (WAPM) of money market funds do not exceed 90 days, as required by Securities and Exchange Commission (SEC) Rule 2a-7.

**Controls:**

1. For each new security purchased, a trade department analyst at XYZ Service Provider compares the terms entered in the trade system to the corresponding information in the documentation of the security purchase, including the date used for the WAPM calculation (for example, interest-rate reset date or maturity date).
2. On a quarterly basis, XYZ Service Provider's compliance staff verifies that the computation logic in its securities accounting system

(SAS), which affects the calculation of the funds' WAPM, is consistent with applicable provisions of SEC Rule 2a-7 and regulatory guidance issued.

3. On a daily basis, using reports and information produced by the SAS, XYZ Service Provider's compliance staff determines whether any of the funds' WAPM exceeds 75 days. If so, the compliance staff alerts the portfolio manager so that this information can be taken into account by the portfolio manager when making prospective investment management decisions for the fund. If a fund's WAPM exceeds 80 days, the compliance staff also alerts the fund's treasurer.
4. On a daily basis, using reports and information produced by the SAS, XYZ Service Provider's compliance staff identifies changes of 3 days or more in any fund's WAPM from the fund's prior day WAPM, and researches the fund's investing activities sufficiently to identify the reason for the change and whether there is a reasonable basis for the change. The results of the research are documented and provided to a compliance department manager for his or her written review and approval.

## Appendix B—Illustrative Practitioner’s Examination Report Containing a Qualified Opinion on the Suitability of the Design and Operating Effectiveness of a Service Provider’s Controls in Achieving Specified Compliance Control Objectives

*Paragraph .66 of AT section 101 (AICPA, Professional Standards) states, in part, "If conditions exist that individually or in combination result in one or more material misstatements or deviations from the criteria, the practitioner should modify the report and, to most effectively communicate with the reader of the report, should ordinarily express his or her conclusion directly on the subject matter, not on the assertion." The following illustrative practitioner's report relates to an examination engagement in which the practitioner identified a control deficiency in the operating effectiveness of the service provider's controls; accordingly, the practitioner reports on the subject matter, rather than on the assertion. Also, in an explanatory paragraph preceding the opinion paragraph, the practitioner describes the matters giving rise to the qualification. In this engagement, the practitioner has concluded that the deficiency in controls is not sufficiently pervasive to warrant an adverse opinion.*

### Report of Independent Accountants

To the Management of ABC Service Provider:

*[Introductory paragraph]*

We have examined whether the controls described in the accompanying document, "ABC Service Provider's Description of Specified Compliance Control Objectives and Related Controls" (management's description), were:

- Suitably designed, as of December 31, 20X1, to provide reasonable assurance that the specified compliance control objectives established by management of ABC Service Provider and described therein would be achieved, if those controls were complied with satisfactorily; *[and user organizations applied the controls contemplated in the design of ABC Service Provider's controls<sup>1</sup>]*; and
- Operating with sufficient effectiveness to provide reasonable assurance that the specified compliance control objectives described therein were achieved during the period from January 1, 20X1 to December 31, 20X1.

Management of ABC Service Provider is responsible for the suitability of the design and operating effectiveness of these controls in achieving the specified compliance control objectives. Our responsibility is to express an opinion based on our examination.

*[Scope paragraph]*

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining on a test basis, evidence supporting the suitability

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<sup>1</sup> Refer to user controls only in situations in which the application of controls by the user organizations is necessary to achieve the specified control objectives. Otherwise omit this reference.

of the design and operating effectiveness of the controls in achieving the specified compliance control objectives 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 perform and did not perform an examination of ABC Service Provider's or user organizations' compliance or internal control over compliance with Federal Securities Laws, as that term is defined by Securities and Exchange Commission (SEC) Rule 38a-1, under the Investment Company Act of 1940 ("Federal Securities Laws"). We also were not engaged to perform and did not perform an examination of ABC Service Provider's compliance with its contractual obligations to its clients during the period from January 1, 20X1 to December 31, 20X1.

Our examination was limited to examining, for the purposes described above, the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives included in management's description and did not consider any other compliance control objectives or controls that may be relevant to ABC Service Provider's or user organizations' compliance or internal control over compliance with Federal Securities Laws. Further, the relative effectiveness and significance of specific controls at ABC Service Provider, and their effect on user organizations' compliance or internal control over compliance with Federal Securities Laws 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 such controls or such other factors at individual user organizations.

The compliance control objectives and related controls set forth in management's description have been provided to enable user organizations, when performing their annual compliance reviews as required by SEC Rule 38a-1 under the Investment Company Act of 1940, to consider such information along with information about their own compliance or internal control over compliance with Federal Securities Laws, and any other relevant information.

*[Inherent limitations paragraph]*

Management's description is as of December 31, 20X1. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the system or controls in existence. The potential effectiveness of controls in achieving the specified compliance control objectives established by ABC Service Provider is subject to inherent limitations and, accordingly, lack of compliance with controls and instances of errors or fraud may occur and not be detected. Furthermore, the projection of any evaluations, based on our findings, to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with such controls may deteriorate, or changes made to the system or controls, or the failure to make needed changes to the system or controls, may alter the validity of such evaluations.

*[Explanatory paragraph]*

Management of ABC Service Provider has included in its description a control requiring that the manager of the advertising and sales department review and approve performance data used in ABC Service Provider's advertising and sales literature prior to its release to the public. Our tests of operating effectiveness noted that the manager of the advertising and sales department did not review and approve the aforementioned performance data prior to its release to the public. The manager's failure to perform this control is a deficiency in the operating effectiveness of the service provider's controls that resulted in the nonachievement of the compliance control objective included in manage-

ment's description: "Performance data used in advertising and sales literature are accurate and approved before release to the public."

*[Opinion paragraph]*

In our opinion ABC Service Provider's controls were suitably designed at December 31, 20X1 to provide reasonable assurance that the specified compliance control objectives, as described in management's description, would be achieved, if those controls were complied with satisfactorily *[and user organizations applied the controls contemplated in the design of ABC Service Provider's controls<sup>2</sup>]*. Also, in our opinion, except for the deficiency described in the preceding paragraph, ABC Service Provider's controls were operating with sufficient effectiveness to provide reasonable assurance that the specified compliance control objectives were achieved during the period from January 1, 20X1 through December 31, 20X1, based on the specified compliance control objectives set forth in management's description.<sup>3</sup>

*[Restricted use paragraph]*

This report is intended solely for the information and use of chief compliance officers, management, boards of directors, and the independent auditors of ABC Service Provider and of the entities that use the services of ABC Service Provider, and is not intended to be and should not be used by anyone other than these specified parties.

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*[Signature of Independent Accountant]*

March 31, 20X2

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<sup>2</sup> Refer to user controls only in situations in which the application of controls by the user organizations is necessary to achieve the specified control objectives. Otherwise omit this reference.

<sup>3</sup> In instances in which a control is not suitably designed, the phrase "except for the deficiency described in the preceding paragraph" would be inserted in the first sentence of the opinion paragraph, which relates to the suitability of the design of controls.

## Appendix C—Additional Illustrative Compliance Control Objectives

*Note: The following are additional illustrative compliance control objectives pertaining to various services service providers might provide. These illustrative compliance control objectives are only examples and should not be viewed as representative of or a complete set or description of compliance control objectives that a service provider might be expected to (1) establish and implement to meet any contractual responsibilities to funds or any other clients, (2) monitor for achievement, or (3) include in its description of specified compliance control objectives and related controls in an attestation engagement covered by this Statement of Position (SOP). Additionally, there may be other areas of responsibility (beyond those listed below) that a service provider might assume on behalf of funds or any other clients that might result in the inclusion and presentation of different or additional compliance control objectives and related controls for engagements covered by this SOP.*

### Fund Advertising and Sales Literature

Controls provide reasonable assurance that:

1. Advertising and sales literature is reviewed for compliance with the service provider's established policies and is timely submitted to the National Association of Securities Dealers (NASD) for approval
2. Comments from the NASD on advertising and sales literature are reviewed and timely reflected in advertising and sales literature as required
3. Performance data used in advertising and sales literature are accurate and approved before release
4. Expiring advertisement and sales literature is identified and updated or disposed of before the expiration date
5. Regulatory changes are monitored and reflected in current and future advertising and sales literature

### Valuation of Client Assets or Investments

Controls provide reasonable assurance that:

1. Securities price information is received from authorized sources in accordance with client instructions and is entered completely and accurately into the portfolio accounting system
2. Foreign exchange rates are received from authorized sources in accordance with client instructions and are entered completely and accurately into the portfolio accounting system
3. Securities that do not have readily determinable market values (for example, those valued at fair value in good faith), including international equity securities whose values are determined by adjusting the closing price on the foreign securities exchange, are valued according to consistently applied policies and procedures established by the service provider's client

4. For registered money-market-fund securities valued at amortized cost, valuation is monitored for compliance with the "mark-to-market" provision of Securities and Exchange Commission (SEC) Rule 2a-7 and deviations in excess of established thresholds are reported in accordance with client instructions

### **Privacy**

Controls provide reasonable assurance that:

1. The use of and access to nonpublic client information is restricted to authorized personnel
2. Customers of the fund are provided with a notice of privacy policies at the time they become a customer and in the event of a change to the privacy policy
3. Access to and use of material nonpublic information is restricted to authorized personnel
4. At least annually, employees are provided with written policies related to material nonpublic information and instruction about those policies
5. Customer information is disclosed only to authorized third parties

### **Transfer Agency**

Controls provide reasonable assurance that:

1. As required by policies and procedures, the identity of any person seeking to open an account with the fund is verified by examining specified documents and other information and maintaining records of the information used to verify the person's identity
2. Cash equivalents under \$10,000 are monitored and tracked for a rolling 12-month period; Internal Revenue Service (IRS) Form 8300 is filed, and the shareholder is notified as required by the IRS
3. Certificate redemption requests are processed in a timely manner and archived in a secure manner for subsequent inquiry
4. Missing, lost, stolen, or counterfeit certificate notifications are processed in a timely manner, and Form X-17F-1A is filed with the Securities Information Center within the required number of business days
5. Transfer agent employees are fingerprinted and the related records are maintained for the required time period
6. Shareholder financial-related transactions are priced using the appropriate net asset value per share
7. Dividends are processed completely and accurately; dividend distributions are reconciled between the fund's general ledger and the shareholder accounting system; and any exceptions are researched and resolved by the next reporting period
8. Signature guarantees pertaining to shareholder transactions are reviewed upon presentation; rejected signature guarantees are communicated to the compliance department for tracking

### **Investment Compliance**

Controls provide reasonable assurance that on a weekly basis:

1. Securities holdings are monitored for compliance with prospectus guidelines

2. Securities holdings are monitored to ensure that the portfolio meets a 15 percent liquidity standard
3. Securities of money market funds are monitored for compliance with the portfolio maturity and credit quality provisions of SEC Rules 2a-7c.2 and 2a-7c.3, respectively

## **Appendix D—Matters Identified in Securities and Exchange Commission Release Nos. IC-26299 and IA-2204 Adopting Rules 38a-1 and 206(4)-7 Pertaining to Compliance Policies and Procedures of Funds and Investment Advisers**

As described in paragraph .15 of this Statement of Position (SOP), when management of the service provider establishes the compliance control objectives and related controls that are the subject of the engagement, it should consider, among other things, the compliance matters identified in Securities and Exchange Commission (SEC) Release Nos. IC-26299 and IA-2204 adopting Rule 38a-1 under the Investment Company Act of 1940 and Rule 206(4)-7 under the Investment Advisers Act of 1940, respectively. The SEC Release indicates that the SEC expects the policies and procedures of funds and their advisers to, at a minimum, address the following specified areas if those areas are relevant to the services the entity provides:

- Portfolio management processes, including allocation of investment opportunities among clients, and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions
- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services (soft dollar arrangements), and allocates aggregated trades among clients
- Proprietary trading of the adviser and personal trading activities of supervised persons
- Accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel
- Accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction
- Marketing advisory services, including the use of solicitors
- Processes to value client holdings and assess fees based on those valuations
- Safeguards for the privacy protection of client records and information
- Business continuity plans

Additional matters that the SEC expects funds (or their service providers) to address are listed in paragraph .02. This SOP does not require that a service provider's compliance control objectives address all of the relevant areas identified in the SEC Release; however, the areas listed in this paragraph and in paragraph .02 comprise matters that, if relevant in the circumstances, should be considered by management of the service provider in determining compliance control objectives to be included in the scope of the attestation engagement.

The following is a summary of the additional areas, identified in the SEC Release, for which a fund or its service providers would be expected to have policies and procedures.

*Pricing of portfolio securities and fund shares.* The Investment Company Act of 1940 requires funds to sell and redeem their shares at prices based on their current net asset value, to pay redemption proceeds promptly, and, when market quotations are readily available, to calculate net asset values using the market value of the portfolio securities. If a market quotation is not readily available, the fund should use the fair value of the security, as determined in good faith by the fund's board. Further, Rule 38a-1 requires funds to adopt policies and procedures requiring the fund to monitor for circumstances that may necessitate the use of fair value prices, establish criteria for determining when market quotations are no longer reliable for a particular portfolio security, provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security, and regularly review the appropriateness and accuracy of the method used in valuing securities and make any necessary adjustments.

*Processing of fund shares.* Pursuant to SEC rules, an investor submitting a purchase order or redemption request must receive the price next calculated after receipt of the purchase order or redemption request. A fund must have procedures in place that segregate investor orders received before the fund prices its shares (which will receive that day's price) from those that were received after the fund prices its shares (which will receive the following day's price). Rule 38a-1 requires funds to approve and periodically review the policies and procedures of transfer agents. Funds should also take affirmative steps to protect themselves and their shareholders against late trading by obtaining assurances that those policies and procedures are effectively administered.

*Identification of affiliated persons.* To prevent self-dealing and overreaching by persons in a position to take advantage of the fund, the Investment Company Act of 1940 prohibits funds from entering into certain transactions with affiliated persons. Funds should have policies and procedures in place to identify these persons and to prevent unlawful transactions with them.

*Protection of nonpublic information.* The federal securities laws prohibit insider trading, and section 204A of the Investment Advisers Act of 1940 requires investment advisers (including advisers to funds) to establish, maintain, and enforce policies and procedures designed to prevent the adviser or any of its associated persons from misusing material, nonpublic information. Fund advisers should incorporate their section 204A policies into the policies required by Rule 38a-1. A fund's compliance policies and procedures should also address other potential misuses of nonpublic information, including the disclosure to third parties of material information about the fund's portfolio, its trading strategies or pending transactions, and the purchase or sale of fund shares by advisory personnel based on material, nonpublic information about the fund's portfolio.

*Compliance with fund governance requirements.* Fund boards are responsible for, among other things, approving the fund's advisory contracts, underwriting agreements, and distribution plans. The Investment Company Act of 1940 requires that fund boards be elected by fund shareholders and that a certain percentage of the board be "independent directors." To rely on many of the SEC's exemptive rules, independent directors must constitute a majority of the board, must be selected and nominated by other independent directors, and, if they hire legal counsel, must hire independent legal counsel. A fund's policies and procedures should be designed to guard against, among other things, an improperly constituted board, the failure of the board to properly consider matters entrusted to it, and the failure of the board to request and consider

information required by the Investment Company Act of 1940 from the fund adviser and other service providers.

*Market timing.* Under Rule 38a-1, a fund must have procedures reasonably designed to ensure compliance with its disclosed policies regarding market timing. Market timing is the excessive short-term trading of mutual fund shares that may be harmful to the fund. These procedures should provide for monitoring of shareholder trades or flows of money in and out of the funds in order to detect market timing activity, and for consistent enforcement of the fund's policies regarding market timing. If the fund permits any waivers of those policies, the procedures should be reasonably designed to prevent waivers that would harm the fund or its shareholders or subordinate the interests of the fund or its shareholders to those of the adviser or any other affiliated person or associated person of the adviser. Fund boards are strongly urged by the SEC to require fund advisers, or other persons authorized to waive market timing policies, to report to the board at least quarterly all waivers granted so that the board can determine whether the waivers were proper. Many funds' prospectuses already disclose market timing policies, and failure to adhere to those disclosed policies violates the antifraud provisions of the federal securities laws. Moreover, a fund adviser who waives or disregards those policies for the benefit of itself or a third party has breached its fiduciary responsibilities to the fund.

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## Appendix E—Illustrative Practitioner’s Agreed-Upon Procedures Report

The following is an illustrative agreed-upon procedures report for procedures performed at a service provider.

### Independent Accountant’s Report on Applying Agreed-Upon Procedures

To the Management of XYZ Service Provider:

We have performed the procedures enumerated in Attachment X which were agreed to by XYZ Service Provider, solely to assist you in evaluating XYZ Service Provider's internal control over compliance during the year ended December 31, 20X1. Management of XYZ Service Provider is responsible for maintaining effective internal control over compliance with federal securities laws, regulations, and related SEC rules. 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 XYZ Service Provider. Consequently, we make no representation regarding the sufficiency of the procedures described in Attachment X either for the purpose for which this report has been requested or for any other purpose.

The procedures performed and the findings are included in Attachment X.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on internal control over compliance by XYZ Service Provider for the year ended December 31, 20X1. 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 XYZ Service Provider and is not intended to be and should not be used by anyone other than this specified party.<sup>1</sup>

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[Signature of Independent Accountant]

March 31, 20X2

### Chief Compliance Officers Task Force

BRIAN GALLAGHER, *Chair*  
JOSEPH GRAINGER  
RICHARD N. MURPHY

BRENT D. OSWALD  
PATRICIA PITEO

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<sup>1</sup> Paragraph .36 of AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*), and paragraph .36 of this SOP address adding specified parties as users of an agreed-upon procedures report.

The AICPA is grateful to Stephen Callahan, Matthew Epp, Michael P. Fay, Kevin W. O'Connell, and Mark Twerdok for their technical assistance with this document.

**AICPA Staff**

CHARLES E. LANDES  
*Vice President Professional  
Standards and Services*

JUDITH M. SHERINSKY  
*Technical Manager  
Audit and Attest Standards*





## AUD Section 45

# Statement of Position 12-1 — Reporting Pursuant to the Global Investment Performance Standards

October 2012

### NOTE

This Statement of Position (SOP) is an interpretative publication, and it represents the recommendations of the AICPA's Investment Performance Standards Task Force regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to engagements to report pursuant to Global Investment Performance Standards. The Auditing Standards Board (ASB) has found the recommendations in this SOP to be consistent with existing standards covered by the "Compliance With Standards Rule" (ET sec. 1.310.001) of the AICPA Code of Professional Conduct.

Interpretative publications are not as authoritative as a pronouncement of the ASB; however, if a practitioner does not apply the attestation guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions addressed by this SOP.

## Introduction and Background

**.01** To promote fair representation, full disclosure, and greater comparability of investment performance, the CFA Institute developed the Global Investment Performance Standards (GIPS standards).<sup>1</sup> Although compliance with the GIPS standards is voluntary, an investment management firm's claim of compliance with the GIPS standards gives current and potential clients more confidence in the integrity of the performance presentations and the general practices of a compliant firm.

**.02** All references to the GIPS standards in this Statement of Position (SOP) refer to the 2010 edition of the GIPS standards. The GIPS standards specify that they include any updates, guidance statements, interpretations, questions and answers, and clarifications published by the CFA Institute and the GIPS Executive Committee, all of which are available at [www.gipsstandards.org](http://www.gipsstandards.org), as well as in the *GIPS Handbook*.

**.03** The GIPS standards recommend that investment management firms obtain independent third-party verification. *Verification* is a process in which an independent third party, referred to as a verifier, assesses whether (a) the

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<sup>1</sup> For information on the appropriate use of the Global Investment Performance Standards registered trademark, see the CFA Institute website at [www.cfainstitute.org](http://www.cfainstitute.org).

firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis, and (b) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification is intended to provide a firm and its existing and prospective clients with greater confidence in the firm's claim of compliance with the GIPS standards. Verification does not provide absolute assurance that a firm is in compliance with the GIPS standards.

**.04** In addition to verification, a firm may choose to have a verifier perform a specifically focused performance examination of any of the firm's composites and their associated compliant presentations. A *compliant presentation* is defined as a presentation for a composite that contains all the information required by the GIPS standards and that may also include additional or supplemental information. The GIPS standards permit a report on the performance examination of a composite and its associated compliant presentation to be issued only if a verification report has also been issued.

**.05** A verifier may or may not be a CPA. A CPA in public practice hired to perform a verification or performance examination is referred to in this SOP as a practitioner. [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

## Scope

**.06** This SOP provides guidance to practitioners for engagements to examine and report on aspects of a firm's claim of compliance with the GIPS standards (a verification). It also provides guidance on engagements to examine and report on any of the firm's composites and their associated compliant presentations (a performance examination). Practitioners are required to perform such engagements pursuant to AT section 101, *Attest Engagements* (AICPA, *Professional Standards*).

**.07** Although a verification consists of examining aspects of a firm's compliance with the GIPS standards and the design of certain policies and procedures, a verification is not a compliance attestation engagement or an internal controls attestation engagement as governed by AT section 601, *Compliance Attestation*, and AT section 801, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*), respectively.

**.08** This SOP supersedes SOP 06-1, *Reporting Pursuant to the Global Investment Performance Standards*. This SOP also supersedes paragraphs 11.37–.42 of chapter 11, "Independent Auditor's Reports and Client Representations," of the AICPA Audit and Accounting Guide *Investment Companies* (as of May 1, 2012).

## Overview of the GIPS Standards

### Compliance With the GIPS Standards

**.09** The GIPS standards establish both requirements and recommendations for firms to follow when calculating and presenting investment performance. Adherence to the recommendations of the GIPS standards is encouraged. The GIPS standards use the term *must* to indicate requirements and the term *should* to indicate recommendations. AT section 101 uses the terms *must*, *is required*, or *should* to indicate requirements and *may* to indicate recommen-

dations. To avoid confusion, this SOP uses the terms *is required* or *must* to indicate requirements of AT section 101 or the GIPS standards.

**.10** The GIPS standards require an entity to define itself as a firm. For a firm to claim compliance with the GIPS standards, the firm must meet all the requirements of the GIPS standards on a firmwide basis. Firms are prohibited from claiming compliance "except for . . ." or making any other statements that may indicate partial compliance with the GIPS standards.

**.11** The GIPS standards provide *suitable criteria*, as defined in AT section 101, for verifications and performance examinations. The criteria are available to *users*, as defined in AT section 101, as they are posted to [www.gipsstandards.org](http://www.gipsstandards.org). The GIPS standards require verifiers to use the criteria set forth therein. Consequently, practitioners who perform a verification or performance examination pursuant to the GIPS standards are required to understand the GIPS standards, including interpretative guidance.

**.12** Practitioners are required to be independent of the firm, in accordance with the AICPA Code of Professional Conduct and the *GIPS Guidance Statement on Verifier Independence*.

## Verification

**.13** A verification tests whether the

- a. firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis.
- b. firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

The GIPS standards specify procedures that practitioners are required to perform for a verification, as well as recommendations and guidance (see chapter IV of the GIPS standards, the *GIPS Guidance Statement on Verification*, and the *GIPS Guidance Statement on Verifier Independence*).

**.14** According to the GIPS standards, when a firm has obtained a verification report, the firm may state that it is verified. This statement may or may not be accompanied by a presentation of performance history for a specific composite. A verification, however, does not imply that the verifiers have examined the accuracy of the performance results of any specific composite presentation that may accompany the verification report (see paragraph .39).

## Performance Examination

**.15** In addition to a verification, a firm may choose to have a verifier conduct a performance examination. The GIPS standards specify procedures that practitioners are required to perform for a performance examination and also include recommendations and guidance (see the *GIPS Guidance Statement on Performance Examinations*). A verification is required to be performed prior to, or concurrent with, any performance examination. A firm is not permitted to state that a particular composite and its associated compliant presentation have been independently examined with respect to the GIPS standards unless the firm has also obtained a firmwide verification report covering the periods of the performance examination. Firms cannot state that a particular composite and its associated compliant presentation have been GIPS verified or make any claim to that effect.

## Verification and Performance Examination Engagements

### Engagement Objectives

**.16** Practitioners are required to conduct verifications and performance examinations in accordance with attestation standards established by the AICPA. In addition, the GIPS standards specify that these engagements must be conducted in accordance with the procedures required in the GIPS standards. This SOP is not intended to provide all the required and recommended procedures set forth in the GIPS standards or all the applicable attestation standards established by the AICPA.

**.17** For a verification, the practitioner's objective is to express an opinion on whether, in all material respects, the

- a. firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis.
- b. firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

**.18** For a performance examination of a specific composite, the practitioner's objective is to express an opinion on whether, in all material respects, the firm has

- a. constructed the composite and calculated the composite performance in compliance with the GIPS standards.
- b. prepared and presented the composite presentation in compliance with the GIPS standards.

A firm that has met the requirements of the GIPS standards with regard to a specific composite presentation is considered to have prepared and presented that composite presentation in compliance with the GIPS standards.

### Planning the Engagement

**.19** Paragraph .44 of AT section 101 specifies that planning an attest engagement involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners need to have sufficient knowledge to enable them to adequately understand the events, transactions, and practices that, in their judgment, have a significant effect on the subject matter or assertions. Such knowledge includes a sufficient understanding of the investment management industry and the GIPS standards, AICPA interpretive guidance, and applicable laws and regulations regarding the calculation and presentation of investment performance. The GIPS standards also address qualifications for verifiers.

### Establishing an Understanding With the Client

**.20** The practitioner is required to establish an understanding with the client regarding the services to be performed to reduce the risk that either the practitioner or client may misinterpret the needs or expectations of the other party. The understanding is required to include the objectives of the engagement, management's responsibilities, the practitioner's responsibilities, limitations of the engagement, and any limitations on the use of the practitioner's name and report. The understanding may include a statement that if the client intends to use the practitioner's report(s) or refer to the practitioner in connection with any sales or advertising literature, the client will provide a draft of

such literature to the practitioner for his or her review and comment prior to issuance.

.21 The practitioner is required to document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter (see appendix A, "Example Engagement Letter—Verification and Performance Examination," of this SOP for an example engagement letter).

## Obtaining Sufficient Evidence

.22 In conducting an attest examination, the practitioner's objective is to accumulate sufficient evidence to restrict attestation risk<sup>2</sup> to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be inferred by his or her report. A practitioner is required to select from all available procedures (that is, procedures that assess inherent and control risk and that restrict detection risk) any combination that can mitigate attestation risk to such an appropriately low level.

.23 When conducting an attest examination, the practitioner is required to consider the following presumptions, bearing in mind they are not mutually exclusive and may be subject to important exceptions:

- Evidence obtained from independent sources outside an entity provides greater assurance about the subject matter or assertion than evidence secured solely from within the entity.
- Information obtained from the practitioner's direct personal knowledge (such as through physical examination, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.
- The more effective the controls over the subject matter, the more assurance they provide about the subject matter or assertion.

.24 As noted previously, the GIPS standards specify procedures that practitioners are required to perform for a verification and performance examination of one or more specific composites and their associated compliant presentations, as well as recommendations and guidance (see chapter IV of the GIPS standards, the *GIPS Guidance Statement on Verification*, the *GIPS Guidance Statement on Performance Examinations*, and the *GIPS Guidance Statement on Verifier Independence*). A practitioner may perform other procedures in addition to those specified in the GIPS standards. Regardless of the scope of the engagement, the practitioner is required to obtain sufficient evidence to provide a reasonable basis for the opinion expressed in the report.

.25 The GIPS standards permit the use of a sampling methodology when performing verification or performance examination procedures. The practitioner may find it helpful to consider the guidance in the AICPA Audit Guide *Audit Sampling* when performing procedures that involve the use of sampling.

.26 The GIPS standards specify that a verifier must understand the firm's policies and procedures for establishing and maintaining compliance with all the applicable requirements and adopted recommendations of the GIPS standards, evaluate whether all applicable policies are properly included and adequately documented, and then test the firm's compliance with the established policies and procedures.

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<sup>2</sup> See footnote 9 in paragraph .45 of AT section 101, *Attest Engagement* (AICPA, *Professional Standards*), for the definition of *attestation risk*.

**.27** When a performance examination of one or more composites and their associated presentations is conducted subsequent to, not concurrent with, a verification, the practitioner is required to update the practitioner's understanding of the firm's policies and procedures and inquire about any other changes that may affect the planning and conduct of the performance examination. In addition, the practitioner is required to follow the preperformance examination procedures required by the GIPS standards.

**.28** The GIPS standards require that firms initially claiming compliance with the GIPS standards report, at a minimum, 5 years of investment performance for each composite presented (or performance since inception of the composite or firm if the period since inception is less than 5 years). After the initial presentation of GIPS-compliant performance, the firm must add an additional year of performance until the firm presents a 10-year GIPS-compliant performance record. Thereafter, at a minimum, a 10-year GIPS-compliant performance record must be presented.

**.29** The initial minimum period for which verifications can be performed is one year of the firm's presented performance or from firm inception date to period-end if less than one year. Subsequent verifications may cover any additional time periods, with annual updates being common and quarterly updates also performed. After the initial verification or performance examination is complete, it is industry practice to append subsequent verification or performance examination periods to the initial period. For example, if an initial performance examination was completed on a firm from January 1, 2006, to December 31, 2010, the following year's performance examination period would cover from January 1, 2006, to December 31, 2011. Documentation for each annual engagement is required to indicate the procedures performed supporting the consideration of prior period opinions. Such procedures may include inquiries and evaluation of the implication of the findings of current year's procedures for prior periods.

**.30** During a verification or performance examination, the practitioner is required to consider information about subsequent events and subsequently discovered facts that come to his or her attention. Such subsequent events and subsequently discovered facts include circumstances and events that affect prior period-compliant presentations. Errors in prior period-compliant presentations would be assessed in accordance with the firm's error correction policies. If a correction is required by the firm's error correction policy, and the firm does not correct the error, the practitioner is required to consider the implications for the performance examination and, if applicable, the related verification. If the firm corrects, or has corrected, a prior period-compliant presentation, the practitioner would perform appropriate testing of material revisions to previously reported information, including disclosures, regarding the changes and would consider the implications on the practitioner's ability to issue his or her report (see paragraph .34).

## Representation Letter

**.31** The GIPS standards specify that the verifier must obtain a representation letter from the firm before issuing an opinion on a verification or performance examination. The representations for a verification and performance examination(s) can be included in one letter. Appropriate parties to sign the representation letter are responsible persons with an appropriate level of authority (for example, chief executive officer, chief financial officer, chief compliance officer, or chief investment officer).

**.32** The GIPS standards include a listing of required representations, as well as a listing of other representations that are typically included, for both verifications and performance examinations. The GIPS standards require that the representation letter include, among other representations, confirmation that policies and procedures used in establishing and maintaining compliance with the GIPS standards are as described in the firm's policies and procedures documents and have been consistently applied throughout the period(s). The representation letter must also include confirmation that the firm complies with the GIPS standards for the period(s) and any other relevant representations made to the practitioner during the engagement. Because the practitioner is concerned with events occurring up to the date of the practitioner's report, the written representations are dated as of the date of the practitioner's report.

**.33** Appendix B, "Example Representation Letter," of this SOP contains an example representation letter that includes required and recommended management representations. Management's refusal to furnish all appropriate written representations constitutes noncompliance with the GIPS standards that would preclude the practitioner from rendering an opinion (see paragraph .34).

## Reporting

**.34** The GIPS standards do not permit the issuance of a report with a qualified or an adverse opinion or a disclaimer of opinion for either a verification or performance examination. After conducting the procedures for a verification or performance examination, the practitioner may conclude that

- a. the records of the firm cannot support a verification or performance examination, or
- b. the firm is not in compliance with the GIPS standards, including situations in which the composite presentation does not comply with the GIPS standards.

In such situations, the GIPS standards specify that the practitioner must issue a statement to the firm clarifying why it was not possible to issue a verification or performance examination report.

**.35** When a performance examination report cannot be issued, the GIPS standards require the practitioner and firm to consider the impact of the practitioner's inability to provide the performance examination report on the investment management firm's claim of compliance with the GIPS standards.

**36** AT section 101 permits the practitioner to report either on the assertions or directly on the subject matter to which the assertions relate. According to AT section 101, when the practitioner is reporting on management's assertion, the practitioner's examination report is required to include an identification of the assertion and responsible party. When the assertion does not accompany the practitioner's report, the first paragraph of the report is required to contain a statement of the assertion. The illustrative reports in appendix C, "Illustrative Attest Report: Verification (Reporting Directly on the Subject Matter)," and appendix D, "Illustrative Attest Reports: Verification and Performance Examination (Reporting Directly on the Subject Matter)," of this SOP present examples of reporting directly on the subject matter because that is industry practice.

**.37** The first standard of reporting in AT section 101 specifies that "the practitioner must identify the subject matter or the assertion being reported on and state the character of the engagement in the report." Accordingly, for engagements covered by this SOP, the practitioner is required to clearly indicate in the report whether a verification, performance examination, or both have

been performed. The GIPS standards require that the report state the period(s) covered.

**.38** Appendix C of this SOP presents an illustrative report for a verification. Appendix D of this SOP presents illustrative reports for a verification and performance examination.

**.39** The GIPS standards require that the verification report include a statement indicating that verification does not ensure the accuracy of any specific composite presentation (see the verification report in appendix C of this SOP). This disclaimer of opinion is an acknowledgement of the fact that the practitioner cannot control whether the verification report may accompany a composite presentation distributed by the firm, even though no performance examination was conducted.

**.40** The GIPS standards specify that the compliant presentation for the specified composite(s) that is (are) the subject of a performance examination report must be included in, or attached to, the performance examination report. The practitioner may request that the firm's composite presentation for an examined composite disclose that publically available benchmark returns have not been examined by the practitioner to avoid the implication that the practitioner is providing assurance on the development of the benchmark. The practitioner also should add a paragraph to a performance examination report disclaiming an opinion on composite presentations included or attached for any periods that were not examined by the practitioner or stating that the report does not relate to any composite presentations other than those identified in the report.

**.41** When a firm has changed verifiers, and prior periods presented were subject to verification or performance examination by another verifier, the firm may request that the practitioner refer to all verified or examined periods in his or her report. A practitioner may decide to refer to the report(s) of a predecessor verifier. The successor practitioner would consider the appropriateness of referring to reports on verifications or performance examinations conducted by other verifiers in the specific circumstances. If the successor practitioner decides to refer to the report(s) of the predecessor verifier, the report would be modified appropriately. Appendix E, "Illustrative Attest Report: Successor Practitioner Report—Verification and Performance Examination," of this SOP contains an example of a successor practitioner's report referring to the predecessor verifier's performance examination report.

## Other Information

**.42** When other information is included in a document containing a composite compliant presentation or presentations and the practitioner's performance examination report thereon to which the practitioner, at the firm's request, devotes attention, the practitioner's responsibility with respect to other information in such a document does not extend beyond the information identified in his or her report, and the practitioner has no obligation to perform any procedures to corroborate any other information contained in the document. However, the practitioner is required to read the other information not covered by the practitioner's report and consider whether it or the manner of its presentation is materially inconsistent with the information appearing in the practitioner's report. If the practitioner believes the other information is materially inconsistent with the information appearing in the practitioner's report, the practitioner is required to request the firm to revise the other information. If the other information is not revised to eliminate the material inconsistency,

the practitioner may conclude that it is necessary to withdraw the report and may wish to seek legal advice.

**.43** If, while reading the other information, as required in paragraph .42, the practitioner becomes aware of information that he or she believes is a material misstatement of fact that is not a material inconsistency, as described in paragraph .42, the practitioner is required to discuss the matter with the firm. In connection with this discussion, the practitioner is required to consider that he or she may not have the expertise to assess the validity of the statement, there may be no standards by which to assess its presentation, and there may be valid differences of judgment or opinion. If the practitioner concludes there is a valid basis for concern, the practitioner is required to propose that the client consult with some other party whose advice may be useful, such as the entity's legal counsel. If, after discussing the matter, the practitioner concludes that a material misstatement of fact remains, the action taken will depend on the practitioner's judgment in the circumstances. The practitioner is required to consider steps such as notifying in writing the client's management and, when appropriate, those charged with governance of his or her views concerning the information and consulting legal counsel about further action appropriate in the circumstances.

## Effective Date

**.44** This SOP is effective upon issuance.

## Appendix A—Example Engagement Letter—Verification and Performance Examination

The following is an illustration of an example engagement letter that may be used for this kind of engagement.

*[Practitioner Letterhead]*

*[Client's Name and Address]*

Dear \_\_\_\_\_:

This will confirm our understanding of the arrangements for our examination of whether (1) Investment Firm (the Firm) has complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS standards) on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0; this is referred to as a verification under the GIPS standards. *[When also conducting a performance examination, add: We have also been engaged to conduct an examination (referred to as a performance examination under the GIPS standards) of [specify composites] and their associated compliant presentations for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards.]*

Our examination will be conducted in accordance with the attestation standards established by the American Institute of Certified Public Accountants and criteria set forth in the GIPS standards. Our responsibility is to express an opinion based on our examination. Our examination will include examining, on a test basis, evidence about the Firm's compliance with the previously mentioned requirements; evaluating the design of the Firm's policies and procedures previously referred to; and performing the procedures for a verification required by the GIPS standards and such other procedures as we considered necessary in the circumstances.

The Firm's management is responsible for

- selecting the GIPS standards as the criteria against which we will evaluate its compliance and for determining that the GIPS standards are appropriate criteria for its purposes.
- compliance with all applicable laws, regulations, contracts, and agreements, including the GIPS standards.
- the design, implementation, and monitoring of the policies and procedures upon which compliance is based.
- making available to us all records and related information relevant to your examination.
- providing a signed representation letter at the completion of our examination.<sup>1</sup>

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<sup>1</sup> The independent practitioner may wish to include in the engagement letter an understanding with the Firm about any limitation or other arrangements regarding liability of the practitioner or Firm.

If conditions not now anticipated preclude us from performing our examination procedures and issuing a report, as contemplated by the preceding paragraph, we will advise you promptly and take such action as we deem appropriate.

Working papers that are prepared in connection with this engagement are our property. The working papers are prepared for the purpose of providing principal support for our report(s).

As you are aware, there are inherent limitations in the examination process, including, for example, selective testing and the possibility that collusion or forgery may preclude the detection of material errors, fraud, and illegal acts.

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees. The quoted fees assume that you will provide an accumulation of data for the period to be tested and that the records provided to us are clear, concise, and accurate.

In the event we are requested or authorized by management or required by government regulation, subpoena, or other legal process to produce our documents or personnel as witnesses with respect to our engagement, the Firm will reimburse us for our professional time and expenses, as well as any fees and expenses of our counsel, incurred in responding to such requests.

If the Firm intends to use our report in whole or part or refer to [*name of practitioner*] in connection with any sales or advertising literature, a draft of such literature will be provided to us for review and comment prior to issuance.

Either party may terminate this agreement at will.

If these arrangements are acceptable, please sign one copy of this letter and return it to us. We appreciate the opportunity to serve you.

Very truly yours,

[*Name of Practitioner*]

**Accepted and agreed to:**

[*Client Representative's Signature*]

[*Title*]

[*Date*]

## Appendix B—Example Representation Letter

[Date]

[Name of Practitioner]

We are providing this letter in connection with your examination of whether (1) Investment Firm (the Firm) has complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS standards) on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0. [When also conducting a performance examination, add: (3) constructed the [specify composite(s)] and calculated the [specify composite(s)] performance for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards; and (4) prepared and presented the compliant presentation(s) for [specify composite(s)] for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards.]

We confirm, to the best of our knowledge and belief, the following representations made to you during your examination(s):

1. We are responsible for (a) compliance with all the composite construction requirements of the GIPS standards on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and (b) the design of the Firm's policies and procedures to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0. We further confirm that we are responsible for the selection of the GIPS standards as the criteria against which you are evaluating our compliance and for determining that the GIPS standards are appropriate criteria for our purposes.
2. We assert to you that (a) we have complied with all the composite construction requirements of the GIPS standards on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0; (b) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0; and (c) the Firm's policies and procedures are as described in the firm's GIPS policies and procedures documents and have been consistently applied for the periods from January 1, 20X1, to December 31, 20Y0.
3. We assert that we are in compliance with the GIPS standards on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and we are not aware of any matters contradicting the assertions nor have we received any communications from the CFA Institute or regulatory agencies concerning (a) noncompliance with the GIPS standards or our assertions with regard thereto or (b) noncompliance with any other criteria relevant to investment performance.
4. We have [no knowledge of] [disclosed to you all information that we are aware of regarding] (a) fraud or alleged fraud involving management or employees who have significant roles in the Firm's policies and procedures relating to compliance with the GIPS standards or (b) fraud or alleged fraud involving others that could have a material effect on the Firm's compliance with the GIPS standards.

5. We have made available to you all records relevant to your examination.
6. There are no violations or possible violations of laws or regulations, including the Investment Advisers Act of 1940 (*if applicable*), whose effects should be considered for disclosure in your report or in the composite compliant presentations.
7. We acknowledge responsibility for maintaining sufficient books and records, as required by the GIPS standards and/or applicable regulatory requirements, and we have maintained such records to comply with those requirements.
8. We are not aware of any events that occurred subsequent to the period being reported on and through the date of this letter that would have a material effect on the outcome of the examination.

*When also conducting a performance examination, add:*

9. We assert that we have constructed [*specify composite(s)*] and calculated the composite performance for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards; and that [*refer to accompanying composite compliant presentation(s)*] of [*specify composite(s)*] for the periods from January 1, 20X1, to December 31, 20Y0, is prepared and presented in compliance with the GIPS standards.

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[*Name of Chief Executive Officer and Title*]

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[*Name of Chief Financial Officer and Title*]

## Appendix C—Illustrative Attest Report: Verification (Reporting Directly on the Subject Matter)

### Independent Accountant's Verification Report

Investment Firm  
10 Main Street  
Anytown, USA

We have examined whether (1) Investment Firm (the Firm) has complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS standards) on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0. The Firm's management is responsible for compliance with the GIPS standards and the design of its policies and procedures. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the Firm's compliance with the previously mentioned requirements; evaluating the design of the Firm's policies and procedures previously referred to; and performing the procedures for a verification required by the GIPS standards and 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, in all material respects

- the Firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0; and
- the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0.

We have not been engaged to examine and did not examine any presentations of the Firm's composites for any period, including any presentations that may accompany this report, and accordingly, we express no opinion on any such performance.<sup>1</sup>

[Signature]

September 1, 20Y1

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<sup>1</sup> If the verifier has issued a separate performance examination report concurrently, it may insert the following instead: "This report does not relate to any composite presentation of the Firm that may accompany this report, and accordingly, we express no opinion on any such performance."

## Appendix D—Illustrative Attest Reports: Verification and Performance Examination (Reporting Directly on the Subject Matter)

### Example 1—Verification and Performance Examination Report

#### Independent Accountant's Verification and Performance Examination Report

Investment Firm  
10 Main Street  
Anytown, USA

We have examined whether (1) Investment Firm (the Firm) has complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS standards) on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0. We have also examined the accompanying [*refer to accompanying composite compliant presentation*] of the Firm's XYZ Composite for the periods from January 1, 20X1, to December 31, 20Y0. The Firm's management is responsible for compliance with the GIPS standards and the design of its policies and procedures and for the [*refer to accompanying composite compliant presentation*]. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the Firm's compliance with the previously mentioned requirements; evaluating the design of the Firm's policies and procedures previously referred to; examining, on a test basis, evidence supporting the accompanying composite compliant presentation; and performing the procedures for a verification and performance examination required by the GIPS standards and 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, in all material respects,

- the Firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0; and
- the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0.

Also, in our opinion, in all material respects, the Firm has

- constructed the XYZ Composite and calculated the XYZ Composite performance for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards; and
- prepared and presented the [*refer to accompanying composite compliant presentation*] of the Firm's XYZ Composite for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards.

This report does not contain an opinion on accuracy of any composite presentation of the Firm other than the [refer to accompanying composite compliant presentation] of the Firm's XYZ Composite for the periods from January 1, 20X1, to December 31, 20Y0.

[Signature]

September 1, 20Y1

### Example 1A—Illustrative GIPS-Compliant Presentation for Report Example 1

#### Investment Firm XYZ Composite January 1, 20X1, to December 31, 20Y0

Year	Composite Gross Return (%)	Composite Net Return (%)	Custom Benchmark Return (%)	Composite 3-Yr St Dev (%)	Benchmark 3-Yr St Dev (%)	Number of Portfolios	Internal Dispersion (%)	Composite Assets (\$ M)	Firm Assets (\$ M)
20X1	-10.5	-11.4	-11.8			31	4.5	165	236
20X2	16.3	15.1	13.2			34	2.0	235	346
20X3	7.5	6.4	8.9			38	5.7	344	529
20X4	1.8	0.8	0.3			45	2.8	445	695
20X5	11.2	10.1	12.2			48	3.1	520	839
20X6	6.1	5.0	7.1			49	2.8	505	1,014
20X7	-21.3	-22.1	-24.9			44	2.9	475	964
20X8	16.5	15.3	14.7			47	3.1	493	983
20X9	10.6	9.5	13.0			51	3.5	549	1,114
20Y0	2.7	1.7	0.4	7.1	7.4	54	2.5	575	1,236

Investment Firm (the Firm) claims compliance with the Global Investment Performance Standards (GIPS standards) and has prepared and presented this report in compliance with the GIPS standards. The Firm has been independently verified for the periods from January 1, 20X1, to December 31, 20Y0. The verification report is available upon request. Verification assesses whether (1) the Firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

Notes:

1. The Firm is a balanced portfolio investment manager that invests solely in U.S. securities. The Firm is defined as an independent investment management firm that is not affiliated with any parent organization. Firm policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
2. The composite includes all institutional balanced portfolios that invest in large-cap U.S. equities and investment-grade bonds with the goal of providing long-term capital growth and steady income from a well-diversified strategy. Although the strategy allows for equity exposure ranging between 50 percent and 70 percent, the typical allocation is between 55 percent and 65 percent. The account minimum for the composite is \$5 million.

3. The custom benchmark is 60 percent YYY U.S. Equity Index and 40 percent ZZZ U.S. Aggregate Bond Index. The benchmark is rebalanced monthly.
4. Valuations are computed and performance reported in U.S. dollars.
5. Gross-of-fees returns are presented before management and custodial fees but after all trading expenses. Composite and benchmark returns are presented net of nonreclaimable withholding taxes. Net-of-fees returns are calculated by deducting the highest fee of 0.083 percent from the monthly gross composite return. The management fee schedule is as follows: 1 percent on the first \$25 million and 0.60 percent thereafter.
6. This composite was created in February 20X1. A complete list of composite descriptions is available upon request.
7. Internal dispersion is calculated using the equal-weighted standard deviation of annual gross returns of those portfolios that were included in the composite for the entire year.
8. The 3-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. The standard deviation is not presented for 20X1 to 20X9 because monthly composite and benchmark returns were not available and is not required for periods prior to 20Y0.

## Example 2—Performance Examination Report With a Reference to a Separate Verification Report

### Independent Accountant's Performance Examination Report

Investment Firm  
10 Main Street  
Anytown, USA

We have examined the accompanying<sup>1</sup> [*refer to accompanying composite compliant presentations*] of Investment Firm's (the Firm's) ABC and XYZ Composites for the periods from January 1, 20X1, to December 31, 20Y0. The Firm's management is responsible for these compliant presentations. Our responsibility is to express an opinion based on our examination. We previously conducted an examination (also referred to as a verification) of whether (1) the Firm has complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS standards) on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0; our report dated August 7, 20Y1, with respect thereto is attached.

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 accompanying composite compliant presentations and performing the procedures for a performance examination required by the GIPS standards and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

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<sup>1</sup> See example 1A for an illustrative composite-compliant presentation that would accompany the report.

In our opinion, in all material respects, the Firm has

- constructed the Firm's ABC and XYZ Composites and calculated the composite performance for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards; and
- prepared and presented the [*refer to accompanying composite compliant presentations*] of the Firm's ABC and XYZ Composites for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards.

This report does not attest to the accuracy of any composite presentation of the Firm other than the Firm's ABC and XYZ Composites.

[*Signature*]

September 1, 20Y1

## Appendix E—Illustrative Attest Report: Successor Practitioner Report—Verification and Performance Examination

### Reporting Directly on the Subject Matter (Verification and Performance Examination Report) in Successor Practitioner's Report When the Predecessor Verifier's Report Is Not Presented

#### Independent Accountant's Verification and Performance Examination Report

Investment Firm  
10 Main Street  
Anytown, USA

We have examined whether (1) Investment Firm (the Firm) has complied with the composite construction requirements of the Global Investment Performance Standards (GIPS standards) on a firmwide basis for the period from January 1, 2011, to December 31, 2011, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 2011. We have also examined the accompanying [*refer to accompanying composite compliant presentation*] of the Firm's XYZ Composite for the period from January 1, 2011, to December 31, 2011. The Firm's management is responsible for compliance with the GIPS standards and the design of its policies and procedures and for the [*refer to accompanying composite compliant presentation*]. Our responsibility is to express an opinion based on our examination. [*Refer to accompanying composite compliant presentation*] of the Firm's XYZ Composite for the periods from January 1, 2002, to December 31, 2010, was examined by other independent verifiers, whose report is dated August 27, 2011.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the Firm's compliance with the previously mentioned requirements; evaluating the design of the Firm's policies and procedures previously referred to; examining, on a test basis, evidence supporting the accompanying composite compliant presentation; and performing the procedures for a verification and performance examination required by the GIPS standards and 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, in all material respects

- the Firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis for the period from January 1, 2011, to December 31, 2011; and
- the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 2011.

Also, in our opinion, in all material respects, the Firm has

- constructed the Firm's XYZ Composite and calculated the composite performance for the period from January 1, 2011, to December 31, 2011, in compliance with the GIPS standards; and
- prepared and presented the [*refer to accompanying composite compliant presentation*] of the Firm's XYZ Composite for the period from January 1, 2011, to December 31, 2011, in compliance with the GIPS standards.<sup>1</sup>

We have not been engaged to examine and did not examine the Firm's XYZ Composite for any period prior to January 1, 2011, as shown in the accompanying [*refer to the accompanying composite compliant presentation*], and accordingly, we express no opinion on any such performance.

This report does not attest to the accuracy of any composite presentation of the Firm other than the Firm's XYZ Composite.

[*Signature*]

March 1, 2012

### Investment Performance Standards Task Force

Todd Johnson, *Chair*

Jonathan Boersma

Kimberly S. Cash

Karen Foley

Steve Perazzoli

Kenneth Robinson

John Stomper

Dan Strasshofer

Karyn D. Vincent

### AICPA Staff

Charles E. Landes

*Vice President*

*Professional Standards and Services*

Ahava Z. Goldman

*Senior Technical Manager*

*Audit and Attest Standards*

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<sup>1</sup> See example 1A in appendix D, "Illustrative Attest Reports: Verification and Performance Examination (Reporting Directly on the Subject Matter)," of this Statement of Position for an illustrative composite-compliant presentation that would accompany the report.

## AUD Section 50

# ***Statement of Position 13-1—Attest Engagements on Greenhouse Gas Emissions Information***

April 2013

### NOTE

This Statement of Position (SOP) is an interpretative publication, and it represents the recommendations of the AICPA's Sustainability Task Force regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to attest engagements on greenhouse gas emissions information. The Auditing Standards Board (ASB) has found the recommendations in this SOP to be consistent with existing standards covered by the "Compliance With Standards Rule" (ET sec. 1.310.001) of the AICPA Code of Professional Conduct.

Interpretative publications are not as authoritative as a pronouncement of the ASB; however, if a practitioner does not apply the attestation guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions addressed by this SOP.

## Introduction

.01 Certain atmospheric gases (carbon dioxide, methane, nitrous oxide, water vapor, and others) are called greenhouse gases (GHGs) because they are believed to contribute to the retention of outgoing energy, trapping heat somewhat like the glass panels of a greenhouse. For the purposes of GHG emissions reporting, GHGs include carbon dioxide and any other gases required by the applicable criteria to be included in the GHG emissions schedules, such as

- methane (CH<sub>4</sub>);
- nitrous oxide (N<sub>2</sub>O);
- perfluorocarbons (PFCs);
- hydrofluorocarbons (HFCs); and
- sulphur hexafluoride (SF<sub>6</sub>).

.02 Gases other than carbon dioxide are often expressed in terms of carbon dioxide equivalents (CO<sub>2</sub>-e). Due to a number of global and national initiatives to reduce GHG emissions, many entities are quantifying their GHG emissions for internal management purposes, and many are also preparing a GHG emissions schedule

- as part of a regulatory disclosure regime.
- as part of an emissions trading program.

- to inform investors and others on a voluntary basis. Voluntary disclosures may be, for example, published as a stand-alone document, included as part of a broader sustainability report or in an entity's annual report, or made to support inclusion in a public carbon registry.

.03 Entities may also participate in *emission reduction*<sup>1</sup> projects to reduce the emission of GHGs, such as by setting emission limits or modifying the emission source. Emission reduction is measured in relation to a *baseline*. Emission reductions may be registered and traded (that is, purchased and sold). Paragraphs .29–.30 describe the attributes to be met by an emission reduction for it to be registered or traded, and paragraph .45 provides examples of GHG emission reduction projects.

## GHG Reporting in the United States

.04 Voluntary reporting programs in which some U.S. companies participate include the following:

- The Carbon Disclosure Project (CDP), an organization based in the United Kingdom that works with shareholders and corporations to encourage them to disclose their GHG emissions. The CDP scores entities based on factors such as the extent to which a company measures its carbon emissions, the frequency and relevance of its disclosure to key corporate stakeholders, and whether the company engages a third party to verify emissions data to promote greater confidence and use of the data. Entities with sufficiently high scores are listed in the Carbon Disclosure Leadership Index (CDLI).
- The Climate Registry ([www.theclimateregistry.org](http://www.theclimateregistry.org)) is a nonprofit collaboration among North American states, provinces, territories, and Native Sovereign Nations that sets standards to calculate, verify, and publicly report GHG emissions into a single registry.

Certain industries and jurisdictions require GHG emissions reporting but may not require attestation services.

.05 Reasons that entities report GHG emissions and request attestation services related to GHG emissions include the following:

- To participate in GHG emissions reductions programs.
- To respond to shareholder resolutions calling for companies to report and have their corporate social responsibility or GHG emissions information verified by a third party.
- To demonstrate responsible corporate behavior.
- The desire to be listed in the CDLI.
- To satisfy requests from customers regarding information about GHG emissions within their supply chain. For example, in October 2009, Section 13 of Executive Order 13514, Federal Leadership in Environmental, Energy, and Economic Performance, directed the U.S. General Services Administration (GSA) with the Department of Defense and the Environmental Protection Agency to assess the feasibility of requiring federal suppliers to provide GHG emissions

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<sup>1</sup> Terms defined in the glossary are italicized the first time they appear in this statement of position.

data to the government. In August 2010, GSA launched the Federal Supplier Greenhouse Gas Emissions Inventory Pilot, a three-year program in which small businesses are required to develop annual GHG emissions inventories through September 2013. The program's purpose is to assess the benefits and challenges experienced by small businesses when completing a GHG emissions inventory.

## Terms and Definitions Used by Registries and Regulatory Frameworks

.06 Appendix A, "Glossary," in this statement of position (SOP) contains a glossary of common terms relating to GHG engagements. Different registries and regulatory frameworks may use different terms and definitions for similar services. A *validation* is a service that would provide assurance on the feasibility of the design of an emission reduction project, usually before inception of the project; an entity would typically engage an engineering or a consulting firm to provide such a service. This SOP does not provide guidance on validation standards. A *verification* is the objective and independent assessment of whether the reported GHG emissions properly reflect the GHG impact of the entity in conformance with preestablished GHG accounting and reporting standards. Various GHG registries and regulatory frameworks may not define these terms in exactly the same way; thus, the practitioner should obtain the official definitions of such terms under the registry or regulatory framework relevant to the engagement. However, practitioners should not use terms such as *validation* or *verification* in their attest reports on GHG emissions regardless of whether the registry or regulatory framework uses such terms because AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), requires the terms *examination* or *review* to be used to describe such engagements.

## Scope of This SOP

.07 This SOP provides guidance for practitioners performing

- an examination or
- a review

of a GHG emissions statement containing either

- a schedule with the subject matter or
- an assertion

relating to information about an entity's GHG emissions, such as

- a GHG *inventory* (an entity's emissions of GHGs for a specified period, typically, a year or a series of years, or a baseline *GHG inventory*), or
- a GHG emission reduction in connection with
  - the recording of the reduction with a registry or
  - a trade of that reduction or *credit*.

Such engagements should be performed pursuant to AT section 101. This SOP provides guidance on the application of AT section 101 to GHG emissions attest engagements. This SOP is not intended to provide all the guidance set forth in the applicable standards established by the AICPA. This SOP supersedes SOP 03-2, *Attest Engagements on Greenhouse Gas Emissions Information*.

**.08** In an examination engagement of a GHG emissions statement, the practitioner chooses a combination of attestation procedures, which can include inspection, observation, confirmation, recalculation, reperformance, analytical procedures, and inquiry. In a review engagement, the types of procedures performed generally are limited to inquiries and analytical procedures (see paragraph .59 for further description of review procedures). Determining the attestation procedures to be performed on a particular engagement is a matter of professional judgment. Because GHG emissions reporting covers a wide range of circumstances, the nature, timing, and extent of procedures are likely to vary considerably from engagement to engagement.

**.09** Unless otherwise stated, the matters discussed in this SOP apply to both examination and review engagements. Because a review engagement is substantially less in scope than an examination, the procedures the practitioner will perform in a review engagement will vary in nature and extent from those performed in an examination engagement. Paragraphs .59 and .64 describe in tabular form procedures that are relevant to an examination or review engagement. Procedures that would ordinarily be performed in both an examination and a review are shown in one column across a row. Similar procedures are shown in separate columns in a row, and when a procedure is not ordinarily performed in a review engagement, the review column in that row has been deliberately left blank. Although some procedures are shown only for examination engagements, they may nonetheless be appropriate in review engagements in circumstances in which procedures, in addition to inquiry and analytical procedures, are determined to be necessary by the practitioner.

## Engagement Acceptance Considerations

**.10** The following are examples of matters addressed in AT section 101 that are relevant to a practitioner's decision about whether to accept an engagement:

- Independence (see paragraphs .11–.12).
- Whether the practitioner has adequate technical knowledge of the subject matter to perform the engagement, including evaluation of the work of any specialists involved in the engagement (see paragraphs .13–.19).
- Whether the practitioner will be performing a sufficient portion of the engagement to assume overall responsibility (see paragraphs .20 and .54).
- Considerations in selecting and using the work of a specialist, when applicable (see paragraphs .21–.23).
- Existence of suitable criteria (see paragraphs .24–.30).
- Materiality considerations (see paragraph .31).
- Expectations of users of the GHG inventory or reduction information and the practitioner's report thereon.
- Whether the entity is likely to have adequate information systems and controls to provide reliable GHG information.
- Whether sufficient evidence is likely to exist, including when the entity has changed measurement methods for GHG emissions from one period to the next (see paragraphs .33 and .66).
- The scope of the entity's GHG inventory (see paragraphs .34–.35 for a discussion of *boundaries* and paragraphs .36–.38 for a discussion of direct and indirect emissions for a GHG inventory).

- Availability of historical data. If the practitioner is engaged to perform the attest service at a date considerably later than the base year, there is a risk that historical data for the base year may not be available (see paragraph .39 for a discussion of baselines).

## Independence

.11 The practitioner performing an attest engagement is required to be *independent* pursuant to the "Independence Rule" (ET sec. 1.200.001) of the AICPA Code of Professional Conduct. [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

.12 Certain GHG registries and regulatory frameworks set rules that prohibit professionals who provide attest services on GHG emissions statements from providing other services to the entity for a period of time. For example, a GHG framework or registry may set independence requirements that specifically prohibit a practitioner who has performed certain services for an entity from also providing a verification (that is, an examination or review) of an entity's GHG emissions statement for a certain period of time. Such independence requirements, which may be beyond those of the AICPA, or other limitations on the scope of services set by the relevant framework or registry may preclude the practitioner from performing an attestation engagement that is acceptable under such GHG framework or to such registry.

## Adequate Knowledge of Subject Matter and Use of a Specialist

.13 Paragraph .02 of AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*), states that "the engagement must be performed by a practitioner having adequate knowledge of the subject matter." Paragraph .22 of AT section 101 states that "this knowledge requirement may be met, in part, through the use of one or more specialists on a particular attest engagement if the practitioner has sufficient knowledge of the subject matter (a) to communicate to the specialist the objectives of the work and (b) to evaluate the specialist's work to determine if the objectives were achieved." Relevant considerations in determining whether to accept an attest engagement on a GHG emissions statement include whether the practitioner's involvement in the engagement and understanding of the subject matter are sufficient to enable the practitioner to discharge his or her responsibilities. The practitioner may involve internal specialists as part of the engagement team or engage external specialists to assist the team. The practitioner should accept an attest engagement on a GHG emissions statement only if the practitioner is satisfied that the engagement team, along with a practitioner's external specialist, collectively possesses the necessary professional competencies to perform the GHG emissions engagement.

.14 Professional competencies necessary to perform a GHG emissions engagement may include

- understanding emissions trading programs and related market mechanisms, when relevant.
- understanding who the intended users of the information in the entity's GHG emissions statement are and how they are likely to use that information.

- knowledge of applicable laws and regulations, if any, that affect how the entity should report its emissions or impose a limit on the entity's emissions.
- GHG quantification and measurement methodologies, including the associated scientific and measurement uncertainties, and alternative methodologies available.
- knowledge of the applicable criteria, including, for example
  - identifying appropriate *emissions factors*.
  - identifying those aspects of the criteria (see paragraphs .24–.28) that call for significant or sensitive estimates to be made or for the application of considerable judgment.
  - methods used for determining organizational boundaries (that is, the entities whose emissions are to be included in the GHG emissions statement).
  - which emissions reductions are permitted to be included in the entity's GHG emissions statement.

**.15** In most attest engagements on GHG emissions, the nature of the entity's operations, emissions, or the emissions measurement methodology in general requires specialized skill or technical knowledge in a particular field other than accounting or auditing, such as environmental engineering. The practitioner should possess adequate technical knowledge of the subject matter to understand how GHG emissions information might be misstated and to design procedures to respond to the risks of material misstatement. A practitioner may obtain adequate knowledge of the subject matter through formal or continuing education, including self-study, or through practical experience. When determining whether the practitioner has adequate technical knowledge, the practitioner should read the criteria selected by the *responsible party* (defined as the person or persons, either as individuals or representatives of the entity, responsible for the subject matter)<sup>2</sup> to understand what is involved in the measurements.

**.16** Particular areas of expertise that may be relevant in such cases include the following:

- Information systems expertise
  - Understanding how emissions information is generated, including how data is initiated, recorded, processed, corrected as necessary, and reported in the GHG emissions statement.
- Scientific and engineering expertise
  - Mapping the flow of materials through a production process and the accompanying processes that create emissions, including identifying the relevant points at which source data is gathered. This may be particularly important when considering whether the entity's identification of emissions sources is complete.

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<sup>2</sup> Paragraph .11 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*).

- Analyzing chemical and physical relationships between inputs, processes, and outputs and relationships between emissions and other variables. The capacity to understand and analyze these relationships will often be important when designing analytical procedures.
- Identifying the effect of uncertainty on the measurement of GHG emissions.
- Knowledge of the quality control policies and procedures implemented at testing laboratories, whether internal or external.
- Experience with specific industries and related emissions creation and removal processes. Creation and removal procedures for scope 1 emissions quantification (see paragraph .36) vary greatly depending on the industries and processes involved (for example, the nature of electrolytic processes in aluminum production, combustion processes in the production of electricity using fossil fuels, and chemical processes in cement production are all different).
- The operation of physical sensors and other quantification methods and the selection of appropriate emissions factors.

**.17** If the entity is a service entity whose GHG emissions are limited to the use of purchased electricity and natural gas or oil, the practitioner may be able to use published factors to convert the electricity, gas, or oil used to GHGs emitted to obtain evidence about how the entity calculated its emissions. Under those circumstances, the practitioner may not need to use a specialist, provided that the practitioner possesses sufficient technical knowledge regarding the published factors, including an understanding of the nature of each factor and the distinctions between alternatives. If the entity has significant industrial operations with numerous sources of emissions, however, it is more likely that the practitioner will need to use a specialist.

**.18** If specialized skills are needed to supplement the practitioner's technical knowledge, the practitioner should seek the assistance of a professional possessing such skills, who may be either a member of the engagement team or an outside professional. The practitioner should possess adequate technical knowledge to direct, supervise, and review the specialist's work in the former situation and understand and evaluate the specialist's work in the latter situation.

**.19** When the responsible party employs a specialist to develop evidence that is used to support the assertion or presentation, the practitioner should evaluate whether the practitioner or another member of the engagement team possesses adequate technical knowledge to understand and evaluate the specialist's work or whether the practitioner should seek assistance from an external specialist. The practitioner may find it helpful to consider the provisions of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), when evaluating the competence, capabilities, and objectivity of the responsible party's specialist.

**.20** When using the work of an external specialist, the practitioner should consider the nature and magnitude of the specialist's work in relation to the overall engagement to determine whether the practitioner will be performing a sufficient portion of the engagement to assume overall responsibility.

## Considerations When Selecting and Using the Work of a Specialist

.21 Considerations when selecting a specialist include the following:

- The specialist's expertise and competence in the subject matter
- The relevance of the specialist's expertise to the practitioner's objectives in the attest engagement
- The objectivity of the specialist
- The nature and extent of the anticipated use of the specialist

.22 Examples of matters that may require the practitioner to consider using the work of a specialist or having a specialist participate in the GHG engagement include

- reviewing the quality of client-provided data (for example, appropriateness and accuracy).
- evaluation of the reasonableness of emission factors, such as
  - whether it is necessary or appropriate to use a derived emissions factor versus a published emissions factor.
  - the population and selection of appropriate published emissions factors.
  - assessment of the methodology used to calculate the specific GHG emissions (see paragraphs .33 and .66).
- reviewing the work of the responsible party's specialist (for example, to assess whether the assumptions underlying the methodology are reasonable).

.23 Regardless of whether the specialist is employed by the practitioner's firm or an external specialist is engaged by the practitioner, the practitioner should follow the guidance in this SOP and may find it helpful to consider the provisions of AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*). When the practitioner considers using the work of a specialist engaged by the responsible party, the practitioner should follow the guidance contained in this SOP and may find it helpful to consider the provisions of AU-C section 500, including evaluating the relationship of the specialist to the responsible party.

## Criteria

.24 AT section 101 states that in order for the engagement to be performed, the practitioner must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users.

.25 Criteria that are established or developed by groups composed of experts that follow due process procedures, including exposure of the proposed criteria for public comment, ordinarily should be considered suitable.

.26 Frameworks establishing criteria for GHG emissions statements usually include measurement, presentation, and disclosure considerations. Different industries, regulatory organizations, or organizations acting in a standard-setting role may have developed guidance on measurement relevant to an industry, regulated group, or GHG emissions in general. Alternatively, an entity may develop its own criteria for measurement of emissions.

.27 The practitioner should consider whether criteria selected by the responsible party are suitable (see paragraphs .23–.32 of AT section 101 for guidance on suitability of criteria). For guidance on the availability of criteria, see paragraphs .33–.34 of AT section 101.

.28 Most entities will need to select a framework and refine the application of measurement criteria, perhaps using software tools for measuring emissions in specific industries or using certain industrial processes, such as cement production or aluminum smelting. The practitioner should review the entity's measurement protocol and consider whether the entity's measurement methods are appropriate. See appendix B, "Sources for GHG Emission Protocols and Calculation Tools."

## Attributes to Be Met by GHG Emission Reductions

.29 Various registries and GHG emissions trading programs have specified attributes to be met by an emission reduction for it to be registered or traded. Common attributes are identified and described in the following list; however, definitions may vary by trading program. In the context of a specific registry or emissions trading program, additional requirements to be met by the emission reduction may exist:

- a. *Ownership.* In many cases, ownership is clear. Examples of such cases include efficiency upgrades at a manufacturing facility or fuel-switching at a power plant. However, for some project types, particularly those with renewable energy and demand-side management projects that offset or displace fossil-fuel emissions, demonstrating ownership can be challenging. Ownership of the reductions may be open to dispute because the reductions do not occur on the site of the project but, rather, on the site of a fossil-fueled facility whose power was displaced. These are known as *indirect emission reductions* because the reductions occur at facilities other than the one where the project has been undertaken. The possibility that the direct source of emissions would claim title to the same reductions claimed by the project developer or that the joint venture partners would claim title to the same reductions of their joint venture (referred to as *double-counting*) represents a risk that buyers prefer to avoid. It is possible that multiple claimants, such as the owner of the emitting source, technology vendors, and the entity installing the technology, could claim ownership of these reductions.
- b. *Real.* An emission reduction is real if it is a reduction in actual emissions that results from a specific and identifiable action or undertaking that is not a mere change in activity level (for example, due to typical business fluctuations) and net of any leakage to a third party or jurisdiction. *Leakage* occurs when an emission reduction project causes emissions to increase beyond the project's boundaries. Entities entering into an emission reduction project typically must demonstrate that the emission reduction will not cause emissions to increase beyond the project's boundaries.
- c. *Quantifiable or measurable.* An emission reduction is quantifiable or measurable if the total amount of the reduction can be determined, and the reduction is calculated in an accurate and replicable manner.

- d. *Surplus*. An emission reduction is surplus if the reduction is not otherwise required of a source by current regulations or a voluntary commitment to reduce emissions to a specified level.
- e. *Establishment of a credible emissions baseline*. Many programs measure emission reductions by comparing a credible emissions baseline without the project to the emissions baseline with the project. A reduction quantity is not meaningful unless it is compared with a credible baseline (that is, a baseline compiled in accordance with the current protocol, using the same boundaries and scope).
- f. *Unique*. Credits should be created and registered only once from a specific reduction activity and time.

**.30** Some registries or emissions trading programs may have a requirement for *additionality*. Environmental additionality requires that the emission reductions achieved by the project would not have occurred in the absence of the project (the reduction must be additional to any required reductions; that is, if the entity has taken on a cap, the reduction must be additional to the cap). A credible emission baseline is crucial for an entity to demonstrate additionality. Various GHG registries and regulatory frameworks may not define additionality and the terms referred to in paragraph .29 in exactly the same way; thus, the practitioner should obtain the official definitions of such terms under the registry or regulatory framework relevant to the engagement.

## Materiality

**.31** Paragraph .67 of AT section 101 addresses materiality in attestation engagements. Also, the applicable GHG registry or voluntary or regulatory framework may set specific materiality limits. If a GHG registry or framework sets specific materiality requirements that are more stringent than those of AT section 101, before accepting the engagement the practitioner should consider whether it is possible to meet such requirements.

## Uncertainty in the Measurement of GHG Emissions

**.32** The term *uncertainty* as used in the field of GHG emissions refers to variability in the measurement of GHG emissions rather than the term *uncertainty* as defined in the auditing literature. Uncertainty in GHG emissions estimates can be due to a variety of factors. Examples of matters that may create or increase uncertainty in GHG emissions estimates include the following:

- Use of factors that are poorly researched or uncertain (for example, factors for CH<sub>4</sub> and N<sub>2</sub>O from combustion processes)
- Use of average case factors not perfectly matched to specific and varying circumstances (for example, miles per gallon, average kgCO<sub>2</sub>/MWh generated)
- Deliberate estimation to compensate for missing data (for example, nonreporting facilities or missing fuel bills)
- Assumptions that simplify calculation of emissions from highly complex processes
- Imprecise measurement of emissions-producing activity (for example, miles traveled in airplanes or rental vehicles, hours per year specific equipment is used)

- Insufficient frequency of measurement to account for natural variability
- Poor calibration of measuring instruments

## Consistency

**.33** Measurement of the GHG inventory requires consistent application of measurement methods. If the entity has changed measurement methods from one period to the next, the practitioner should consider the implications on the engagement (for example, whether it is essential that the same methods be used because either comparative information is presented or a reduction is being calculated and, if so, whether the entity has restated the prior period's results using the same measurement method as the current period). (See paragraphs .39, .66, and .72.)

## Boundaries

**.34** Determining which operations owned or controlled by the entity to include in the entity's GHG emissions statement is known as "determining the entity's organizational boundary." In some cases, laws and regulations define the boundaries of the entity for reporting GHG emissions for regulatory purposes. In other cases, the applicable criteria may allow a choice between different methods for determining the entity's organizational boundary (for example, the criteria may allow a choice between an approach that aligns the entity's GHG emissions reporting with its financial statements and another approach that treats, for example, joint ventures or associates differently). Determining the entity's organizational boundary may require the analysis of complex organizational structures such as joint ventures, partnerships, and trusts and complex or unusual contractual relationships. For example, a facility may be owned by one party, operated by another, and process materials solely for another party.

**.35** Determining the entity's organizational boundary is different from what some criteria describe as determining the entity's "operational boundary." The operational boundary relates to which categories of scope 1, 2, and 3 emissions will be included in the GHG emissions statement and is determined after setting the organizational boundary. Leakage may affect the choice of operational boundaries. When planning the engagement, the practitioner should obtain an understanding of the boundaries that have been set by the entity and the potential for leakage. If leakage has occurred, the entity may account for it by adjusting its baseline or by changing its boundaries.

## Scopes for Reporting GHG Emissions: Direct and Indirect Emissions

**.36** Reporting GHG emissions and emission reductions may encompass one or more of the following three scopes of emissions:

- a. *Scope 1: Direct GHG Emissions.* Emissions from sources that are owned or controlled by the entity. These are emissions associated with the following:
  - Stationary combustion from fuel burned in the entity's stationary equipment, such as boilers, incinerators, engines, and flares
  - Mobile combustion from fuel burned in the entity's transport devices, such as trucks, trains, airplanes and boats

- Process emissions from physical or chemical processes, such as cement manufacturing, petrochemical processing, and aluminum smelting
  - Fugitive emissions, which are intentional and unintentional releases, such as equipment leaks from joints and seals and emissions from wastewater treatment, pits, and cooling towers
- b. *Scope 2: Indirect GHG Emissions From the Generation of Imported or Purchased Electricity, Heat, or Steam.* Emissions that are a consequence of the activities of the entity, but which occur at sources that are owned or controlled by another entity. Scope 2 emissions are associated with energy that is transferred to, and consumed by, the entity.
- c. *Scope 3: Other Indirect Emissions,* including the following:
- Employee business travel
  - Outsourced activities, contract manufacturing, and franchises
  - Transportation by the vendor or contractor of, for example, materials, products, waste, and employees
  - Emissions from product use and end of life
  - Employee commuting
  - Production of imported materials

**.37** The practitioner should determine whether the proposed scope of the engagement is appropriate and whether it covers one or more of the following:

- a. Direct GHG emissions
- b. Indirect GHG emissions associated with the generation of imported or purchased electricity, heat, or steam
- c. Other indirect emissions

**.38** Some reporting programs may classify these emissions sources differently than those noted in paragraph .36. The practitioner should evaluate the potential for double-counting of emissions and reductions, especially in instances of indirect emissions and shared ownership or control. If the practitioner has been engaged to report on an entity's indirect emissions, especially those emissions for a supplier not under the direct control of the entity, the practitioner should consider whether he or she can obtain a written assertion from the responsible party and obtain sufficient evidence to form a conclusion. The practitioner also should consider the availability or existence of data for emitting sources not under the direct control of the entity.

## Baselines

**.39** A *baseline* is the amount of the entity's emissions for a specified base year against which any future changes in emissions are evaluated. Management should recalculate the baseline, however, for changes in scope and boundaries, subsequent acquisitions, and sales or closing of emitting sources. If the practitioner is engaged to perform the attest service at a date considerably later than the base year, there may be differences in the quality of the data and consistency of methodology between the base year and the current year.

## Objective of the Engagement

### GHG Inventory

**.40** The criteria selected are used by the entity to measure and present and by the practitioner to evaluate the specific subject matter of the attestation engagement. It is anticipated that appropriate disclosures will be included in the presentation, not just the quantity of GHG emissions for a period of time. The presentation may include, or be accompanied by, other information that is not subject to the practitioner's engagement, such as the discussion of the responsible party's commitment and strategy, projections, and targets related to its GHG emissions. Therefore, the form of the conclusion will vary depending upon the information presented under the selected criteria on which the practitioner is engaged to report.

**.41** The practitioner's objective for an examination of GHG emissions information typically is to express an opinion about whether

- a. the entity's schedule of GHG emissions is presented, in all material respects, in conformity with the criteria selected by the responsible party (see paragraphs .24–.28), or
- b. the responsible party's written assertion about the schedule of GHG emissions is fairly stated, in all material respects, based on the criteria selected by the responsible party.

**.42** The practitioner's objective for a review of GHG emissions information typically is to express a conclusion, based on the work performed, about whether any information came to the practitioner's attention that indicates that

- a. the entity's schedule of GHG emissions is not presented, in all material respects, in conformity with the criteria selected by the responsible party, or
- b. the responsible party's written assertion about the schedule of GHG emissions is not fairly stated, in all material respects, based on the criteria selected by the responsible party.

### GHG Emission Reduction Information

**.43** The practitioner's objective in an examination of GHG emission reduction information typically is to express an opinion about whether

- a. the entity's GHG emission reduction information related to a specific project or on an entity-wide basis is presented, in all material respects, in conformity with the criteria selected by the responsible party, or
- b. the responsible party's written assertion about the GHG emission reduction information related to a specific project or on an entity-wide basis is fairly stated, in all material respects, based on the criteria selected by the responsible party.

**.44** The practitioner's objective in a review of GHG emission reduction information is to express a conclusion, based on the work performed, about whether any information came to the practitioner's attention that indicates that

- a. the entity's GHG emission reduction information related to a specific project or on an entity-wide basis is not presented, in all material respects, in conformity with the criteria selected by the responsible party, or

- b. the responsible party's written assertion about the GHG emission reduction information related to a specific project or on an entity-wide basis is not fairly stated, in all material respects, based on the criteria selected by the responsible party.

### **Examples of GHG Emission Reduction Projects**

.45 Examples of GHG emission reduction projects include, but are not limited to, the following:

- Use of renewable energy systems, such as wind, solar, and other low emission technologies, in place of higher emission technologies
- Change in processes to increase energy efficiency, such as the installation and use of more energy-efficient equipment
- Carbon sequestration: no-till farming; agricultural grass and tree plantings
- Change from more GHG-intensive fuels to less GHG-intensive fuels (for example, from coal to natural gas or nuclear power)
- Recovery and use of agricultural and landfill methane
- Improvement in the fuel efficiency of vehicle fleets
- Reduction in venting or flaring on offshore oil production platforms (installation of zero flare systems; rapid response to unplanned events)
- Cessation of operations at noneconomical plants and transfer of production to more efficient plants
- Demand-side management projects

### **Prerequisite for Engagements Related to GHG Emission Reduction Information**

.46 As a prerequisite to performing an examination or review of GHG emission reduction information, the practitioner should obtain sufficient evidence about the entity's GHG emissions for the period in which the project took effect to provide a reasonable basis for the conclusion that is expressed in the practitioner's report on the GHG emission reduction information.

.47 In some cases, one practitioner has reported on an entity's GHG inventory, but another practitioner is engaged to report on the entity's GHG emission reduction information. When the practitioner engaged to report on the GHG emission reduction information is deciding whether he or she may rely on the work of the other practitioner, the practitioner may find it helpful to consider the provisions of AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*). Other important considerations in this situation are the level of assurance obtained by the other practitioner and the consistency of the assumptions and methods used to measure the GHG emission reduction with those used to measure the GHG inventory reported on by the other practitioner. (See paragraphs .33 and .66).

.48 Members of professions other than public accounting are subject to their own professional requirements; those requirements may differ from those of the public accounting profession. When a non-CPA has provided verification services (see paragraph .06) with respect to an entity's GHG inventory and the

practitioner is engaged to examine or review an entity's GHG reduction, the practitioner should perform procedures to obtain sufficient evidence with respect to the entity's GHG inventory as part of performing the attest engagement to report on the entity's GHG emission reduction (for example, evaluating the appropriateness of the methodology and any emission factors used and whether the base year emissions were adjusted if needed). The practitioner may find it helpful to consider certain aspects of the specialist's work in accordance with AU-C section 620.

## Written Assertion by the Responsible Party

.49 A written assertion by a responsible party may be presented to a practitioner in a number of ways, such as in a narrative description, within a schedule, or as part of a representation letter appropriately identifying what is being presented and the point in time or period of time covered. An example of a written assertion on a GHG inventory is as follows:

XYZ Company asserts that its schedule of GHG emissions for the year ended December 31, 20XX, is presented in conformity with *[identify criteria selected by the responsible party]*.

An example of a written assertion on a GHG emission reduction project is as follows:

XYZ Company reduced GHG emissions in connection with project ABC by 50,000 tons of CO<sub>2</sub> equivalents for the year ended December 31, 20XX, from its GHG emissions in the prior year, based on *[identify criteria selected by the responsible party]*.

## Engagement Performance

### Agreement on Engagement Terms

.50 The practitioner should establish an understanding with the client regarding the services to be performed. The understanding should include the objectives of the engagement, management's responsibilities, the practitioner's responsibilities, and the limitations of the engagement. The practitioner should document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter.

### Planning the Engagement

.51 Relevant information about obtaining an understanding and other considerations when planning an examination or review engagement typically includes the following:

- Applicable to GHG inventories and reductions
  - The nature of the entity's business and whether the entity has operations, and, therefore, GHG emission sources, in multiple locations and the types of GHG emissions produced
  - The business purpose or reason behind emissions measurements or emission reductions

- The oversight of, and responsibility for, emissions information within the entity
- The organizational and operational boundaries used for the emissions inventory
- Whether there have been any mergers, acquisitions, divestitures, sales of emitting sources, or outsourcing of functions with significant emissions that may require adjustment of the entity's baseline
- Whether all significant sources of emissions have been identified by the entity
- The potential for double-counting of emissions and, if applicable, reductions
- When applicable, any regulatory framework(s) (for example, state- or country-specific regulations, *permits*, or operating licenses governing emissions where the entity has operations) or any requirements relevant to a voluntary commitment to register or reduce GHG emissions
- How GHG emissions have been calculated and reported, including emissions factors and their justification, and any assumptions on which estimates are based
- The protocols that were used for measurement of emissions and whether they were used in a consistent manner throughout the entity over the period under examination or review
- Whether there is a need to use the work of a specialist
- Whether the entity's internal audit function is relevant to the engagement
- Whether to obtain a legal letter (legal letters are generally not obtained in a review engagement)
- Applicable to GHG reductions only
  - The type(s) of emission reduction(s) (for instance, a switch in fuel type or change in production process) (see paragraph .33).
  - Whether the emitting entity is required by a registry or regulatory framework to engage an outside specialist to evaluate the scientific or engineering basis for the proposed reduction project (sometimes referred to as a *validation*). Those rules may further specify that the party evaluating the science cannot be the same party as the verifier. When applicable, whether another reputable party has evaluated the science and found it to be acceptable and the implications of findings in the report.
  - Whether there are any ownership issues relating to the GHG emission reduction credits to be sold. (For example, in the case of a landfill, the seller may own the landfill or have ownership rights over the emission reduction by virtue of a contract.)

### **Consideration of Internal Control Over Gathering and Reporting GHG Emissions Data**

.52 Paragraph .52c of AT section 101 states "the more effective the controls over the subject matter, the more assurance they provide about the subject matter or the assertion." For an examination engagement, obtaining an understanding of internal control over gathering and reporting GHG emissions data, including *data assembly* and data retention, assists the practitioner in assessing control risk and planning the engagement. Relevant matters to understand regarding internal control include the following components of the entity's internal control:

- a. The control environment.
- b. The information system, including the related business processes, and communication of emissions-reporting roles and responsibilities and significant matters relating to emissions reporting.
- c. The entity's risk assessment process related to gathering, processing, and reporting GHG emissions data.
- d. Control activities relevant to the engagement. An attest engagement does not require an understanding of all the control activities related to each significant type of emission and disclosure in the GHG emissions schedule or to every assertion relevant to them.
- e. Monitoring of controls

.53 For a review engagement, obtaining an understanding of the entity's internal control over gathering and reporting GHG emissions data, including data assembly and data retention, may assist the practitioner with

- a. identifying types of potential misstatements in the GHG emissions statement, including types of omissions, and considering the likelihood of their occurrence.
- b. selecting the inquiries and analytical procedures, and other procedures if necessary, that will provide a basis for reporting whether any information causes the practitioner to believe
  - i. the entity's GHG emissions statement is not presented, in all material respects, in conformity with the criteria selected by the responsible party, or
  - ii. the responsible party's written assertion about the GHG emissions statement is not fairly stated, in all material respects, based on the criteria selected by the responsible party.

### **Part of Attest Engagement Performed by Other Practitioners**

.54 If another practitioner is reporting on the GHG emissions information for a subsidiary of the entity, that practitioner also should follow the guidance in this SOP. The practitioner who is engaged to report on the entity as a whole should consider whether the practitioner for the subsidiary has the skill and knowledge required to conduct the engagement. AU-C section 600 provides guidance on the professional judgments the auditor makes when deciding whether the auditor may serve as group engagement partner and use the work and reports of component auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or

investments included in the financial statements presented. The practitioner who is engaged to report on the entity as a whole may find that guidance helpful when performing an attest engagement on GHG emissions, and another practitioner is reporting on the GHG emissions of a subsidiary or other component of the client entity. Other relevant information for the practitioner reporting on the subsidiary is whether the subsidiary is using the same protocol, scope of reporting, and boundaries as the parent entity.

## Attestation Risk

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

**.56** Examples of causes of possible misstatements of GHG inventory or GHG emission reduction information include the following:

- Human error in calculations
- Use of incorrect emissions factors
- Omission from the inventory of emissions from one or more emitting sources
- Omission from the inventory of one or more GHG emissions (for example, omission of methane emissions)
- Failure to properly account for leakage (for example, when the entity has outsourced a major function that accounted for a significant part of its GHG emissions baseline but has not adjusted its baseline to reflect such change)
- Failure to appropriately adjust the baseline for events such as sales or acquisitions of emitting sources
- Existence of one or more significant deficiencies in the entity's internal control over reporting of emissions information
- Double counting of an emission source within the entity

## Obtaining Sufficient Evidence

**.57** When conducting an examination engagement, the practitioner should accumulate sufficient evidence to restrict attestation risk to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be imparted by his or her report. A practitioner should select from all available procedures—that is, procedures that assess inherent and control risk and restrict detection risk—any combination that can restrict attestation risk to such an appropriately low level. (See paragraph .54 of AT section 101.)

**.58** In a review engagement, the objective is to accumulate sufficient evidence to restrict attestation risk to a moderate level. To accomplish this, the types of procedures performed generally are limited to inquiries and analytical procedures (rather than also including search and verification procedures). Nevertheless, there will be circumstances in which inquiry and analytical procedures (a) cannot be performed, (b) are deemed less efficient than other procedures, or (c) yield evidence indicating that the subject matter or assertion may be incomplete or inaccurate. In the first circumstance, the practitioner should

perform other procedures that he or she believes can provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would have provided. In the second circumstance, the practitioner may perform other procedures that he or she believes would be more efficient to provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would provide. In the third circumstance, the practitioner should perform additional procedures.

**.59** The procedures listed in the following table may be performed, among others, in an examination or review engagement of a GHG inventory or an emission reduction to restrict attestation risk to an appropriate level for the engagement:

<i><b>Examination</b></i>	<i><b>Review</b></i>
a. Obtaining evidence about how emissions were calculated and any underlying methodologies, emission factors, and assumptions used.	a. Inquiring about how emissions were calculated and any underlying methodologies, emission factors, and assumptions used.
b. Evaluating the appropriateness of techniques used to calculate the emissions or emission reduction, including how completeness and uncertainty are addressed in those calculations (see paragraphs .61–.63).	
c. Determining whether there have been any changes in the protocol(s) used to calculate emissions and, when applicable, determine whether a subsidiary uses the same protocol.	c. Inquiring about whether there have been any changes in the protocol(s) used to calculate emissions and, when applicable, about whether a subsidiary uses the same protocol.
<p>d. Conducting site visits as considered appropriate. To obtain adequate coverage of total emissions, particularly in an examination, the practitioner may decide that it is appropriate to perform procedures on location at a selection of facilities. Factors that may be relevant to such a decision include</p> <ul style="list-style-type: none"> <li>• the nature of emissions at different facilities.</li> <li>• the number and size of facilities and their contribution to the entity's overall emissions.</li> <li>• whether facilities use different processes or processes using different technologies. When this is the case, it may be appropriate to perform procedures on location at a selection of facilities using different processes or technologies.</li> <li>• the methods used at different facilities to gather emissions information.</li> <li>• the experience of relevant staff at different facilities.</li> <li>• varying the selection of facilities over time.</li> </ul>	

*(continued)*

<i>Examination</i>	<i>Review</i>
e. Determining whether there have been any changes in baselines, such as sales or acquisitions of operational facilities or subsidiaries.	e. Inquiring about whether there have been any changes in baselines, such as sales or acquisitions of operational facilities or subsidiaries.
f. When applicable, obtaining information about the frequency of meter readings and calibration and maintenance of meters.	f. When applicable, inquiring about the frequency of meter readings and calibration and maintenance of meters.
g. Reading relevant contracts.	
h. Tracing information to supporting documents.	
i. Inquiring about the existence of fraud or illegal acts or suspected fraud or illegal acts affecting the entity involving (1) management, (2) employees who have significant roles in the entity's processes and procedures relating to measurements of emissions in conformity with the criteria specified previously, or (3) others when the fraud or illegal acts could have a material effect on measurements of emissions in conformity with the selected criteria.	
j. Inquiring about the nature of significant judgments and estimates made by management and any uncertainties regarding measurements; considering management's process for, and internal control over, developing those estimates; inquiring about key factors and assumptions underlying those estimates; and evaluating the reasonableness thereof.	
k. When applicable, tracing emissions factors used to recognized sources.	k. When applicable, inquiring about the source of emissions factors.
l. Determining whether emissions factors have been properly applied and whether the underlying assumptions are documented and have a reasonable basis.	l. Inquiring about whether emissions factors have been properly applied and whether the underlying assumptions are documented and have a reasonable basis.
m. Performing analytical procedures (for example, change in amounts from the previous year, fluctuations in amounts during the present year, and variation from an independent expectation developed by the practitioner).	

<i>Examination</i>	<i>Review</i>
<i>n.</i> When applicable, comparing emission data to records of number of units sold or produced for the period.	<i>n.</i> When applicable, performing analytical comparisons of emission data to number of units sold or produced for the period.
<i>o.</i> When applicable, confirming details of the transaction(s) (for example, quantity of methane sold or purchased) with the other party to the transaction.	
<i>p.</i> Inquiring about whether there have been any changes in production levels (lower emissions due to a drop in production level might not be permanent) and obtaining evidence supporting production levels.	<i>p.</i> Inquiring about whether there have been any changes in production levels (lower emissions due to a drop in production level might not be permanent).
<i>q.</i> Inquiring about whether there have been any communications from regulators concerning emission levels or noncompliance with permits or regulatory programs.	
<i>r.</i> Obtaining supporting evidence for any emission reduction credits that are banked, purchased from, or sold to a third party (such information may be included in a public report on a GHG inventory).	<i>r.</i> Inquiring about any emission reduction credits that are banked, purchased from, or sold to a third party (such information may be included in a public report on a GHG inventory).
<i>s.</i> Obtaining and reading environmental (or Environmental, Health and Safety [EH&S]) internal audit reports and minutes of audit committee meetings (or other relevant board committees to which the environmental or EH&S internal auditors report).	<i>s.</i> Inquiring about relevant information in environmental or EH&S internal audit reports and minutes of audit committee meetings (or other relevant board committees to which the environmental or EH&S internal auditors report).
<i>t.</i> Inquiring about whether there have been any subsequent events that would affect the subject matter or the assertion (see paragraph .66).	

*(continued)*

<i>Examination</i>	<i>Review</i>
<p><i>u.</i> Obtaining a legal letter when considered appropriate (for example, to address [1] non-compliance with regulatory programs [emissions exceed permitted amount], [2] ownership of credits, or [3] the existence of any unasserted claims).</p>	
<p><i>v.</i> Obtaining written representations from management.</p>	

**.60** In a review engagement, the practitioner ordinarily is not required to corroborate management's responses to inquiries with other evidence; however, the practitioner should consider the reasonableness and consistency of management's responses in light of the results of other review procedures and the practitioner's knowledge of the entity's business and the industry in which it operates and, as noted in paragraph .58, the practitioner may need to perform additional procedures.

### ***Techniques to Calculate Emissions and Reductions***

**.61** Reductions are calculated by comparing the amount of emissions from one period to another. For entities reporting on a facility basis, this will usually be calculated annually. For entities reporting on a project basis, the period may vary depending on the nature of the project.

**.62** Measurement techniques include, but are not limited to, the use of mass balance equations, emissions factors, stack tests, and direct measurement of emissions, including continuous emission monitors.

**.63** For reductions calculated in comparison to a base year, adjustments are evaluated to the base year based on structural changes with the entity's organization and changes in ownership or control of the emitting source(s), or both. (Mergers, acquisitions, sales of emitting sources, outsourcing of certain functions, and entering into joint ventures would likely require adjustment of the baseline.) Note that adjustments of the baseline based on organic growth or decline are generally not appropriate.

### ***Procedures Specific to GHG Emission Reduction Engagements***

**.64** In addition to the procedures described in paragraph .59, procedures that may be relevant, among others, in an examination or review engagement of GHG emission reduction information are included in the following table:

<i>Examination</i>	<i>Review</i>
a. Obtaining evidence of significant changes in the production process, switches from one fuel type to another, or other changes resulting in the emission reduction.	a. Making inquiries about whether there have been any significant changes in the production process, switches from one fuel type to another, or other changes resulting in the emission reduction.
b. Evaluating techniques used by the entity to calculate the emission reduction (see paragraphs .61–.63).	
c. Inquiring about the reason or business purpose for the reduction and considering the possible implications with respect thereto. Consider obtaining from management a written representation regarding the reason for the reduction project (see paragraph .30 on additionality).	
d. Inquiring about whether there are any permits applicable to the facility and, if so, examine the permit for factors that may have a bearing on the reduction project (for example, reductions that meet other requirements cannot be transferred); obtaining a management representation specific to permits.	d. Inquiring about whether there are any permits applicable to the facility and, if so, about how they might bear on the reduction project (for example, reductions that meet other requirements cannot be transferred); consider obtaining a management representation specific to permits.
e. When applicable, reading reports prepared by the seller for purposes other than the sale of the GHG emission reduction credits (for example, an emission report filed with a regulatory agency) and checking for consistency of information related to the sale.	
f. Agreeing or confirming details of GHG emission reduction credits with the relevant GHG registry.	f. If information is publicly available, comparing detail of GHG emission reduction credits with the relevant GHG registry.

## Consideration of Subsequent Events

**.65** Events or transactions sometimes occur subsequent to the point in time or period of time of the subject matter being tested, but before the date of the practitioner's report, that have a material effect on the subject matter and, therefore, require adjustment or disclosure in the presentation of the subject matter or the assertion. These occurrences are referred to as *subsequent events*. When performing an attest engagement, the practitioner should consider information about subsequent events that comes to his or her attention. Although the practitioner has no responsibility to detect subsequent events, the practitioner should inquire of the responsible party (and his or her client,

if the client is not the responsible party) about whether they are aware of any subsequent events through the date of the practitioner's report that would have a material effect on the subject matter or the assertion. If the practitioner has decided to obtain a representation letter from the responsible party, the letter ordinarily would include a representation concerning subsequent events. (Paragraphs .95–.99 of AT section 101 provide additional guidance on the consideration of subsequent events in an attest engagement.) Types of events that may represent a subsequent event in the context of an attest engagement on GHG emissions include the following:

- Changes in baseline emissions due to events such as acquisition or disposition of facilities, change in number of shifts at a facility, or change in production levels
- Destruction of the facility to which an emission reduction relates
- In the case of a GHG emission reduction, unplanned or accidental release of sequestered carbon
- Investigations or regulatory actions related to emissions

## Adequacy of Disclosure

.66 The practitioner is required by AT section 101 to consider the adequacy of disclosure of material matters. (See paragraphs .70 and .76–.77 of AT section 101.) Examples of matters that may be material include

- changes in the entity's boundaries or emissions calculation methodologies.
- mergers, divestitures, acquisitions, or closures.
- uncertainties in the measurement of GHG emissions (see paragraph .32).

## Representation Letter

.67 In an examination or review engagement, the practitioner should consider obtaining a representation letter from the responsible party. Written representations from the responsible party ordinarily confirm representations explicitly or implicitly given to the practitioner, 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. Examples of matters that might appear in such a representation letter include the following:

- a. Management's (responsible party's) assertion about the subject matter based on the criteria selected
- b. A statement acknowledging responsibility for the subject matter and, when applicable, the assertion
- c. A statement acknowledging responsibility for selecting the criteria, when applicable
- d. A statement acknowledging responsibility for determining that such criteria are appropriate for its purposes, when the responsible party is the client
- e. A statement acknowledging ownership of the emissions or emission reductions
- f. A statement that all known matters contradicting the assertion or presentation and any communication from regulatory agencies

- affecting the subject matter or the assertion have been disclosed to the practitioner
- g.* A statement regarding the absence of undisclosed or unrecorded emission sources
  - h.* A statement that knowledge of illegal acts, fraud, or suspected illegal acts or fraud affecting the entity involving (i) management, (ii) employees who have significant roles in the entity's processes and procedures relating to measurements of emissions in conformity with the criteria specified previously, or (iii) others when the illegal acts or fraud could have a material effect on measurements of emissions in conformity with the selected criteria has been disclosed to the practitioner
  - i.* A statement that management (responsible party) has disclosed to the practitioner all significant deficiencies in the design or operation of internal control over its GHG inventory
  - j.* A statement regarding the availability of all records relevant to the subject matter
  - k.* A statement that management (responsible party) has responded fully to all inquiries made by the practitioner during the engagement
  - l.* A statement that any known events subsequent to the period (or point in time) of the subject matter being reported on that would have a material effect on the subject matter (or, if applicable, the assertion) have been disclosed to the practitioner
  - m.* Other matters as the practitioner deems appropriate
  - n.* Relevant to an emission reduction, a statement regarding the business purpose of the emission reduction project
  - o.* Relevant to an emission reduction, a statement that the reduction is both real and additional to any requirements

Appendix C, "Illustrative Management Representation Letter," includes an illustrative management representation letter.

**.68** When the client is not the responsible party, the practitioner should consider obtaining a letter of written representations from the client as part of the attest engagement. Examples of matters that might appear in such a representation letter include the following:

- a.* A statement regarding whether the client is aware of any matters that might contradict the subject matter or the assertion
- b.* A statement that all known events subsequent to the period (or point in time) of the subject matter being reported on that would have a material effect on the subject matter (or, if applicable, the assertion) have been disclosed to the practitioner
- c.* A statement acknowledging the client's responsibility for selecting the criteria, when applicable
- d.* A statement acknowledging the client's responsibility for determining that such criteria are appropriate for its purposes
- e.* Other matters as the practitioner deems appropriate

**.69** If the responsible party or the client refuses to furnish all written representations that the practitioner deems necessary, a scope limitation exists, and the practitioner should consider the effects of such a refusal on his or her ability to issue a conclusion about the subject matter. In an examination, if the

practitioner believes that the representation letter is necessary to obtain sufficient evidence to issue a report, the responsible party's or the client's refusal to furnish such evidence in the form of written representations is sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause the practitioner to disclaim an opinion or withdraw from an examination engagement. However, based on the nature of the representations not obtained or the circumstances of the refusal, the practitioner may conclude, in an examination engagement, that a qualified opinion is appropriate. Further, the practitioner should consider the effects of the refusal on his or her ability to rely on other representations. When a scope limitation exists in a review engagement, the practitioner should withdraw from the engagement. (See paragraph .75 of AT section 101.)

## Reporting

**.70** AT section 101 permits the practitioner to report either on the written assertion or directly on the subject matter to which the assertion relates. However, as stated in paragraph .66 of AT section 101, if conditions exist that, individually or in combination, result in one or more material misstatements or deviations from the criteria, the practitioner should modify the report and, to most effectively communicate with the readers of the report, should ordinarily express his or her conclusion directly on the subject matter, not on the assertion.

**.71** The report may contain a paragraph emphasizing measurement uncertainties, such as the following:

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

**.72** When the measurement methods, and the application thereof, have not been consistent from period to period, the practitioner should consider whether to modify the practitioner's report. The form of the modification depends on the circumstances (for example, whether the presentation or management's assertion appropriately disclose those facts or whether prior periods, if presented or used in the calculation of a reduction, are restated). If the responsible party (that is, in most cases, the client) does not appropriately restate the baseline and prior period(s) inventory for a material change, the practitioner should include an explanatory paragraph in the practitioner's report describing the lack of consistency and should express a qualified or adverse opinion in an examination report or a modified conclusion in a review report due to a departure from the criteria. If the responsible party does appropriately restate, the practitioner should consider including an explanatory paragraph (following the opinion or conclusion paragraph) in his or her report that refers to the change in the measurement methods or application.

**.73** When the practitioner is engaged to report on GHG emissions of one or more particular locations or subsidiaries or on reductions related to one or more specific projects, the report may include a paragraph stating that the practitioner was not engaged to examine or review the entity-wide emissions or reductions and, accordingly, the practitioner is not expressing any form of conclusion on such entity-wide information.

**.74** When the trading program or GHG registry contains specific materiality requirements that are more stringent than those of AT section 101, the practitioner may include a reference to those requirements in the attest report.

**.75** AT section 101 requires the report on an attest engagement to contain a statement of management's responsibility for the subject matter or the assertion. The statement of management's responsibility may also address management's responsibility for selecting and adhering to the criteria used.

**.76** Illustrative reports for the following are included in the appendices noted:

- Appendix D, "Illustrative Examination Reports on GHG Emissions Information": Examination of an entity's GHG emissions information for a period of time
- Appendix E, "Illustrative Examination Reports on GHG Emission Reduction Information": Examination of an entity's GHG emission reduction information
- Appendix F, "Illustrative Review Reports on GHG Emissions Information": Review of an entity's GHG emissions information for a period of time
- Appendix G, "Illustrative Review Reports on GHG Emission Reduction Information": Review of an entity's GHG emission reduction information

**.77** The practitioner, in his or her attest report, may refer to the report of another practitioner under the following circumstances:

- When reporting on an attest engagement on GHG emissions and another practitioner has reported on the GHG emissions of a subsidiary or other component of the client entity
- When reporting on an attest engagement on an emission reduction and another practitioner has reported on the entity's GHG inventory for the prior period

See example 3 in appendix D and appendix F in this SOP, respectively, for an example examination and review report that refers to the report of another practitioner.

**.78** The practitioner reporting on the emission reduction would only be able to make reference to the report of the practitioner reporting on the GHG inventory information if both practitioners are reporting at the same level of assurance on emissions information for the same emission source(s) addressed by the reduction project. For example, in an emission reduction engagement

- if practitioner A reported on an examination of GHG inventory for Plant X for which practitioner B is reporting on an examination of the emission reduction, practitioner B may divide responsibility by referring to the work of practitioner A in his or her report. However, if practitioner A reported on an examination of the company's GHG inventory for its nationwide operations taken as a whole, practitioner B, who is reporting only on an examination of the reduction project at Plant X, would need to perform sufficient additional procedures on the GHG inventory at Plant X and would not refer to the work of practitioner A in his or her report.
- if practitioner A reported on a review of GHG inventory for Plant X for which practitioner B is reporting on an examination of the

emission reduction, practitioner B would need to perform sufficient additional procedures on the GHG inventory at Plant X and should not refer to the work of practitioner A in his or her report.

## Attest Documentation

**.79** Paragraphs .100–.107 of AT section 101 set documentation requirements. The practitioner should be aware that the GHG registry or regulatory program relevant to the attest engagement may have set additional documentation requirements for those providing assurance on GHG emissions inventories or reductions (sometimes referred to as *verifiers*).

## Effective Date

**.80** This SOP is effective for reports on GHG emissions information issued on or after September 15, 2013. Early implementation is permitted.

## Appendix A—Glossary

**additionality.** A project is *additional* if it would not have happened but for the incentive provided by the credit trading program (for example, Clean Development Mechanism [CDM] or Joint Implementation [JI]). The Kyoto Protocol specifies that only projects that provide emission reductions that are *additional* to any that would occur in the absence of the project activity shall be awarded certified emission reductions (CERs) in the case of CDM projects or emission reduction units (ERUs) in the case of JI projects. This is often referred to as *environmental additionality*. *Financial additionality* is the notion that a project is made commercially viable through its ability to generate value in the form of certified emission reductions. Various greenhouse gas (GHG) registries or regulatory frameworks may define these terms differently.

**allowance.** The unit of trade under a trading system. In a closed trading system, trading of allowances is permitted only between parties subject to the program or regulatory system. Allowances grant the holder the right to emit a specific quantity (for example, one ton) of emissions once. The total quantity of allowances issued by regulators dictates the total quantity of emissions possible under the system. Allowances are typically granted to emitters by governmental entities or agencies either for free or for a fee. At the end of each compliance period, each source must surrender sufficient allowances to cover its emissions during that period. In an open trading system, trades can be made between parties within the system and parties outside the system.

**baseline.** The amount of the entity's emissions for a specified base year against which any future changes in emissions are evaluated. Emission reductions targets are often expressed as a percent reduction from the baseline emission level.

**boundaries.** There are two types of boundaries: organizational and operational. When accounting for GHG emissions from partially owned entities, it is important to draw clear organizational boundaries, which should be consistent with the organizational boundaries that have been drawn up for financial reporting purposes. After the entity has determined its organizational boundaries in terms of the entities it owns or controls, it must then set operational boundaries with respect to direct and indirect emissions. The World Resources Institute/ World Business Council for Sustainable Development (WRI/WBCSD) Greenhouse Gas Protocol provides additional guidance on setting organizational and operational boundaries with respect to GHG emissions.

**closed trading system.** In a closed trading system, trading of allowances is permitted only between parties subject to the program or regulatory system. See also **open trading system**.

**credit.** The term *credit* is used in a number of contexts, most commonly in relation to emission reductions that have been achieved in excess of the required amount for one of the following:

- The Kyoto Protocol's JI, also known as ERUs
- The Kyoto Protocol's CDM, specifically known as CERs

- The Kyoto-related and voluntary trading programs

**data assembly.** The process the entity uses to "roll-up" individual site or process level information to a facility- or corporate-level report. For example, the entity may choose to have a manufacturing unit report only the number of widgets it produced each year and have corporate-level environmental staff apply the appropriate emission factors to calculate the resultant emissions. Alternatively, the entity may choose to have all calculations done at the operational level and assign only quality control responsibilities to the corporate staff.

**direct GHG emissions.** Direct GHG emissions, or scope 1 emissions, are emissions from sources that are owned or controlled by the entity. These are emissions associated with the following:

- Stationary combustion from fuel burned in the entity's stationary equipment, such as boilers, incinerators, engines, and flares
- Mobile combustion from fuel burned in the entity's transport devices, such as trucks, trains, airplanes, and boats
- Process emissions from physical or chemical processes, such as cement manufacturing, petrochemical processing, and aluminum smelting
- Fugitive emissions, which are intentional and unintentional releases, such as equipment leaks from joints and seals and emissions from wastewater treatment, pits, and cooling towers

**emissions factor.** A mathematical factor or ratio for converting the measure of an activity (for example, liters of fuel consumed, kilometers travelled, the number of animals in husbandry, or tons of product produced) into an estimate of the quantity of GHGs associated with that activity.

**emission reduction.** The process by which an entity reduces its emissions of GHGs as compared to a baseline.

**GHG inventory.** An entity's GHG emissions for a specified period, typically a year or a series of years, is referred to as its GHG inventory. See also **baseline**.

**indirect GHG emissions.** Indirect emissions, or scope 2 reporting under the WRI/WBCSD Greenhouse Gas Protocol, represent emissions from the generation of imported or purchased electricity, heat, or steam. Other indirect emissions, or scope 3 reporting under the GHG Protocol, include the following:

- Employee business travel
- Outsourced activities, contract manufacturing, and franchises
- Transportation by the vendor or contractor of, for example, materials, products, waste, and employees
- Emissions from product use and end of life
- Employee commuting
- Production of imported materials

**inventory.** See **GHG inventory**.

**leakage.** Leakage occurs when an emission reduction project causes emissions to increase beyond the project's boundaries. Entities entering into an emis-

sion reduction project typically must demonstrate that the emission reduction will not cause emissions to increase beyond the project's boundaries.

**offset.** Offsets are created when a source makes voluntary, permanent emission reductions that are in surplus to any required reductions. Entities that create offsets can trade them to other entities to cover growth or relocation. Regulators may be required to approve each trade. Regulators normally require a portion of the offsets to be retired to ensure an overall reduction in emissions. Offsets are an open system (an open system is one in which trades can be made between parties within the system and parties outside the system). One offset is an emission reduction that a pollution source has achieved in excess of permitted levels or required reductions, or both. The excess amount is the credit and can be sold on the market.

**open trading system.** In an open trading system, trades can be made between parties within the system and parties outside the system. See also **closed trading system**.

**permits.** Certificates of operation that allow holders to operate a facility provided they do not exceed a specified rate (kilograms/tons per day). Permits are often designated as an upper limit. Because few systems operate at 100 percent of capacity at all times, actual emissions are usually a fraction of the theoretical upper limit of allowed emissions. However, as new permits become harder to obtain, existing operations are motivated to increase their level of operations under their existing permits (for example, by adding a second shift, thereby legally increasing the overall quantity of emissions). **Allowances** are transferable, whereas the permit itself is attached to a specific installation or site.

**uncertainty.** As used in the field of GHG emissions, uncertainty refers to uncertainty in the measurement of GHG emissions that arises from imprecise measurement methods and factors.

**validation.** The process used to ensure that a given project, if implemented, can achieve the projected reduction results. The entity may validate the feasibility of the design of an emission reduction project internally, or the entity may engage an outside party (typically an engineering or a consulting firm) to perform the validation.

**verification.** The objective and independent assessment of whether the reported GHG inventory properly reflects the GHG impact of the entity in conformance with preestablished GHG accounting and reporting standards. Some registries define *verification* as the process used to ensure that a given participant's GHG inventory (either the baseline or the annual result) has met a minimum quality standard and complied with a specific registry's procedures and protocols for calculating and reporting GHG emissions.

**verified emission reductions.** Verified emission reductions are created, in the absence of government rules, by project-based activities that are defined by the buyer and seller and verified by a third party.

### Emissions Trading Programs

**baseline-and-credit program.** In a baseline-and-credit program (that is, credit- or project-based trading), each participant is provided a baseline against which its performance is measured. If an action is taken to reduce emissions, the difference between the baseline and the actual emissions, where actual emissions are less than the baseline, can be credited and traded. The baseline established for crediting purposes can be fixed or dynamic, decreasing or increasing over time. The key distinction between

a cap-and-trade program and a baseline-and-credit program is that the former regulated sources' emissions are required to remain under an emissions cap, which is a fixed quantity. Such a limit is not necessarily imposed in a baseline-and-credit program. The Kyoto Protocol's CDM, for example, would operate as a baseline-and-credit program.<sup>1</sup>

**cap-and-trade program.** In a cap-and-trade program (that is, allowance-based trading), the maximum level of emissions that can be released from sources is set by the control authority. This level is the cap. All sources are required to have allowances to emit. The allowances are freely transferable; they can be bought or sold. The control authority issues exactly the number of allowances needed to produce the desired emission level. An example of this kind of system is the U.S. Environmental Protection Agency's nationwide Acid Rain Program, under which allowances of SO<sub>2</sub> and NO<sub>x</sub> can be traded to comply with an emissions cap.<sup>2</sup>

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<sup>1</sup> Adapted from Richard Rosenzweig and Josef Janssen, *The Emerging International Greenhouse Gas Market* (Arlington: Pew Center on Global Climate Change, 2002).

<sup>2</sup> United States Environmental Protection Agency (EPA) (May 10, 2012), Cap and Trade, Retrieved November 29, 2012 from [www.epa.gov/captrade/](http://www.epa.gov/captrade/) and U.S. EPA (July 25, 2012), Acid Rain Program, Retrieved November 29, 2012, from [www.epa.gov/airmarkets/progsregs/arp/index.html](http://www.epa.gov/airmarkets/progsregs/arp/index.html).

## Appendix B—Sources for GHG Emission Protocols and Calculation Tools

These tools are included solely as informational resources. They are not, however, endorsed by the AICPA.

<i>Tool Name</i>	<i>Website</i>
World Resource Institute/World Business Council for Sustainable Development (WRI/WBCSD) Greenhouse Gas Protocol	<a href="http://www.ghgprotocol.org/standards/corporate-standard">www.ghgprotocol.org/standards/corporate-standard</a>
GHG Calculation Tools (cross-sector and sector specific tools)	<p><a href="http://www.ghgprotocol.org/calculation-tools">www.ghgprotocol.org/calculation-tools</a> This website contains tools for calculating</p> <ul style="list-style-type: none"> <li>• N2O emissions from the production of adipic acid.</li> <li>• CO2 and PFC emissions from the production of aluminum.</li> <li>• CO2 emissions from the production of ammonia.</li> <li>• CO2 emissions from the production of cement.</li> <li>• HFC-23 emissions from the production of HCFC-22.</li> <li>• CO2 emissions from the production of iron and steel.</li> <li>• CO2 emissions from the production of lime.</li> <li>• N2O emissions from the production of nitric acid.</li> <li>• CO2 emissions from mobile combustion.</li> <li>• GHG emissions from office-based organizations.</li> <li>• GHG emissions from pulp and paper mills.</li> <li>• PFC emissions from the production of semiconductor wafers.</li> <li>• CO2 emissions from stationary combustion.</li> </ul>
The Climate Registry	<p><a href="http://www.theclimateregistry.org">www.theclimateregistry.org</a>  <a href="http://www.theclimateregistry.org/resources/protocols/">www.theclimateregistry.org/resources/protocols/</a>  <a href="http://www.theclimateregistry.org/resources/verification/">www.theclimateregistry.org/resources/verification/</a></p>

## Appendix C—Illustrative Management Representation Letter

[Date]

[Name of CPA Firm]

We are providing this letter in connection with your [examination / review] of our assertion(s) that [describe assertion(s), for example, the accompanying schedule of greenhouse gas (GHG) emissions for XYZ Company for the year ended December 31, 20XX, is presented in conformity with (identify criteria used, for example, the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard and the Corporate Value Chain [Scope 3] Accounting and Reporting Standard published by the World Business Council for Sustainable Development and the World Resource Institute)].

We are responsible for [describe assertions and subject matter]. We further confirm that we are responsible for the selection of [identify criteria] as the criteria against which you are evaluating our assertion(s). Further we confirm that we are responsible for determining that [identify criteria] represent appropriate criteria for our purposes.

We confirm, to the best of our knowledge and belief, the following representations made to you during your [examination / review]:

1. We are not aware of any matters contradicting the assertion(s), nor have we received any communications from regulatory agencies or [identify organizations to which the company reports GHG emissions] affecting the subject matter or our assertion(s) on such subject matter.
2. We have disclosed to you all significant emission sources. There are no material emissions that have not been recorded in the greenhouse gas (GHG) emission records underlying our assertion(s) referred to above. GHG emissions have been reported for the entities where the Company has operational control.
3. There has been no (a) fraud involving management or employees who have significant roles in the Company's processes and procedures relating to measurements of emissions in conformity with the criteria specified above or (b) fraud involving others that could have a material effect on measurements of emissions in conformity with the selected criteria.
4. There are no significant deficiencies in the design or operation of the Company's internal control over its GHG inventory.
5. We have made available to you all records relevant to your [examination / review] of the aforementioned subject matter or assertion(s).
6. We have responded fully to all inquiries made by you during the engagement.
7. [Add additional representations as deemed appropriate.]

We are not aware of any events that occurred subsequent to the period being reported on and through the date of this letter that would have a material effect on the aforementioned subject matter or assertion(s).

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[Name of chief executive officer and title]

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[Name of corporate environmental officer and title]

[The following illustrates an example of a written assertion and additional representations that should be obtained in connection with GHG emission reductions:]

Example assertion in connection with an emission reduction:

XYZ Company reduced GHG emissions in connection with project ABC by 50,000 tons of CO<sub>2</sub> equivalents for the year ended December 31, 20XX, based on [identify criteria selected by the responsible party].

Additional representations:

The GHG emission reduction project was undertaken for the purpose of [describe business purpose]. The GHG emission reductions were achieved as a direct result of the project and not as a result of any changes in activity level. The GHG emission reductions related to the project are both real and additional to any requirements. Further, we have satisfactory title to all GHG emission reduction credits related to the project, and there are no liens or encumbrances on such GHG emission reduction credits, nor have any GHG emission reduction credits been pledged as collateral.

## Appendix D—Illustrative Examination Reports on GHG Emissions Information

The examination report examples illustrated herein are for general use. See paragraphs .78–.83 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), for requirements and guidance on restricting the use of an attest report.

### ***Example 1—Examination Report on Subject Matter***

#### **Independent Accountant’s Report**

We have examined the accompanying schedule of greenhouse gas emissions of XYZ Company for [*identify period, for example, the year ended December 31, 20XX*]. XYZ Company's management is responsible for the schedule. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the nature of the company's greenhouse gas emissions; examining, on a test basis, evidence supporting the company's schedule of greenhouse gas emissions; and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

In our opinion, the schedule referred to above presents, in all material respects, the greenhouse gas emissions of XYZ Company for [*identify period, for example, the year ended December 31, 20XX*] in conformity with [*identify criteria*].

[*Signature*]

[*Date*]

### ***Example 2—Examination Report on Management’s Assertion***

#### **Independent Accountant’s Report**

We have examined management's assertion that [*identify the assertion, for example, the accompanying schedule of greenhouse gas emissions for XYZ Company for the year ended December 31, 20XX, is presented in conformity with (identify criteria)*]. XYZ Company's management is responsible for the assertion. Our responsibility is to express an opinion on the assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the nature of the company's greenhouse gas emissions; examining, on a test basis, evidence supporting management's assertion; and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature

and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary. In our opinion, management's assertion referred to above is fairly stated, in all material respects, based on [*identify criteria*].

[*Signature*]

[*Date*]

***Example 3—Examination Report on Subject Matter; Includes Reference to the Examination Report of Another Practitioner***

**Independent Accountant's Report**

We have examined the accompanying schedule of greenhouse gas emissions of XYZ Company and subsidiaries for the year ended December 31, 20XX. XYZ Company's management is responsible for the schedule. Our responsibility is to express an opinion based on our examination. We did not examine the schedule of greenhouse gas emissions for ABC Company, a wholly owned subsidiary, which reflected 20 percent of the related consolidated emissions. This schedule was examined by other accountants, whose report has been furnished to us and our opinion, insofar as it relates to the amounts included for ABC Company, is based solely on the report of the other accountants.

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 the nature of the company's greenhouse gas emissions; examining, on a test basis, evidence supporting the company's schedule of greenhouse gas emissions; and performing such other procedures as we considered necessary in the circumstances. We believe that our examination and the report of the other accountants provide a reasonable basis for our opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

In our opinion, based on our examination and the report of the other accountants, the schedule referred to above presents, in all material respects, the greenhouse gas emissions of XYZ Company for the year ended December 31, 20XX, in conformity with [*identify criteria*].

[*Signature*]

[*Date*]

## Appendix E—Illustrative Examination Reports on GHG Emission Reduction Information

The examination report examples illustrated herein are for general use. See paragraphs .78–.83 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), for requirements and guidance on restricting the use of an attest report.

### ***Example 1—Examination Report on Subject Matter***

#### **Independent Accountant's Report**

We have examined the schedule of reductions of greenhouse gas emissions of XYZ Company related to the ABC project for the year ended December 31, 20XX, from its GHG emissions in the prior year. XYZ Company's management is responsible for the schedule. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the nature of the company's greenhouse gas emissions; examining, on a test basis, evidence supporting the greenhouse gas emission reduction information; and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and the methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Our engagement related to the specific project identified above. We were not engaged to, and did not, examine XYZ Company's entity-wide greenhouse gas emissions inventory or whether XYZ Company has reduced its entity-wide greenhouse gas emissions inventory. Accordingly, we do not express an opinion or any other form of assurance on its entity-wide greenhouse gas emissions inventory or changes from prior periods.

In our opinion, the schedule of reductions of greenhouse gas emissions of XYZ Company related to ABC project for the year ended December 31, 20XX is presented, in all material respects, in conformity with *[identify criteria]*.

*[Signature]*

*[Date]*

### ***Example 2—Examination Report on Management's Assertion***

#### **Independent Accountant's Report**

We have examined management's assertion that *[identify the assertion, for example, XYZ Company reduced GHG emissions in connection with project ABC by 50,000 tons of CO2 equivalents for the year ended December 31, 20XX, from its GHG emissions in the prior year]* based on *[identify criteria selected by management]*. XYZ Company's management is responsible for the assertion. Our responsibility is to express an opinion on the assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the nature of the company's greenhouse gas emissions; examining, on a test basis, evidence supporting management's assertion; and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Our engagement related to the specific project identified above. We were not engaged to, and did not, examine XYZ Company's entity-wide greenhouse gas emissions inventory or whether XYZ Company has reduced its entity-wide greenhouse gas emissions inventory. Accordingly, we do not express an opinion or any other form of assurance on its entity-wide greenhouse gas emissions inventory or changes from prior periods.

In our opinion, management's assertion referred to above is fairly stated, in all material respects, based on the *[identify criteria]*.

*[Signature]*

*[Date]*

## Appendix F—Illustrative Review Reports on GHG Emissions Information

The review report examples illustrated herein are for general use. See paragraphs .78–.83 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), for requirements and guidance on restricting the use of an attest report.

### ***Example 1—Review Report on Subject Matter***

#### **Independent Accountant's Report**

We have reviewed the accompanying schedule of greenhouse gas emissions of XYZ Company for [*identify period, for example, the year ended December 31, 20XX*]. XYZ Company's management is responsible for the schedule.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review consists principally of applying analytical procedures and making inquiries of persons responsible for the greenhouse gas emission information. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the company's schedule of greenhouse gas emissions. Accordingly, we do not express such an opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and the methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Based on our review, nothing came to our attention that caused us to believe that the schedule referred to above is not presented, in all material respects, in conformity with [*identify criteria*].

[*Signature*]

[*Date*]

### ***Example 2—Review Report on Management's Assertion***

#### **Independent Accountant's Report**

We have reviewed management's assertion that [*identify the assertion, for example, the accompanying schedule of greenhouse gas emissions for XYZ Company for the year ended December 31, 20XX, is presented in conformity with (identify criteria)*]. XYZ Company's management is responsible for the assertion.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review consists principally of applying analytical procedures and making inquiries of persons responsible for the assertion. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assertion. Accordingly, we do not express such an opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Based on our review, nothing came to our attention that caused us to believe that management's assertion referred to above is not fairly stated, in all material respects, based on the [identify criteria].

[Signature]

[Date]

***Example 3—Review Report on Subject Matter; Includes Reference to the Review Report of Another Practitioner***

**Independent Accountant's Report**

We have reviewed the accompanying schedule of greenhouse gas emissions of XYZ Company and subsidiaries for the year ended December 31, 20XX. XYZ Company's management is responsible for the schedule. We have not reviewed the schedule of greenhouse gas emissions for ABC Company, a wholly owned subsidiary, which reflected 20 percent of the related consolidated emissions. That schedule was reviewed by other accountants, whose report has been furnished to us, and our conclusion, insofar as it relates to the amounts included for ABC Company, is based solely on the report of the other accountants.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review consists principally of applying analytical procedures and making inquiries of persons responsible for the greenhouse gas emission information. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the company's schedule of greenhouse gas emissions. Accordingly, we do not express such an opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and the methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Based on our review and the report of the other accountants, nothing came to our attention that caused us to believe that the schedule referred to above is not presented, in all material respects, in conformity with [identify criteria].

[Signature]

[Date]

## Appendix G—Illustrative Review Reports on GHG Emission Reduction Information

The review report examples illustrated herein are for general use. See paragraphs .78–.83 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), for requirements and guidance on restricting the use of an attest report.

### *Example 1—Review Report on Subject Matter*

#### Independent Accountant's Report

We have reviewed the schedule of reductions of greenhouse gas emissions of XYZ Company related to the ABC project for the year ended December 31, 20XX, from its GHG emissions in the prior year. XYZ Company's management is responsible for the schedule.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review consists principally of applying analytical procedures and making inquiries of persons responsible for the greenhouse gas emission reduction information. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the company's schedule of reductions of greenhouse gas emissions. Accordingly, we do not express such an opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Our engagement related to the specific project identified above. We were not engaged to, and did not, review XYZ Company's entity-wide greenhouse gas emissions inventory or whether XYZ Company has reduced its entity-wide greenhouse gas emissions inventory. Accordingly, we do not express any conclusion on its entity-wide greenhouse gas emissions inventory or changes from prior periods.

Based on our review, nothing came to our attention that caused us to believe that the schedule of reductions of greenhouse gas emissions of XYZ Company related to ABC project for the year ended December 31, 20XX, is not presented, in all material respects, in conformity with [*identify criteria*].

[*Signature*]

[*Date*]

### *Example 2—Review Report on Management's Assertion*

#### Independent Accountant's Report

We have reviewed management's assertion that [*identify the assertion, for example, XYZ Company reduced GHG emissions in connection with project ABC by 50,000 tons of CO2 equivalents for the year ended December 31, 20XX from its GHG emissions in the prior year*] based on [*identify criteria selected by management*]. XYZ Company's management is responsible for the assertion.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review consists principally of applying analytical procedures and making inquiries of persons

responsible for the assertion. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assertion. Accordingly, we do not express such an opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Our engagement related to the specific project identified above. We were not engaged to, and did not, review XYZ Company's entity-wide greenhouse gas emissions inventory or whether XYZ Company has reduced its entity-wide greenhouse gas emissions inventory. Accordingly, we do not express any conclusion on its entity-wide greenhouse gas emissions inventory or changes from prior periods.

Based on our review, nothing came to our attention that caused us to believe that management's assertion referred to above is not fairly stated, in all material respects, based on [*identify criteria*].

[*Signature*]

[*Date*]

**AICPA Sustainability Task Force**

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 Dorsey L. Baskin  
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The Task Force acknowledges the assistance of Raymon Adiletta.





## AUD Section 55

# ***Statement of Position 13-2—Performing Agreed-Upon Procedures Engagements That Address the Completeness, Mapping, Consistency, or Structure of XBRL-Formatted Information***

September 2013

### NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA XBRL Assurance Task Force of the AICPA Assurance Services Executive Committee to provide guidance regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to engagements in which a practitioner performs and reports on agreed-upon procedures related to the completeness of the XBRL files, mapping of the source information consistency of the XBRL files with the source information or structure of the XBRL files. In this SOP, the source information consists of the financial statements (including notes) and required schedules to be formatted in XBRL. The terms *completeness*, *mapping*, *consistency*, and *structure* as used in this SOP are defined in paragraph .07 of this SOP. This SOP supersedes SOP 09-1, *Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data*.

This SOP is recognized as an attestation interpretation as defined in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Attestation interpretations are recommendations on the application of SSAEs in specific circumstances, including engagements for entities in specialized industries. Attestation interpretations are issued under the authority of the Auditing Standards Board (ASB). The members of the ASB have found this SOP to be consistent with existing SSAEs.

A practitioner should be aware of and consider attestation interpretations applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions of this SOP.

## Introduction and Background

.01 This Statement of Position (SOP) provides practitioners with guidance on performing agreed-upon procedures engagements for issuers submitting exhibits to the SEC containing eXtensible Business Reporting Language (XBRL)

files<sup>1</sup> and is based on the application guidance of the principles and criteria in the exhibit of *Principles and Criteria for XBRL-Formatted Information*.<sup>2</sup> However, this SOP also may be considered for performing agreed-upon procedures engagements for other applications of XBRL. This SOP supersedes SOP 09-1, *Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data*.

## SEC Rules

**.02** The SEC issued a release, "Interactive Data to Improve Financial Reporting," adopting final rules (SEC rules) that require issuers to submit their financial statements and the related notes and required schedules in interactive data format using XBRL, as an exhibit to their financial statements submitted to the SEC via the Electronic Data-Gathering, Analysis, and Retrieval (EDGAR) system and to provide these XBRL files on their corporate websites.

**.03** In order for XBRL to be a useful tool for investors and other users of business information, the data contained in XBRL files needs to be accurate and reliable. Preparers of XBRL-formatted information are responsible for providing complete and accurate information in their XBRL files on which investors and other users of business information may rely. For issuers, the SEC rules emphasize the SEC's expectation that preparers of XBRL-formatted information take the initiative to develop practices to promote tagging processes that result in complete and accurate XBRL files.

**.04** The SEC rules<sup>3</sup> state that, "an auditor will not be required to apply AU section 550, *Other Information in Documents Containing Audited Financial Statements*, AU section 722, *Interim Financial Information*, or AU section 711, *Filings under Federal Securities Statutes*, to the interactive data provided as an exhibit in a company's reports or registration statements, or to the viewable interactive data." Although the SEC rules do not require auditor involvement with the XBRL files, issuers may voluntarily obtain third-party services to assist them in assessing the quality of their XBRL files.

## XBRL Terminology

**.05** In this SOP, the term *XBRL-formatted information* (commonly referred to as *tagged information*) means information that has been represented using XBRL and included in one or more electronic files. XBRL is a global standard that provides unique electronically readable codes (tags) representing each item in the financial statements or other business reports.

**.06** Taxonomies are dictionaries that contain the terms used in financial statements and other business reports and their corresponding XBRL tags. Taxonomies specify the elements to be used for individual items of information, such as the element for the line item "cash and cash equivalents," and for a group of items, such as narrative disclosures. Taxonomies also identify relationships among terms, (for example, the term *cash and cash equivalents* is related to the term *current assets*). Business rules may be expressed within a taxonomy, such

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<sup>1</sup> Information formatted in interactive data is referred to herein as "XBRL files."

<sup>2</sup> *Principles and Criteria for XBRL-Formatted Information* provides preparers, reviewers, practitioners, and users of information formatted in XBRL with criteria for evaluating the completeness of the XBRL files, mapping of the source information, consistency of the XBRL files with the source information, or structure of the XBRL files.

<sup>3</sup> The AU section numbers in the SEC rules refer to *PCAOB Standards and Related Rules*, "Interim Standards."

as "gross assets less accumulated depreciation should equal the net assets." Reporting companies may add to the dictionaries of terms, relationships, and business rules (that is, they may extend the taxonomy).

## Agreed-Upon Procedures Engagements

.07 Given that management of an entity is responsible for the accuracy and reliability of the XBRL files, including identification of and compliance with the SEC's requirements, management (or other specified parties, such as the audit committee) may decide to engage a practitioner to provide attestation services to assist it in assessing the quality of its XBRL files, which may include assessing the completeness of the XBRL files (completeness), the mapping of the source information (mapping), the consistency of the XBRL files with the source information (consistency), or the structure of the XBRL files (structure) as defined here:

**Completeness of the XBRL files.** All required information is formatted at the required level of detail, as defined by the SEC's requirements. Only permitted information is included in the XBRL files.

**Mapping of the source information.** The elements selected are consistent with the meaning of the corresponding business reporting concepts in the source information in accordance with the SEC's requirements.

**Consistency of the XBRL files with the source information.** All formatted information in the XBRL files is consistent with the source information and formatted in accordance with the SEC's requirements.

**Structure of the XBRL files.** XBRL files are structured in accordance with the SEC's requirements.

.08 The engagement is performed under AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*). Not all of the provisions of AT section 201 are discussed in this SOP. Rather, this SOP includes guidance to assist practitioners in applying certain aspects of AT section 201 to the subject matter of XBRL files.

.09 The specified parties are responsible for the sufficiency (nature, timing, and extent) of the agreed-upon procedures because they best understand their own needs. The practitioner performs the procedures and reports his or her findings. Because the procedures are intended to meet the needs of the specified parties and may not be appropriate for others, use of these reports is restricted to the specified parties.

.10 To avoid misunderstanding, it is not appropriate for the entity to refer to services obtained from a practitioner in connection with an agreed-upon procedures engagement in a document that is available to anyone other than the specified parties (for example, general use audited financial statements or SEC filings).

## Conditions for Engagement Performance

.11 A practitioner may perform an agreed-upon procedures engagement described in this SOP provided that

- a. the practitioner is independent.

- b. management acknowledges its responsibilities for the XBRL files and provides the practitioner with one or more written assertions about its XBRL files. (Illustrative assertions are presented in appendix A of this SOP.)
- c. the practitioner and the specified parties agree upon the procedures to be performed by the practitioner.
- d. the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes.
- e. criteria for the determination of findings are agreed upon among the practitioner and the specified parties.
- f. the procedures to be applied with respect to the completeness, mapping, consistency, or structure of the XBRL files are expected to result in reasonably consistent measurement using the criteria agreed upon by the specified parties.
- g. evidential matter related to the completeness, mapping, consistency, or structure of the XBRL files is expected to exist to provide a reasonable basis for expressing the findings in the practitioner's report.
- h. when applicable, the practitioner and the specified parties agree on any materiality limits for reporting purposes. (See the materiality discussion in paragraph .27.)
- i. use of the report is restricted to the specified parties.

.12 There are audit committee preapproval requirements applicable to acceptance of agreed-upon procedures engagements. Such requirements have been established by the SEC, PCAOB, and other regulatory bodies.

## Agreement on and Sufficiency of Procedures

.13 To satisfy the requirement that the practitioner and the specified parties agree upon the procedures performed or to be performed, and that the specified parties take responsibility for the sufficiency of those procedures for their purposes, ordinarily the practitioner should communicate<sup>4</sup> directly with and obtain affirmative acknowledgment from each of the specified parties. For example, this may be accomplished by meeting with the specified parties or distributing a draft of the anticipated report or a copy of an engagement letter to the specified parties and obtaining their agreement.

.14 AT section 201 permits an agreed-upon procedures report to be used by multiple specified parties. However, because the objective of the engagement described in this SOP generally is to provide information to management or the audit committee of the entity about its XBRL files, ordinarily it is anticipated that the only specified parties will be management or the audit committee.

.15 The practitioner should not report on an engagement if the specified parties do not agree upon the procedures performed or to be performed and do not take responsibility for the sufficiency of the procedures for their purposes.

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<sup>4</sup> Paragraph .07 of AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*), does not require a written communication with the specified parties; it requires only that the practitioner communicate with and obtain affirmative acknowledgement from each of the specified parties. It generally is preferable that the agreement be in writing to avoid any misunderstandings regarding the procedures to be performed and responsibility for the sufficiency of the procedures.

## Subject Matter and Related Assertions

**.16** XBRL files subject to agreed-upon procedures engagements are typically as of a specified date and for a specified period (for example, for SEC purposes the XBRL files may be for comparative financial statements in a specific Form 10-K annual report or Form 10-Q quarterly report). It is common for the agreed-upon procedures to be performed on draft, rather than final XBRL files.

**.17** Because management may engage a third party to assist in the preparation of the XBRL files, assertions also may be made by a third party, as per paragraph .13 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*). For example, a service organization may make assertions that the XBRL files comply with specified SEC EDGAR Filer Manual (EFM) guidelines. Management, however, is responsible for all assertions, including any that are made by third parties.

**.18** Criteria are the standards or benchmarks used to measure, present, and evaluate the subject matter. Suitable criteria must be objective, measurable, complete, and relevant. Criteria to be used in the determination of findings are agreed upon between the practitioner and the specified parties. The specific procedures to be performed are dependent on the relevant criteria against which the XBRL files are to be evaluated. Examples of criteria include those in the exhibit in *Principles and Criteria for XBRL-Formatted Information*, the SEC rules, and sections of the EFM<sup>5</sup> that are agreed upon by the specified parties.

**.19** Appendix D of this SOP presents certain illustrative procedures aligned with the criteria presented in the exhibit of the *Principles and Criteria for XBRL-Formatted Information* that a practitioner might perform and findings that might be reported as part of an agreed-upon procedures engagement related to the completeness, mapping, consistency, or structure of XBRL-formatted information. *Principles and Criteria for XBRL-Formatted Information* focuses on areas that require judgment. The principles and criteria are not designed for measuring compliance with all of the applicable SEC rules and regulations (that is, the EFM includes additional requirements that are not included in this SOP; for example, certain requirements that are checked in an automated manner and those using the SEC's EDGAR XBRL validation process are excluded as well as some SEC requirements related to structure of the XBRL files and format of the information). Therefore, the procedures herein are illustrative and do not represent a complete set of procedures that might be performed in an agreed-upon procedures engagement relating to XBRL-formatted information.

## Establishing an Understanding With the Client

**.20** In accordance with paragraph .10 of AT section 201, the practitioner should establish an understanding with the client regarding the services to be performed. Such an understanding reduces the risk that the client may misinterpret the objectives and limitations of an agreed-upon procedures engagement. The understanding also reduces the risk that the client will misunderstand its responsibilities and the responsibilities of the practitioner. When the practitioner documents the understanding through a written communication with the client (an engagement letter), such communication should be addressed to the client and might include statements

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<sup>5</sup> Certain sections of the SEC's EDGAR Filer Manual (EFM) may not be objective enough to be considered suitable criteria.

- confirming that an agreed-upon procedures engagement will be performed.
- identifying
  - the subject matter of the engagement (that is, the XBRL-formatted information that the specified parties are evaluating and to which the practitioner is to apply agreed-upon procedures) and any written assertion(s) related thereto.
  - the responsible party (for example, management).
  - the criteria for evaluating the XBRL-formatted information (for example, *Principles and Criteria for XBRL-Formatted Information*).
  - the specified parties.
  - any timing sensitivities in the performance of the procedures or delivery of the report.
- indicating that the objective of the practitioner's agreed-upon procedures is to present specific findings to assist the specified parties in evaluating the completeness, mapping, consistency, and structure of the entity's XBRL files.
- acknowledging the specified parties' responsibility for the sufficiency of the enumerated procedures.
- acknowledging management's responsibility for
  - compliance with the SEC's requirements including those related to the completeness, mapping, consistency, and structure of the entity's XBRL files and its assertions thereon.
  - providing accurate and complete information to the practitioner.
- identifying the practitioner's responsibilities, which include, but are not limited to
  - performing the enumerated procedures.
  - providing management with a report and the circumstances under which the practitioner may decline to issue a report.
- indicating that the engagement will be conducted in accordance with attestation standards established by the AICPA.
- enumerating the procedures to be performed.
- acknowledging that
  - the practitioner makes no representation regarding the sufficiency of the enumerated procedures for the specified parties' purposes.
  - the practitioner has no responsibility for the completeness or accuracy of the information provided to the practitioner.
  - an agreed-upon procedures engagement does not constitute an examination, the objective of which would be the expression of an opinion on the completeness, mapping, consistency, and structure of the entity's XBRL files. The report will not express an opinion or any other form of

assurance and, if additional procedures were performed, other matters might come to the practitioner's attention.

- identifying any assistance to be provided to the practitioner.
- describing any arrangements to involve a specialist.
- where applicable, agreeing upon materiality limits.
- indicating that use of the report will be restricted to the specified parties.

An illustrative engagement letter is presented in appendix B of this SOP.

## Nature, Timing, and Extent of Procedures

### Responsibilities of Management

**.21** Management is responsible for both the completeness and accuracy of the source information and compliance with the SEC's requirements, including those related to the completeness, mapping, consistency, and structure of its XBRL-formatted information. That responsibility encompasses

- a. identifying the applicable XBRL-formatted information filing requirements of the SEC.
- b. establishing and maintaining controls relating to the preparation and submission of the entity's XBRL-formatted information to the SEC.
- c. evaluating the completeness, mapping, consistency, and structure of the entity's XBRL-formatted information.
- d. providing XBRL-formatted information in a form and manner that satisfies the SEC's requirements.

### Responsibilities of the Practitioner

**.22** The practitioner is responsible for carrying out the procedures and reporting the findings in accordance with the general, fieldwork, and reporting standards for attestation engagements as established in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). In order to accomplish this, the practitioner should have adequate knowledge of the specific subject matter to which the agreed-upon procedures are to be applied. That knowledge would include an understanding of XBRL and a familiarity with the applicable XBRL taxonomies used, knowledge of the SEC rules and requirements (including permitted taxonomies, such as the permitted version of the U.S. GAAP Taxonomy), as well as knowledge of the source information and supporting records.<sup>6</sup>

### Procedures to Be Performed

**.23** The procedures that the practitioner and specified parties agree upon may be as limited or as extensive as the specified parties desire. However, mere reading of an assertion or specific information about the XBRL-formatted information does not constitute a procedure sufficient to permit a practitioner

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<sup>6</sup> Practitioners performing engagements for audit clients may have specific knowledge of the underlying source information and supporting records and may possess a level of expertise that would significantly lessen the range of judgment needed in performing procedures related to the XBRL-formatted information.

to report on the results of applying agreed-upon procedures. Because of the nature of agreed-upon procedures engagements related to XBRL files, procedures may be modified during the engagement. According to paragraph .15 of AT section 201, in general, there is flexibility in determining the procedures as long as the specified parties acknowledge responsibility for the sufficiency of such procedures for their purposes. However, paragraph .16 of AT section 201 states that the practitioner should not agree to perform procedures that are overly subjective and thus possibly open to varying interpretations. Examples of appropriate procedures are included in appendix D of this SOP. Examples of inappropriate procedures include the following:

- Merely reading a description of the services performed by a third party involved in the preparation of XBRL-formatted information (for example, by a service provider)
- Evaluating the competence or objectivity of another party involved in preparing or in providing assistance in the preparation of the XBRL-formatted information
- Obtaining an understanding about XBRL-related requirements<sup>7</sup>

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

**.24** Generally, the use of a specialist would not be necessary. However, if specialized matters were included in the engagement that required expertise beyond that possessed by the practitioner (such as compliance with certain highly technical aspects of the EFM), the practitioner and the specified parties should explicitly agree to the involvement of the specialist in assisting the practitioner in the performance of those agreed-upon procedures. This agreement may be reached when obtaining agreement on the procedures performed or to be performed and acknowledgment of responsibility for the sufficiency of the procedures, as discussed in paragraph .13. The practitioner's report should describe the nature of the assistance provided by the specialist.

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

### Reporting Considerations

**.26** A practitioner's report on agreed-upon procedures should be in the form of procedures and findings. The practitioner should not provide negative assurance in his or her report about the completeness, mapping, consistency, or structure of the XBRL files. For example, the practitioner should not include

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<sup>7</sup> Although the practitioner may need to obtain an understanding of XBRL-related requirements, obtaining such an understanding is not in itself an agreed-upon procedure (see paragraph .22 of this SOP).

<sup>8</sup> A practitioner's specialist is an individual or organization possessing expertise in a field other than accounting or attestation, whose work in that field is used by the practitioner to assist the practitioner in the performance of the agreed-upon procedures engagement. A practitioner's specialist may be either a practitioner's internal specialist (who is a partner or staff, including temporary staff, of the practitioner's firm or a network firm) who does not participate in the engagement or a practitioner's external specialist.

a statement that "nothing came to our attention that caused us to believe that the assertion is not fairly stated in accordance with the criteria."

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

**.28** The practitioner's report on agreed-upon procedures should include all of the following elements:

- a. A title that includes the word *independent*
- b. Identification of the specified parties
- c. Identification of the subject matter (and any written assertion related thereto) and the character of the engagement
- d. Identification of the party responsible for the XBRL files (for example, management)
- e. A statement that the subject matter (and any written assertions related thereto) is the responsibility of the responsible party (for example, management)
- f. A statement that the procedures performed were those agreed to by the specified parties identified in the report
- g. A statement that the agreed-upon procedures engagement was conducted in accordance with the attestation standards established by the AICPA
- h. A statement that the sufficiency of the procedures is solely the responsibility of the specified parties and a disclaimer of responsibility for the sufficiency of those procedures
- i. A list of the procedures performed (or reference thereto) and related findings
- j. Where applicable, a description of any agreed-upon materiality limits (Refer to the materiality discussion in paragraph .27.)
- k. A statement that the practitioner was not engaged to examine and did not conduct an examination of the subject matter (or the written assertion related thereto), the objective of which would be the expression of an opinion, a disclaimer of opinion on the subject matter (or the written assertion related thereto), and a statement that if the practitioner had performed additional procedures, other matters might have come to his or her attention that would have been reported
- l. A statement restricting the use of the report to the specified parties and that the report is intended solely for the use of the specified parties
- m. Where applicable, reservations or restrictions concerning procedures or findings
- n. Where applicable, a description of the nature of the assistance provided by a specialist
- o. The manual or printed signature of the practitioner's firm
- p. The date of the report

An illustrative report is presented in appendix E of this SOP.

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

## Explanatory Language in the Practitioner's Agreed-Upon Procedures Report

.30 The practitioner may include explanatory language in his or her agreed-upon procedures report related to matters such as the following:

- Disclosure of stipulated facts, assumptions, or interpretations (including the source thereof) used in the application of agreed-upon procedures.
- Description of the condition of records, controls, or data to which the procedures were applied.
- Explanation that the practitioner has no responsibility to update his or her report.
- Explanation of sampling risk.
- Explanation that the procedures performed do not address all of the SEC's requirements for XBRL submissions.
- Explanation that the XBRL files and source information may be updated prior to filing with the SEC. Accordingly, the findings in the report may not correspond to the final XBRL files submitted.

## Adding Specified Parties (Nonparticipant Parties)

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

.32 Many companies hire a third party entity to create the XBRL files or assist them with the tagging process. When a third party does not agree to the procedures and, therefore, does not become a specified party, use of the report by the third party is inappropriate. Such a party, typically, is not considered a specified party to the engagement because it performs this work under the direction of management and is not intending to evaluate the XBRL files based on the agreed-upon procedures and related findings. As a result, the practitioner's findings should be communicated directly to management (and the audit committee) for its evaluation and consideration, which may result in management providing direction to the third party service provider to make changes to the XBRL files.

## Written Representations

**.33** During an attest engagement, the responsible party (for example, management) makes many representations to the practitioner, both oral and written, in response to specific inquiries or through the presentation of the subject matter or an assertion. A practitioner may find a representation letter to be a useful and practical means of obtaining representations from the responsible party. An illustrative representation letter is presented in appendix C of this SOP.

**.34** If management refuses to furnish all written representations that the practitioner deems necessary, the practitioner should consider whether to disclose in his or her report the inability to obtain representations from the responsible party, withdraw from the engagement, or change the engagement to another form of engagement.

## Knowledge of Matters Outside Agreed-Upon Procedures

**.35** The practitioner need not perform procedures beyond the agreed-upon procedures. However, in connection with the application of agreed-upon procedures, if matters come to the practitioner's attention by other means that significantly contradict the subject matter (or written assertions related thereto) referred to in the practitioner's report, the practitioner should include this matter in his or her report (for example, if during the course of performing agreed-upon procedures that address XBRL-formatted financial statements and the related notes and required schedules submitted as an exhibit to the SEC, the practitioner becomes aware by means other than performing the agreed upon procedures that a calculation linkbase has been omitted, the practitioner should include this matter in his or her report).

## Effective Date

**.36** This SOP is effective for any XBRL agreed-upon procedures engagements accepted subsequent to the issuance of this SOP.

## Appendix A—Illustrative Management Assertions

This appendix presents illustrative management assertions for the agreed-upon procedures engagement described in this SOP (agreed-upon procedures that address XBRL-formatted financial statements and the related notes and required schedules submitted as an exhibit to the SEC). These assertions are illustrative only and are not intended to apply to, or be sufficient for, any particular engagement. Management should tailor its assertions to the specific facts and circumstances of the particular engagement.

Management should develop assertions and agreed-upon procedures that meet its objectives. Management's assertions may align with the principles identified in the exhibit of *Principles and Criteria for XBRL-Formatted Information* or may be broader or more detailed as outlined here.

The XBRL files related to the [identify source information and period (for example, the Company's [Quarterly or Annual] Report) on Form [10-K or 10-Q] for the period ended [identify date] to be submitted to the Securities Exchange Commission (SEC)] are in compliance with the SEC's requirements including, but not limited, to the following:

1. **Completeness of the XBRL files.** All required information is formatted at the required levels of detail, as defined by the SEC's requirements. Only permitted information is included in the XBRL files.
2. **Mapping of the source information.** The elements selected are consistent with the meaning of the corresponding business reporting concepts in the source information in accordance with the SEC's requirements.
3. **Consistency of the XBRL files with the source information.** All formatted information in the XBRL files is consistent with the source information and formatted in accordance with the SEC's requirements.
4. **Structure of the XBRL files.** XBRL files are structured in accordance with the SEC's requirements.

## Appendix B—Illustrative Engagement Letter

This appendix presents an illustrative engagement letter<sup>9</sup> for the agreed-upon procedures engagement described in this SOP (engagement described in this SOP addresses the completeness, mapping, consistency, or structure of an entity's XBRL-formatted financial statements and the related notes and required schedules submitted as an exhibit to the SEC). It is intended to be illustrative only.

In this illustrative engagement letter, management and the audit committee of XYZ Company are the specified parties.

[CPA Firm Letterhead]

[Client's Name and Address]

To Management and the Audit Committee of XYZ Company:

This will confirm our understanding of the arrangements for our performance of certain agreed-upon procedures to assist management and the audit committee of XYZ Company in evaluating [*identify subject matter and criteria*] (for example, the completeness of the XBRL files, mapping of the source information to the XBRL files, consistency of the XBRL files) with the source information and the structure of the XBRL files related to the [*identify source information and period*] (for example, the Company's [Quarterly or Annual] Report on Form [10-K or 10-Q] for the period ended [*identify date*] to be submitted to the Securities Exchange Commission [SEC]) in accordance with the *Principles and Criteria for XBRL-Formatted Information*).

The procedures enumerated in the attachment to this letter, which were specified by management and the audit committee of XYZ Company, are the procedures to be performed. Our responsibility is to carry out these procedures and report our findings. We will conduct our engagement in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of management and the audit committee of XYZ Company. Consequently, it is understood that we make no representation regarding the sufficiency of the procedures described in the attachment for the purpose for which this report has been requested or for any other purpose.

Management is responsible for both the completeness and accuracy of the source information and compliance with the SEC's requirements including those related to the completeness of the XBRL files, mapping of the source information to the XBRL files, consistency of the XBRL files with the source information, structure of the XBRL files, and for the information provided to us. Management also is responsible for the design, implementation, effectiveness, and monitoring of controls over the preparation and submission of XYZ Company's XBRL files. It is understood that we make no representation regarding the completeness or accuracy of the source information provided to us during this engagement.

Our engagement to perform agreed-upon procedures is substantially less in scope than an examination, the objective of which is the expression of an

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<sup>9</sup> It should be noted that although paragraph .10 of AT section 201 requires the practitioner to establish an understanding with the client regarding the services to be performed, that understanding is not required to be in writing. It may be preferable that the understanding be in writing to avoid any misunderstandings regarding the services to be performed. paragraph .20 of this SOP describes additional matters that may be appropriate to include in the engagement letter.

opinion on management's assertion regarding the XBRL files. Accordingly, the report will not express an opinion or any other form of assurance thereon and if additional procedures were to be performed, other matters might have come to our attention.

At the completion of the agreed-upon procedures, we expect to issue a report that will state the procedures performed and the findings from those procedures. If, however, we are not able to complete all of the specified procedures, we will so advise you.

Distribution and use of our agreed-upon procedures report is restricted to the audit committee and management of the Company.

*[Discuss other practitioner-specific matters, such as billing arrangements.]*

If this letter correctly expresses your understanding of this engagement, please sign the enclosed copy where indicated and return it to us.

Sincerely,

\_\_\_\_\_  
*[Firm Name or Firm Representative's Signature]*

Accepted and agreed to by XYZ Company

\_\_\_\_\_  
*[Client Representative's Signature (such as Name of Chief Financial Officer)]*

\_\_\_\_\_  
*[Title]*

\_\_\_\_\_  
*[Date]*

## Appendix C—Illustrative Representation Letter

Paragraph .33 of this SOP indicates that a practitioner may find a representation letter to be a useful and practical means of obtaining representations from management. This appendix includes an illustrative representation letter for the agreed-upon procedures engagement described in this SOP (agreed-upon procedures that address the completeness, mapping, consistency, or structure of an entity's XBRL-formatted financial statements and the related notes and required schedules submitted as an exhibit to the SEC). This representation letter is illustrative only and is not intended to be applicable to all engagements. In addition, it may not include items that are relevant to a specific engagement.

[Date]

To [CPA Firm]:

We are providing this letter in connection with the performance of certain agreed-upon procedures to assist management and the audit committee of XYZ Company in evaluating [identify subject matter and criteria (for example, the completeness of the XBRL files, mapping of the source information to the XBRL files, consistency of the XBRL files)] with the source information and structure of the XBRL files related to the [identify source document and period (for example, the Company's [Quarterly or Annual] Report on Form [10-K or 10-Q] for the period ended [identify date] to be submitted to the Securities Exchange Commission [SEC])]. We confirm that we are responsible for the XBRL files relating to our financial statements and the related notes and required schedules, the related assertions (attached hereto)<sup>10</sup> and for compliance with the SEC's requirements including those related to the completeness, mapping, consistency, and structure of XYZ Company's XBRL files and its assertions thereon, and for the completeness and accuracy of information provided to you, including the source information. We also confirm that we are responsible for selecting the criteria specified in the procedures and for determining that such criteria and procedures are sufficient for our purposes.

We confirm, to the best of our knowledge and belief, as of [identify date of agreed-upon procedures report], the following representations made to you during your agreed-upon procedures engagement.

1. All known matters with respect to the XBRL-formatted information relating to our financial statements or the assertions have been disclosed to you.
2. We have made available to you all—
  - a. Financial records and related data requested by you.
  - b. Documents used in the preparation of the XBRL files, such as information provided to a third party and tagging worksheets.
  - c. Output of all validation reports.
3. All of the data in the [identify the source information; for example, financial statements and the related notes and required schedules] that is required to be formatted in XBRL has been accurately and completely formatted and included in the XBRL files using [identify the taxonomy used; for example, U.S. GAAP Financial Reporting Taxonomy, Version X] in accordance with the SEC rules, and

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<sup>10</sup> Management assertions may be incorporated in the representation letter or may be provided separately.

## Statements of Position—Auditing and Attestation

except as communicated to you, the tags have been consistently applied from the prior submission as applicable.

4. There have been no communications from regulatory agencies affecting the XBRL-formatted information relating to our financial statements or previously submitted XBRL exhibits.<sup>11</sup>
5. We have no knowledge of any fraud or suspected fraud affecting the entity's XBRL-formatted information.
6. We have no knowledge of any matters contrary to your findings.
7. *[Add other matters as the practitioner deems appropriate, such as: We have limited the use of extension elements to cases where an appropriate element does not exist in the standard taxonomy.]*

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*[Name of Chief Executive Officer and Title]*

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*[Name of Chief Financial Officer and Title]*

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<sup>11</sup> If this representation letter is obtained subsequent to the issuance of the underlying financial statements, a representation such as the following may be appropriate: "We are not aware of any communication from any regulatory agencies regarding the financial statements or previously submitted XBRL exhibits, and no material modifications exist that need to be made to the financial statements."

## Appendix D—Illustrative Procedures and Findings

This appendix presents a table that includes illustrative procedures that a practitioner might perform and findings that a practitioner might report as part of the agreed-upon procedures engagement described in this SOP (agreed-upon procedures that address the completeness, mapping, consistency, or structure of XBRL-formatted financial statements (including notes) and required schedules submitted as an exhibit to the SEC). These procedures are illustrative only and do not represent a complete set of procedures that might be performed in any specific engagement. In addition, they do not necessarily address every attribute associated with a particular management assertion.

The following items provide additional information about the procedures, the reporting of findings, and sources of information about SEC requirements regarding XBRL-formatted information.

1. Certain agreed-upon procedures may appear in the following table under one assertion, but may be relevant to more than one assertion; however, each procedure would only need to be performed once.
2. As indicated in paragraph .27 of this SOP, the practitioner should report and describe all differences, exceptions, and other findings noted during the application of the agreed-upon procedures as part of his or her findings, unless they are below any agreed-upon materiality limits described in the practitioner's report.
3. In planning for the execution of such an agreed-upon procedures engagement, the practitioner may find it useful to perform additional activities to assist in gaining an understanding of the entity's formatting approach. Examples of such activities may include
  - inquiring of management to gain an understanding of its overall formatting and validation process,<sup>12</sup> including software applications or third-party providers used, and relevant experience and knowledge of those involved with the XBRL reporting process.
  - requesting management to provide a list of known differences between its XBRL files and the SEC requirements.
4. Certain of these procedures may be performed using XBRL software (for example, analysis, querying, validation). Accordingly, as part of tailoring the procedures to a specific agreed-upon procedures engagement, management might agree to or specify the use of a particular XBRL software product and version for performing such procedures.
5. The SEC provides requirements for the proper formatting of the XBRL files and maintains electronic systems to receive, validate, and process the XBRL files. Filers are responsible for compliance with these requirements and are encouraged to make a test submission of the XBRL files prior to submission to the SEC to re-

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<sup>12</sup> Various software applications or third party providers used may produce different reports or present information in a different manner, which may affect the timing, nature, and performance of procedures.

duce the likelihood of the exhibit not being accepted by the SEC systems.<sup>13</sup>

6. This table provides some references to relevant guidance in the SEC's EDGAR Filer Manual (EFM) Version 23.<sup>14</sup> The most current document is available on the SEC's website at <http://xbrl.sec.gov> and is updated frequently.

### Illustrative Procedures and Findings for an Agreed-Upon Procedures Engagement that Addresses the Completeness, Mapping, Consistency, or Structure of XBRL-Formatted Information

	Principles and Criteria <sup>15</sup>		Procedure		Finding
<b>Completeness of the XBRL Files—All required information is formatted at the required levels of detail as defined by the SEC's requirements. Only permitted information<sup>16</sup> is included in the XBRL files.</b>					
A	All information that is required to be formatted as defined by the SEC's requirements is formatted at the appropriate levels of detail in the XBRL files	C1	Inspect the XBRL files <sup>17</sup> to ascertain whether each of the following items in the source information is included in the XBRL files and is formatted at the level of detail noted in the following list:	C1	All such items in the [identify source information] that were required to be formatted as defined by the SEC's requirements were included in the XBRL files and formatted at the level of detail indicated [except as follows: list facts].

<sup>13</sup> The SEC's validation system checks only a subset of the requirements and should not be considered a method to measure compliance with all of the requirements.

<sup>14</sup> Future updates to the EFM could result in changes to the requirements, which could affect the procedures that the client might request be performed.

<sup>15</sup> Principles and criteria listed herein are the same as those listed in the application guidance of the principles and criteria in the exhibit of the *Principles and Criteria for XBRL-Formatted Information*. In some cases, footnotes to these principles and criteria have been modified for improved readability or to provide practitioners with more information.

<sup>16</sup> In a case in which an entity elects to format permitted information in addition to the required information, preparers should consider the level of detail to format such information so that it is not misleading to the user of the XBRL files.

<sup>17</sup> Inspection of the XBRL files may take different forms (for example, different XBRL analysis software may be used to view, manipulate or export the data into various forms for analysis). Alternatively, a mapping worksheet that is prepared by the entity prior to finalizing the XBRL files for submission may be used; in this case additional procedures would be necessary to ascertain whether the selected elements in the mapping worksheet are the same as those included in the final XBRL files.

	Principles and Criteria		Procedure		Finding
A (1)	All information (including parenthetical information) on the face of the financial statements in the source information <sup>18</sup> is formatted in the XBRL files, including facts that represent zero or do not have amounts.		<ul style="list-style-type: none"> <li>● Each amount on the face of the financial statements (including "0" and amounts represented by numbers or words and including amounts in parentheses and amounts in superscript<sup>19</sup> footnotes)</li> <li>● Each line item on the face of the financial statements that represents no value (for example, commitments and contingencies<sup>20</sup> for which there is only disclosure and no value)</li> <li>● Each heading in the financial statements is formatted as an abstract element</li> </ul>		
A (2)	All required document and entity information (DEI) is formatted in the XBRL files.		<ul style="list-style-type: none"> <li>● Each required document and entity information concept is formatted</li> </ul>		

(continued)

<sup>18</sup> Source information for purposes of submission to the SEC is the electronic or paper-based financial statements, including the notes; required schedules under Regulation S-X; and document and entity information (DEI) (which includes document type, document period end date, registrant name, central index key [CIK], fiscal year end date, public float, fiscal year, fiscal period, filer category, and reporting status as well as an indication of whether an amendment flag exists [if so, include a description of the reason for the amendment], whether the filer is not required to file reports, and whether the filer is a well-known seasoned issuer).

<sup>19</sup> Text that is included at the bottom of the page or table that is preceded by a superscript number or symbol which represents a footnote.

<sup>20</sup> Business reporting concepts that have no value for all periods, such as commitments and contingencies, must have the nil attribute set to "true."

	Principles and Criteria		Procedure		Finding
A (3)	Each complete note and required schedule under Regulation S-X are formatted separately using a text block element.		<ul style="list-style-type: none"> <li>Each note to the financial statements is formatted using a text block element</li> <li>Each schedule required by Regulation S-X is formatted using a text block element</li> </ul>		
A (4)	Each significant accounting policy (whether included in the accounting policies note or elsewhere within the notes to the financial statements) is formatted separately using a text block <sup>21</sup> element.		<ul style="list-style-type: none"> <li>Each significant accounting policy, identified by management (whether included in the accounting policies note or other notes to the financial statements), is formatted using a text block element</li> </ul>		
A (5)	Each table within each note is formatted separately using a text block element.		<ul style="list-style-type: none"> <li>Each table within each note is formatted using a text block element</li> </ul>		
A (6)	Each amount <sup>22</sup> disclosed in the notes and required schedules under Regulation S-X (including amounts written as words) is formatted separately.		<ul style="list-style-type: none"> <li>Each amount<sup>23</sup> in the notes that is represented in numbers or words (including "0" and amounts in parentheses and amounts in superscript footnotes)</li> </ul>		

<sup>21</sup> The U.S. GAAP Taxonomy has adopted a convention for distinguishing among text block elements intended for use in tagging accounting policies, tables, and disclosures.

<sup>22</sup> Not all amounts are required to be formatted (for example, there is no need to format the "2" in "2 percent milk") (See SEC Compliance and Disclosure Interpretation 146.16 located on the SEC's website for additional examples).

<sup>23</sup> Optional information may be formatted to provide more context to individual amounts.

	Principles and Criteria		Procedure		Finding
			<ul style="list-style-type: none"> <li>Each amount in the schedules (including "0" and amounts in parentheses and amounts in superscript footnotes) that is represented in numbers or words</li> </ul>		
A (7)	Each amount included in the superscript footnotes is formatted separately.		<i>Preceding bullets address this criterion.</i>		
A (8)	Text that is shown on the face of the financial statements at the bottom of the page or bottom of a table preceded by a superscript is formatted using XBRL footnote links. <sup>24</sup>		<ul style="list-style-type: none"> <li>Text immediately following each superscript footnote number on the face of the financial statements or in tables is formatted using a footnote link</li> </ul>		
B	The XBRL files contain only facts or presentation or calculation relationships that are included in the source information and other required or permitted information (such as DEI <sup>25</sup> required by the SEC) and contain only unused elements and linkbase information that are used intermittently unless otherwise prohibited. <sup>26</sup>	C2	Compare the tagged facts in the XBRL files to the source information and identify any tagged facts that are not included in the source information other than other required (for example, DEI) or permitted information (for example, definitions for extension elements).	C2	All tagged facts that were included in the XBRL files were in the source information or otherwise permitted [except as follows: <i>describe elements and relationships</i> ].

(continued)

<sup>24</sup> The EFM requires this only for the face of the financial statements.

<sup>25</sup> DEI includes information that may be outside of the financial statements such as the number of outstanding shares of a company's stock that is in the hands of public investors, as opposed to company officers, directors, or controlling-interest investors (public float) and CIK.

<sup>26</sup> The entity may carry forward unused elements or presentation, definition, or calculation relationships in the taxonomy that are used intermittently in the instance document (for example, taxonomies may reflect elements or relationships used in instance documents for annual financial statements [Form 10-K] but not used in the instance documents for quarterly financial statements [Form 10-Q]). Used elements or relationships refer to those used in the instance document.

	Principles and Criteria		Procedure		Finding
<b>Mapping of the source information—The elements<sup>27</sup> selected are consistent with the meaning of the corresponding business reporting concepts in the source information in accordance with the SEC's requirements.</b>					
C	Elements used in the XBRL files, considering their attributes; <sup>28</sup> definitions (for example, documentation labels in the label linkbase); and references are consistent with the corresponding business reporting concepts in the underlying source information.	M1	For each element used in the XBRL files, compare the following aspects of the element to the nature of the business reporting concept in the source information: <ul style="list-style-type: none"> <li>● Abstract (that is, true, false)</li> <li>● Data type (for example, block text, monetary value, or other numeric value)</li> <li>● Period type (that is, instant, duration)</li> <li>● Other definitional aspects (that is, documentation labels and standard labels in the label linkbase, and references)</li> </ul>	M1	All such aspects of the elements used in the XBRL files reflect the nature of the business reporting concepts in the [identify: source information] [except for the following: list elements and describe differences].
C (1)	Headings in the source information are represented as abstract elements.		<i>Procedures C1 and M1, listed previously, address this criterion.</i>		<i>See findings under C1 and M1, listed previously.</i>

<sup>27</sup> Elements include line items and combinations of line items, domain members, and axes.

<sup>28</sup> The "basic element attributes" include (a) abstract, (b) data type (that is, whether the content is expected to conform to a certain type of content, such as block text, a monetary value, or other numeric value), (c) period type (that is, whether it is a point in time or a period of time), and (d) balance type (that is, whether it is normally a debit or a credit). The balance attribute is currently not a primary consideration in selecting elements in the SEC program.

	<b>Principles and Criteria</b>		<b>Procedure</b>		<b>Finding</b>
D	The most specific elements or dimensional combination of elements across the entire taxonomy whose attributes; definitions (for example, documentation labels in the label linkbase); and references are consistent with the corresponding business reporting concepts have been used.	M2	Search the taxonomy for any elements and any combination of elements for which element aspects (that is, documentation labels and standard labels in the label linkbase, and references) that reflect more specifically <sup>29</sup> the corresponding business reporting concept without violating the criteria for element selection (aspects of elements as listed previously in procedure M1).	M2	No elements from the [specify taxonomy <sup>30</sup> ] for which definitions and standard labels in the label linkbase, and references may more specifically reflect the corresponding business reporting concepts in the [identify: source information] were noted. Or The following elements from the [specify taxonomy] for which definitions and standard labels in the label linkbase, and references more specifically reflect the corresponding business reporting concepts in the [identify: source information and list the elements and the business reporting concepts].

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<sup>29</sup> This may include identifying more detailed elements. For example, in the case of a concept on the financial statements for short-term investments available for sale, the entity used the short-term investments element in the XBRL files; however, the practitioner may identify short-term investments available for sale as a more specific element. There may be some situations that require the exercise of a level of judgment that may not be appropriate for an agreed-upon procedure engagement. In such cases, the practitioner should not make the judgment but should lay out the facts for the specified parties.

<sup>30</sup> This procedure may be performed against the standard taxonomy (for example, U.S. GAAP Taxonomy as documented in the EFM) or against the extension taxonomy of the instance document (incorporating extension elements).

	Principles and Criteria		Procedure		Finding
D (1)	Certain elements required for use by the SEC (for example, DEI elements or elements for reporting consolidating entities) have been used if applicable.	M3	From the list of required elements per the SEC's EFM (sections 6.5.20, 6.5.21, and 6.6.3 through 6.6.10) pertaining to <ul style="list-style-type: none"> <li>● consolidations and legal entities,</li> <li>● stock classes, and</li> <li>● document and entity-related information</li> </ul> trace the required elements for business reporting concepts included in the source information to inclusion in the XBRL files.	M3	Required elements for business reporting concepts pertaining to consolidations and legal entities, stock classes, and document and entity-related information included in the source information were included in the XBRL files [except for the following elements: <i>list elements not included</i> ].
E	Use of selected elements is permitted (for example, the selected element is not deprecated)	M4	Search the XBRL files to identify the elements <sup>31</sup> in the XBRL files that have a deprecated label in the standard taxonomy.	M4	The XBRL files do not contain any elements that have deprecated labels in the standard taxonomy [except the following elements used in the XBRL files: <i>list elements</i> ].
F	The same business reporting concepts appearing multiple times in the source information are formatted once using the same elements or combination of elements throughout the XBRL files, when appropriate <sup>32</sup>	M5	For business reporting concepts appearing more than once in the source information (including those concepts with values reported for more than one period), search the XBRL files for use of more than one element for the same business reporting concept except when alternative line item and domain member combinations are prescribed by related guidance.	M5	No items were noted in which a different element was used for the same business reporting concept appearing more than once or for different periods [except as follows: <i>describe, for example, cash appearing on the balance sheet was tagged with a different element (or combination of elements) than cash appearing on the cash flow statement</i> ].

<sup>31</sup> The procedure to be performed addresses the situation of deprecated elements; however, there may be other conditions where elements are not permitted. Procedures to address other examples are not included in this SOP because they may be automatically tested with software.

<sup>32</sup> Exceptions exist when business reporting concepts will be formatted using different line item and domain member combinations, or when the related guidance requires different elements to be used based on the level of granularity of the source data being formatted (for example, in situations where concepts must use both dimensional and nondimensional approaches, such as Treasury stock presented on the balance sheet without dimensions and then presented on the statement of stockholders' equity with dimensions). The appropriate use of duplicate elements should be considered, and redundantly formatted facts should be eliminated.

	<b>Principles and Criteria</b>		<b>Procedure</b>		<b>Finding</b>
G	The same elements are used consistently to report the same business reporting concepts, including for each period for which such concepts appear in the underlying source information. <sup>33</sup>		<i>Procedure M5, listed previously, addresses this criterion.</i>		<i>See findings in M5, listed previously.</i>
H	Extension elements are created only when both of the following conditions are met: no suitable elements exist in the selected taxonomy, and extensions are permitted in accordance with the SEC's rules.		<i>Procedures M1, M2, and M3, listed previously, address this criterion.</i>		<i>See findings from M1, M2, and M3, listed previously.</i>
I	Definitions, if provided (for example, documentation labels in the label linkbase) for extension elements used in the instance document, are consistent with the source information.		<i>Procedure M1, listed previously, addresses this criterion.</i>		<i>See findings from M1, listed previously.</i>
<b>Consistency of the XBRL Files With the Source Information—All formatted information<sup>34</sup> in the XBRL files is consistent with the source information and formatted in accordance with the SEC's requirements.</b>					
J	Formatted amounts in the XBRL files reflect the entire numbers of the corresponding business reporting concepts (that is, the XBRL amounts are not scaled <sup>35</sup> ).	CO1	For each amount tagged in the XBRL files, compare such information with the amount of the corresponding business reporting concept in the source information to identify any amount that does not reflect the entire number.	CO1	All amounts in the XBRL files reflect the entire number of the corresponding business reporting concept [except for the following elements: <i>list elements and describe differences</i> ].

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<sup>33</sup> Although the source information may contain different values (for example, positive, negative, or zero) in one period as compared with another (for example, net income [loss]) or represent an ending balance in one period and the beginning balance in the next, the same element should be used in all periods presented. Notwithstanding, there may be certain situations in which the taxonomy may include different elements to reflect positive and negative values (for example, certain elements relating to tax assets and tax liabilities in the U.S. GAAP Taxonomy).

<sup>34</sup> Formatted information includes data (for example, amounts, text, dates); contextual information (for example, monetary units); and relationships (for example, presentation order and calculations).

<sup>35</sup> Amounts in financial statements are often presented in various formats (for example, rounded to millions) and may represent a different scale. However, amounts formatted in XBRL must be entered without such presentational formatting. For example, 23.5 million would be entered as 23500000, 14.3 percent would be entered as .143.

	Principles and Criteria		Procedure		Finding
K	Formatted amounts have the appropriate signs based on the nature of the values in the source information, balance attributes, and definitions (documentation labels in the label linkbase) of the elements.	CO2	For negative amounts in the instance document, that have been tagged with elements whose definitions or standard labels do not include terminology identified in the table in the SEC's Staff Observations (SEC table) <sup>36</sup> (for example, increase/decrease, gain/loss, provided by/used in) within the definition (documentation label in the label linkbase) or standard label, compare the sign <sup>37</sup> to the nature of the value of the corresponding business reporting concepts in the source information.	CO2	The signs for negative amounts for elements with definitions or standard labels that do not include terminology from the SEC table are consistent with the nature of the value of the corresponding business reporting concepts in the [identify: source information] [except for the following: list elements].
		CO3	For elements for which the definition (documentation label in the label linkbase) or standard label includes terminology identified in the SEC table, compare the sign for each amount in the XBRL files to the nature of the value of the corresponding business reporting concept in the source information.	CO3	The signs for the formatted amounts in the XBRL files of elements for which the definitions or standard labels includes terminology in the SEC table are consistent with the nature of the value of the corresponding business reporting concepts in the [identify: source information] [except for the following: list elements and describe differences in signs].

<sup>36</sup> Under the heading "Negative Values" in the SEC's *Staff Observations from the Review of Interactive Data Financial Statements (from December 13, 2011)* is a table in which the SEC staff provides examples of language included in definitions or standard labels of elements that can be negative. This is not necessarily a complete list, therefore, the practitioner and preparer may agree to extend this procedure beyond the elements that have definitions or labels that contain specified language included in the table.

<sup>37</sup> Identified negative amounts may not be an error; however, they likely require further assessment by management.

	Principles and Criteria		Procedure		Finding
L	All text, dates, and uniform resource identifiers in the XBRL files are consistent with the underlying source information.	CO4	For text, dates, and uniform resource identifiers (URIs) tagged in the XBRL files, compare such information with the corresponding concepts in the source information.	CO4	No differences for text, dates, and URIs in the XBRL files as compared with <i>[identify source information]</i> were noted [except for the following elements: <i>list elements and describe differences</i> ].
L (1)	Nil attribute <sup>38</sup> is used only to convey business reporting concepts reported that have no amounts associated but are not zero (for example, commitments and contingencies).	CO5	For each business reporting concept in the source information that represents no value (associated with it) inspect whether the nil attribute for the corresponding element is set to true in the XBRL files.	CO5	Nil attributes were set to true in the XBRL files for each concept in the <i>[identify source information]</i> for which no value is associated [except for the following elements: <i>list elements</i> ].
		CO6	For each element in the instance document for which the nil attribute is set to true, identify those elements that represent business reporting concepts other than commitments and contingencies and preferred stock. <sup>39</sup>	CO6	For none of the elements in the instance document other than commitments and contingencies and preferred stock was the nil attribute set to true. Or Elements in the instance document other than commitments and contingencies and preferred stock for which the nil attribute is set to true include <i>[list elements]</i> .

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<sup>38</sup> A nil attribute is used only for elements in the instance document and presentation to convey business reporting concepts that have no amounts, text, dates, or uniform resource identifiers in the source information.

<sup>39</sup> Management may specify other appropriate concepts for which the nil attribute would be set to true and modify this procedure to include such other appropriate concepts.

	Principles and Criteria		Procedure		Finding
M	Extension elements included in the instance document of the XBRL files for monetary amounts include debit or credit balance attributes or documentation labels with an indication of the meaning of positive or negative values, when applicable, that are consistent with the nature of the business reporting concepts in the underlying source information.	CO7	For each line item in the instance document that has an extension element with a monetary type <ul style="list-style-type: none"> <li>and a balance (debit / credit) attribute, compare the balance attribute to the nature of the business reporting concept in the source information.</li> <li>and not a balance (debit / credit) attribute, inspect the elements for a definition (that is, documentation label) that includes an indication of the meaning of a positive or negative value (for example, "A positive adjustment value indicates a net increase in accounts receivable") and compare such definition to the nature of the business reporting concept in the source information.</li> </ul>	CO7	No monetary type line item extension elements were noted that contain a balance attribute (or definition, as applicable) that is inconsistent with the nature of the business reporting concepts in the <i>[identify source information]</i> [except for the following elements: <i>list elements and describe differences from the source information</i> ].
M (1)	Extension elements included in the XBRL files for monetary amounts of balance sheet or income statement concepts include balance attributes (debit or credit) that are consistent with the nature of the underlying source information.	CO8	Identify the monetary type extension elements included in the XBRL files for monetary amounts presented in the balance sheet or income statement that do not include balance attributes. <i>[Procedure CO7 (first bullet), in combination with this procedure addresses this criterion.]</i>	CO8	No such items were noted for monetary amounts presented on the balance sheet and income statement that do not include balance attributes [except the following elements: <i>list extension elements and describe differences</i> ]. <i>Also see findings for CO7.</i>

	Principles and Criteria		Procedure		Finding
N	The context periods <sup>40</sup> are consistent with the source information (for example, second calendar quarter 2012 is expressed as "2012-04-01 to 2012-06-30").	CO9	For each business reporting concept that appears on the face of the financial statements or in tables in the source information, compare the reporting period (implied and explicitly stated) to the corresponding context period in the XBRL files.	CO9	No differences were noted in the XBRL files relating to context periods for concepts appearing on the face of the financial statements or in tables in the [identify source information] [except for the following elements: list elements and describe differences].
		CO10	<p>For business reporting concepts within narrative text (for example, in the notes), compare the "as of" or period dates in the source information to the dates<sup>41</sup> in the context period of the corresponding elements in the XBRL files.</p> <ul style="list-style-type: none"> <li>● For amounts with a period type of instant                             <ul style="list-style-type: none"> <li>- if a date is specified in the notes (for example, "as of" or "on"), ascertain whether the date for the context period in the XBRL files is the date specified in the source information.</li> <li>- if the month is specified (for example, March), ascertain whether the date for the context period in the XBRL files is the last day of that month.</li> </ul> </li> </ul>	CO10	No differences were noted in the XBRL files relating to context periods for business reporting concepts included with narrative text in the [identify source information] [except the following context periods: list elements and describe differences]

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<sup>40</sup> Context periods for a roll-forward format use the same "instant" context for the beginning balance as for the ending balance of the previous period.

<sup>41</sup> Procedures may be tailored, as appropriate, for application to periods included in the source information in addition to those listed.

	Principles and Criteria		Procedure		Finding
			<ul style="list-style-type: none"> <li>- if the quarter is specified (for example, in the second quarter), ascertain whether the date for the context period in the XBRL files is the end date for that quarter.</li> <li>• For amounts that have a period type of duration</li> <li>- if the month is specified (for example, March), ascertain whether the date for the context period in the XBRL files is first and last day of the month.</li> <li>- if the quarter is specified (for example, in the second quarter), ascertain whether the date for the context period in the XBRL files is the first and last day of the quarter.</li> </ul>		
N (1)	The required DEI elements use the Required Context. <sup>42</sup>	CO11	Compare the contexts used in the XBRL files for DEI to those required by the SEC's EFM (sections 6.5.20 and 6.5.21) pertaining to DEI.	CO11	The context in the XBRL files used for DEI elements agreed with the context required by sections 6.5.20 and 6.5.21 of the SEC's EFM [except the following elements for which the context did not use the Required Context: <i>list elements</i> ].

<sup>42</sup> The *Required Context* is defined in the EFM as the context when the dates cover the current reporting period and no segment or scenario information (that is, dimensional information) is included.

	<b>Principles and Criteria</b>		<b>Procedure</b>		<b>Finding</b>
O	The decimal attribute values are consistent with the degree of accuracy of the amounts as represented in source information (for example, 23.5 million is rounded to the hundred thousandths).	CO12	For each amount in the XBRL files compare the value of the decimal attribute (for example, "-6") to the corresponding degree of accuracy represented in the source information.	CO12	No differences were noted between the decimal attribute values in the XBRL files and the degree of accuracy represented in the [identify source information] [except for the following decimal attributes in the XBRL files: list elements and describe differences].
P	The units defined in the instance document are consistent with the measurements represented in the source information (for example, U.S. dollars are defined as "iso4217:USD", as properly defined in XBRL Specification 2.1).	CO13	For each amount included in the instance document, compare the units (including custom units) to the standard list of units specified by the SEC (for example, in the International Organization for Standardization (ISO) currency codes, or the XBRL International Unit Registry).	CO13	No differences were noted in the units used in the instance document as compared to the standard list of units specified by the SEC [except for the following units in the XBRL files: list elements and describe any differences].
		CO14	For each amount included in the instance document of the XBRL files, compare the units (including custom units) to the nature of the corresponding unit in the source information.	CO14	No differences were noted in the units used in the instance document of the XBRL files as compared to the source information [except for the following units in the instance document of the XBRL files: list elements and describe any differences].
Q	The entity identifier in the instance document properly represents the reporting entity [for example, central index key (CIK)] in accordance with the SEC requirements.	CO15	Compare the identifier(s) used in the instance document to the registrant's unique CIK code.	CO15	The CIK code used in the XBRL files agrees with the registrant's CIK code. Or The following [identify CIK code(s)] were used in the XBRL files that did not agree with the registrant's CIK code.
Q (1)	Only one CIK code is used throughout the XBRL files.	CO16	Search the contexts for the use of more than one CIK code in the XBRL files.	CO16	Only one CIK code was used in the XBRL files. Or The following [identify CIK codes] were used in the XBRL files.

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	Principles and Criteria		Procedure		Finding
R	The format and layout of the text block information are consistent <sup>43</sup> with the format and layout of the content in the source information.	CO17	Compare the format and layout of the text block information in the XBRL files to the form and layout in the source information (for example, content, indentations, italics, bold, color, order).	CO17	No differences were noted in the format and layout of text block information in the XBRL files as compared to the <i>[identify source information]</i> [except for the following elements: <i>list elements and describe differences</i> ].
S	The order and hierarchy (that is, arrangement of appropriate abstracts and line items) reflected in the presentation linkbase are consistent <sup>44</sup> with the SEC's requirements.	CO18	Compare the order and hierarchy of the elements in the presentation linkbase with the source information.	CO18	No differences were noted in the order and hierarchy of the elements in the presentation linkbase as compared to the <i>[identify source information]</i> [except for the following: <i>list elements and describe differences</i> ].
T	Labels <sup>45</sup> are consistent <sup>46</sup> with the captions or meanings in the source information, as applicable.	CO19	Compare labels for line item elements (with no dimensions) reflecting business reporting concepts on the face of the financial statements or in tables in the source information to the captions in the source information. Compare labels for all other tagged facts with the corresponding business reporting concept in the source information.	CO19	No differences other than those permitted <sup>47</sup> were noted with the label information of elements appearing in the rendering as compared to the <i>[identify source information]</i> [except for the following: <i>list elements and describe differences</i> ].

<sup>43</sup> The EFM requires the same format and layout in text blocks as in the source information.

<sup>44</sup> When using dimensions to format information, it may not be possible to present this information in the same order and hierarchy (for example, transposed or intermingled axes for line items and domain members may occur).

<sup>45</sup> Labels in the label linkbase under the SEC rules must be the same as the captions in the source information, including parenthetical information.

<sup>46</sup> *Consistent* means the same as the printed captions in the source information, when required, or within the scope of variances otherwise permitted.

<sup>47</sup> EFM 6.11.3 requires additional information be included in the label for certain elements within a presentation group to distinguish the units in those elements where the majority of the elements within the group use a different unit.

	<b>Principles and Criteria</b>		<b>Procedure</b>		<b>Finding</b>
CO20	Compare standard "en-US" labels used for each extension element in the XBRL files to the labels of other elements in the XBRL files and the standard taxonomy to ascertain whether duplicate standard English labels "en-US" are used.	CO20	No duplicate standard "en-US" labels were noted [except for the following extension elements: <i>list elements with duplicate standard en-US labels</i> ].		
T (1)	The appropriate label roles (in the label linkbase) are specified in presentation groupings and are consistent with the source information, as applicable. (For example, negated labels are used to reverse the sign of numeric values for presentation purposes.)	CO21	<p>Compare the preferred label roles in the XBRL files with the presentation of the corresponding business reporting concept in the source information and the following requirements:</p> <ul style="list-style-type: none"> <li>● For period type of "instant": <ul style="list-style-type: none"> <li>- A Period Start label role was used when concepts were presented as a beginning of a roll forward (for example, cash balances)</li> <li>- A Period End label role was used when concepts were presented as an ending of a roll forward (for example, cash balances)</li> </ul> </li> <li>● Total label role must be used when representing concepts presented as a summation of other line items</li> <li>● Negated label roles were used when necessary to reverse the sign of the numeric value for presentation purposes to correspond to the business reporting concept as presented in the source information.</li> </ul>	CO21	No differences were noted for the preferred label roles as compared to the presentation of the corresponding business reporting concept in the source information and the label requirements [except for the following: <i>list elements and labels and describe differences</i> ].

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	Principles and Criteria		Procedure		Finding
U	Calculations reflected in the source information are included in the calculation linkbase in accordance with the SEC's requirements to the extent possible within the technical limitations <sup>48</sup> of XBRL.	CO22	For those subtotals/totals that have two or more line items in the source information with amounts in the same context and within the dates represented by the period of the Required Context <sup>49</sup> (no dimensional information), compare such relationships with the corresponding calculation relationship in the XBRL files.	CO22	No differences in the calculation relationships were noted in the XBRL files as compared to the source information [except for the following business reporting concepts: <i>list business reporting concepts and describe differences</i> ].
<b>Structure of the XBRL files—XBRL files are structured<sup>50</sup> in accordance with the following listed criteria.</b>					
V	Taxonomies, including versions, referenced in the XBRL files are permitted by the SEC's requirements.	S1	Compare the standard taxonomy used in the XBRL files to the list of permitted taxonomies at <a href="http://www.sec.gov/info/edgar/edgartaxonomies.shtml">www.sec.gov/info/edgar/edgartaxonomies.shtml</a> .	S1	We noted that the standard taxonomy(ies) [ <i>identify taxonomy(ies)</i> ] used in the XBRL files is (are) permitted according to the SEC website. Or We noted that the standard taxonomy(ies) [ <i>identify taxonomy(ies)</i> ] used in the XBRL files is (are) not permitted according to the SEC website.
W	Presentation groupings are consistent with the titles and order of the components of the underlying source information and in accordance with the SEC's requirements.		<i>Procedures S2 and S3, listed subsequently, address this criterion</i>		<i>See findings under S2 and S3.</i>

<sup>48</sup> Due to current limitations of XBRL, calculations cannot be performed across different contexts; accordingly, it is currently not possible to include such calculations in the XBRL files.

<sup>49</sup> See definition of Required Context in footnote 42. Although not required, additional calculations outside of the required context are permitted.

<sup>50</sup> It is beyond the scope of these principles and criteria to include all applicable rules, regulations and technical requirements related to the intended purpose of the XBRL submissions. Notwithstanding, preparers are responsible for identification of and compliance with all of the SEC's requirements and a preparer may choose to request that a practitioner perform procedures with respect to such requirements.

	Principles and Criteria		Procedure		Finding
W (1)	Separate note presentations groupings (base sets) are created for each required level (I, II, III, and IV) and ordered in accordance with the SEC's requirements	S2	Compare the existence and order of the base sets in the presentation linkbase to the financial statement and note whether they appear in order of the source information and the ordering requirements as described in the SEC's EFM (section 6.7.12) as follows: 1. Each financial statement followed by a base set for the parentheticals within the statement [ <i>in order of statements</i> ] 2. Notes (text block) [ <i>order of notes</i> ] 3. Schedules (text block) 4. Significant accounting policies (policies) 5. Notes (tables) 6. Notes (detail) 7. Schedules (detail)	S2	The order of the presentation base sets in the presentation linkbase agreed to the [ <i>identify source information</i> ] and the EFM requirements [ <i>except for the following base sets: list base sets and describe differences</i> ].
W (2)	Titles of presentation groupings are in accordance with the SEC's formatting requirements.	S3	Compare base set titles (role type definition link) in the presentation linkbase to the SEC formatting requirements <sup>51</sup> for the following: 1. Formatting pattern: {SortCode} - {Type} - {Title} (for example: 01 - Statement - Statement of Income) 2. Titles of statements and notes in the source information	S3	No differences were noted with respect to the base set titles [ <i>except the following: list base sets and describe how they did not conform to or agree with the SEC formatting requirements</i> ].

(continued)

<sup>51</sup> This is not a complete list of all SEC formatting requirements. Refer to EFM for requirements.

	<b>Principles and Criteria</b>		<b>Procedure</b>		<b>Finding</b>
X	The entity scheme (for example, <a href="http://www.sec.gov/CIK">www.sec.gov/CIK</a> ) for each context throughout the instance document is in accordance with the SEC's requirements.	S4	For each context, compare the entity scheme to <a href="http://www.sec.gov/CIK">http://www.sec.gov/CIK</a> .	S4	We noted that the entity scheme <a href="http://www.sec.gov/CIK">http://www.sec.gov/CIK</a> was used in all contexts [except for the following: <i>list contexts and describe differences</i> ].
Y	New table structures are only created when no suitable table structure exists in the applicable standard taxonomy's definition linkbase.	S5	Compare the table structures in the definition linkbase (that is, table, axis, domain member, line item) to the predefined table structures <sup>52</sup> in the standard taxonomy's definition linkbase.	S5	No new table structures were created when a suitable table structure existed [except for the following: <i>list contexts and describe differences</i> ]. No differences were noted in table structures as compared to the predefined table structures in the [ <i>specify taxonomies</i> ] [except for the following tables: <i>list tables and describe differences</i> ].
Z	The names of extension elements contain no prohibited information.		<i>Procedure S6, in the following row, addresses this criterion.</i>		<i>See findings under S6.</i>
Z (1)	The names of extension elements (excluding domain members) do not include company- or period-specific information.	S6	Search the element name of each extension element (excluding domain members) for company or period specific information within the element name.	S6	No such elements were noted that have company or period specific information within the element name [except for the following elements: <i>list elements and describe differences</i> ].

<sup>52</sup> Dimensional structures in the definition linkbase of the standard taxonomy contain ordered combinations of tables, axes, line items, and domain members. Definition linkbases for extension taxonomies should include dimensional structures from the standard taxonomy's definition linkbase when they exist.

	<b>Principles and Criteria</b>		<b>Procedure</b>		<b>Finding</b>
AA	The XBRL files include all files required by the SEC (for example, an instance, schemas and linkbases).	S7	Inspect the XBRL files to ascertain whether there is only one of each of the following files <sup>53</sup> included: <ul style="list-style-type: none"> <li>● Instance document</li> <li>● Presentation linkbase</li> <li>● Label linkbase</li> <li>● Calculation linkbase</li> <li>● Schema</li> <li>● Definition linkbase</li> </ul>	S7	Only one of each of the required files was included. Or The following files were missing: <i>[list files]</i> Or Multiple schema files were included.
BB	The language of the information in the XBRL files uses a permitted (or required) language (for example, English).		<i>Procedures S8 and S9, in the following rows, address this criterion.</i>		<i>See findings under S8 and S9.</i>
BB (1)	Elements must include fact values and labels expressed in U.S. English.	S8	For each fact in the source information in a language other than U.S. English, ascertain whether the corresponding formatted information in the XBRL files has values and labels expressed in U.S. English.	S8	No items were noted in which business reporting concepts in the source information in a language other than U.S. English were not formatted in the XBRL files with values and labels expressed in U.S. English [except for the following concepts: <i>list concepts and describe differences</i> ].
		S9	Search extension elements in the XBRL files for any that do not have a standard English "en-US" label.	S9	No elements were noted in the XBRL files that did not have a standard "en-US" label [except for the following elements: <i>list elements and describe differences</i> ].

<sup>53</sup> Although the EFM permits multiple linkbases and schema files, in most cases there will only be one included with the submission.

## Appendix E—Illustrative Agreed-Upon Procedures Report

The following is an illustrative practitioner's report for an agreed-upon procedures engagement described in this SOP (agreed-upon procedures that address the completeness, mapping, consistency, or structure of an entity's XBRL-formatted financial statements [and related notes] and required schedules submitted as an exhibit to the SEC). It is illustrative only and is not intended to be applicable to, or comprehensive for, all engagements. A practitioner should tailor the report to the specific facts and circumstances of each engagement.

### **Independent Accountant's Report on Applying Agreed-Upon Procedures**

To Management and the Audit Committee of XYZ Company:

We have performed the procedures enumerated in Attachment A, which were agreed to by the audit committee and management of XYZ Company, solely to assist you in evaluating the completeness of the XBRL files, mapping of the source information to the XBRL files, consistency of the XBRL files with the source information, and structure of XYZ Company's XBRL files related to the *[identify source information and period]*<sup>54</sup> (for example, the Company's [Quarterly or Annual] Report on Form [10-K or 10-Q] for the period ended *[identify date]* to be submitted to the U.S. Securities Exchange Commission [SEC]). XYZ Company's management is responsible for its XBRL files.

This agreed-upon procedures engagement was performed in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described in Attachment A either for the purpose for which this report has been requested or for any other purpose.

*[Additional explanatory language may be added, such as the following:]*<sup>55</sup>

The procedures performed do not address all of the SEC's requirements for XBRL submissions.

The XBRL files and source information may be updated prior to submitting to the SEC, therefore, the findings in this report may not correspond to the final XBRL files submitted.]

The findings relating to the procedures are included in Attachment A.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on the XBRL files. 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.

---

<sup>54</sup> It is common that these engagements are performed on DRAFT XBRL files and source information (prior to the submission to the SEC). The agreed-upon procedures report should indicate the specific version of the source information and files used.

<sup>55</sup> Refer to paragraph .30 of this SOP for additional examples.

This report is intended solely for the information and use of the audit committee and management of XYZ Company and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[*Include as an attachment an enumeration of the procedures and findings.*]

## Appendix F—Glossary

**abstract.** An attribute of an element to primarily indicate that the element is used only in a hierarchy to group related elements together or to provide headings in a rendering. An abstract element cannot be used to tag data in an instance document.

**attribute.** A property of an element that indicates the kind of data that can be tagged to the concept, such as its data type, period type, and whether the element is abstract.

**axis (pl. axes).** An instance document contains facts; an axis (and domain member) differentiates facts, and each axis represents a way the facts may be classified. For example, revenue for a period might be reported along a business unit axis, country axis, product axis, and so forth.

**balance type.** An attribute of a monetary item type designated as debit or credit; a designation, should be the natural or most expected balance of the element—credit or debit—and, thus, indicates how calculation relationships involving the element may be assigned a weight attribute (–1 or 1), as well as how numbers should be entered into the instance document.

**calculation linkbase.** A taxonomy file that defines weighted summation, aggregating relationships between numeric items expressed as parent-child hierarchies.

**caption.** Explanatory text provided to describe facts presented in a report.

**context.** Entity- and report-specific information (reporting period, segment information, and so forth) required by eXtensible Business Reporting Language (XBRL) that allows tagged data to be understood in relation to other information.

**decimal.** Fact attribute used to express the number of decimal places to which numbers have been rounded.

**deprecated element.** An element within a taxonomy that has been declared not to be used in instance documents for various reasons (for example, superseded, redundant, or incorrect).

**domain.** An element that represents an entire set of other elements that are used to further describe line items; the domain and its members are used to classify facts along the axis of a table. For example, "Arkansas" could be a domain member in the domain "States" and would be used to classify elements, such as revenues and assets, in Arkansas as distinct from other states. When a fact does not have any domain member specified, that means it applies to the entire domain.

**domain member.** An element representing one of the classifications within a domain. A domain member categorizes the information to which it is applied.

**element.** An XBRL component, such as a line item, domain member, and dimension (a dimension is called an axis in the U.S. GAAP Taxonomy). The representation of a business reporting concept, including line items in the face of the financial statements, important narrative disclosures, and rows and columns in tables are all examples of elements in a taxonomy. The terms *concept*, *element*, and *tag* (noun) are often used interchangeably in XBRL.

- element definition.** A description of a reporting concept, most commonly a documentation label in the label linkbase.
- extension element.** An element that is created in an extension taxonomy to define business reporting concepts that have not previously been defined in a standard taxonomy.
- extension taxonomy.** A taxonomy in which users can add additional entity-specific elements and indicate additional relationships to a standard taxonomy in order to define business reporting concepts or element relationships and aspects (presentation, calculation, labels, and so forth) to reflect their own unique reporting characteristics.
- fact.** The occurrence of an amount or other information tagged in an instance document by a taxonomy element or combination of elements.
- formatted information.** Information represented using XBRL and included in one or more electronic files. Commonly referred to as tagged data or structured data.
- hierarchy.** An organizational treelike structure to present relationships between elements (such as order and indentation of elements in linkbases).
- instance or instance document.** A file that contains business reporting information and represents a collection of business facts and report-specific information using elements from one or more XBRL taxonomies.
- label.** Name or description for an element for presentation purposes; under the SEC mandate, for example, each element has, at a minimum, a standard label in U.S. English (such as, cash and cash equivalents) and is unique across the taxonomy.
- label type.** A distinguishing name for each distinct label indicating the circumstances in which it should be used; each is given a separate defining role to use in different presentation situations (for example, beginning, ending, and so forth).
- line item.** Elements that conventionally appear on the vertical axis (rows) of a table or columnar presentation. Line items represent the primary business reporting concepts of tagged data in the instance document.
- linkbase.** A taxonomy file that contains additional defining information and relationships for taxonomy elements. The primary taxonomy linkbases in XBRL are calculation, definition, label, presentation, and reference.
- mapping.** Process of identifying the elements that correspond to lines, columns, and tables in the source information to elements in the taxonomy.
- name.** An attribute that uniquely identifies an element in a schema.
- namespace.** Every element is associated with a universal resource identifier that may identify the organization that maintains the taxonomy. In the 2012 US GAAP Financial Reporting Taxonomy, namespaces start with <http://xbrl.fasb.org/us-gaap/2012>.
- negated label.** A negated label is a special label type that can be referenced in the presentation linkbase. A negated label role is a convention used to indicate that the sign for a tagged amount should be reversed when presented in a rendering.
- nil.** An attribute of an element that, when marked as "true" in an instance document, reflects a concept tagged without a value.

**period type.** An attribute of an element that reflects whether it is reported as a point in time (an instant) or period of time (duration).

**presentation linkbase.** A taxonomy file that defines presentation order of elements in the taxonomy. The presentation linkbase also suggests which label type should be used at each point of presentation.

**render or rendering.** To process an instance document into a layout that facilitates readability and understanding of its contents.

**scaling.** A process that automatically adjusts numeric data to present a specific format, thus saving time of entering zeros during the entry or creation process. The XBRL specification does not support the scaling of numeric values (all values must be reported in their entirety); however, it is a feature commonly found in instance document creation software.

**segment.** Tag that allows additional information to be included in the context of an instance document; this information captures segment information, such as an entity's business units, type of debt, and type of other income.

**sign value.** Denotes whether a numeric fact in an instance has an implied positive (no sign) or a negative (–) value.

**source information.** The information (which may be in electronic format) that is to be formatted in XBRL files (for example, financial statements, including the notes, and required schedules; sustainability reports; or the "Risk/Return Summary" section of the mutual fund prospectuses).

**table.** Generally, a presentation of rows and columns also known as a hypercube. In the presentation linkbase, an element that organizes a set of axes and set of line items to indicate that each fact of one of the line items could be further characterized along one or more of its axes. For example, if a line item is "Sales," and an axis is "Scenario," this means that an instance document could have facts that are either for an unspecified scenario or a specific scenario, such as "forecast."

**tag (noun).** The terms *element* and *tag* are often used interchangeably in XBRL. The tag is the structure that brings together the content being tagged with the associated element from the taxonomy and additional attributes to related contexts, units, and other information.

**tag (verb).** To apply tags to business reporting concepts.

**taxonomy(ies).** Electronic "dictionary" of elements used to report business data, their definitions, and interrelationships.

**type or data type.** Attribute that defines type (for example, monetary, string, share, decimal) of data that an element represents.

**unit of measure.** The units in which numeric items have been measured, such as U.S. dollars (iso4217:USD); shares (xbrli:shares); euros (iso4217:EUR); or compound units, such as U.S. dollars per share.

**validation.** Process of checking that instance documents and taxonomies correctly meet the rules of the XBRL specification and certain requirements of the entity's reporting environment.

**XBRL files.** Electronic files that may include the instance document, taxonomy extension schema, label linkbase, calculation linkbase, presentation linkbase, and definition linkbase documents (or other linkbases)

**XBRL footnote link.** Additional information that is attached to an element used to tag information in superscript footnotes.

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**ACC Section****STATEMENT OF POSITION—ACCOUNTING**

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**INTRODUCTION**

As explained in the "Special Note About FASB *Accounting Standards Codification*<sup>®</sup>" section of this publication, the FASB *Accounting Standards Codification* (ASC) codified thousands of nongovernmental accounting pronouncements (including those of the FASB, EITF, and the AICPA) into FASB ASC, which reduced the generally accepted accounting principles (GAAP) hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is not (not in FASB ASC). FASB ASC codified all AICPA accounting SOPs. This guidance became nonauthoritative on July 1, 2009, in its native form. The authoritative source of this guidance beginning from July 1, 2009, is FASB ASC.

Although AICPA Statement of Position (SOP) 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, was codified for nongovernmental entities as FASB ASC 958-720, it remains authoritative in its native form for governmental entities. GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, identifies AICPA Statements of Positions that have specifically been made applicable to state and local governmental entities by the AICPA and cleared by GASB as sources of established accounting principles in category *b* of the GAAP hierarchy for state and local governmental entities. GASB previously made this SOP, as originally issued, applicable to governmental entities; as such, it is still authoritative for those entities. The SOP is presented here for application by governmental entities as authoritative guidance permitted by GASB.

GASB's exposure draft on *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments* is currently out for comment with comments due December 31, 2014. The anticipated effective date is for periods beginning after June 15, 2015. For more information, [www.gasb.org/](http://www.gasb.org/).

Statements of Position of the Accounting Standards Division present the conclusions of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting.



## ACC Section

## STATEMENT OF POSITION—ACCOUNTING

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## ACC Section 10

### ***Statement of Position 98-2 Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising***

Statement of Position (SOP) 98-2 includes governmental entities in its scope and was cleared by GASB and, thus, is category (b) accounting and financial reporting guidance for state and local governmental entities. GASB is currently re-examining the hierarchy of generally accepted accounting principles (GAAP) for state and local governments and is expected to issue a final new standard in mid-2015. It is anticipated that the final GASB GAAP hierarchy standard will continue to recognize SOP 98-2 as category (b) GAAP. See the AICPA Audit and Accounting Guide State and Local Governments for more information about the GASB GAAP hierarchy.

**March 11, 1998**

#### **NOTE**

Statements of Position (SOPs) on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, identifies AICPA SOPs that have specifically been made applicable to state and local governmental entities by the AICPA and cleared by GASB as sources of established accounting principles in category *b* of the generally accepted accounting principles (GAAP) hierarchy for state and local governmental entities. AICPA members should consider the accounting principles in this SOP if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this SOP should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

[Revised, October 2009, to reflect conforming changes necessary due to the withdrawal of SAS No. 69; Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

## Summary

This Statement of Position (SOP) applies to all nongovernmental not-for-profit organizations (NPOs) and all state and local governmental entities that solicit contributions.

This SOP requires—

- If the criteria of purpose, audience, and content as defined in this SOP are met, the costs of joint activities that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function.
- If any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.
- Certain financial statement disclosures if joint costs are allocated.
- Some commonly used and acceptable allocation methods are described and illustrated although no methods are prescribed or prohibited.

This SOP amends existing guidance in AICPA Audit and Accounting Guides *Health Care Organizations*, *Not-for-Profit Organizations* (which was issued in August 1996 and supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into the Guide), and *Audits of State and Local Governmental Units*.\*

This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

## Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB and the GASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least

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\* The AICPA Audit and Accounting Guide *State and Local Governments* supersedes the 1994 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and subsequent editions of that Guide with conforming changes made by the AICPA staff. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this Statement of Position (SOP) to state and local governments. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of the AICPA Audit and Accounting Guide *State and Local Governments*.]

ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members and three of the five GASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.<sup>†</sup>

The criteria applied by the FASB and the GASB in their review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB and the GASB will propose suggestions, many of which are included in the documents.

## Introduction

.01 Some nongovernmental not-for-profit organizations (NPOs) and some state and local governmental entities,<sup>1</sup> such as governmental colleges and universities and governmental health care providers, solicit support through a variety of **fund-raising activities**.<sup>2</sup> These activities include direct mail, telephone solicitation, door-to-door canvassing, telethons, special events, and others. Sometimes fund-raising activities are conducted with activities related to other functions, such as **program activities** or supporting services, such as **management and general activities**.<sup>3</sup> Sometimes fund-raising activities include components that would otherwise be associated with program or supporting services, but in fact support fund raising.

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<sup>†</sup> This document was cleared prior to July 1, 1997. In July 1997, the GASB increased to seven members. Documents considered by the GASB after July 1, 1997 are cleared if at least four of the seven GASB members do not object. [Footnote renumbered, June 2004, to reflect conforming changes necessary due to the issuance of the AICPA Audit and Accounting Guide *State and Local Governments*.]

<sup>1</sup> This Statement of Position (SOP) uses the term *entity* to refer to both nongovernmental not-for-profit organizations (NPOs) and state and local governments.

<sup>2</sup> Terms that appear in the Glossary [paragraph .30] are set in **boldface type** the first time they appear.

<sup>3</sup> The functional classifications of fund raising, program, and management and general are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Some entities have a functional structure that does not include fund raising, program, or management and general, or that includes other functional classifications, such as **membership development**. This SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. In circumstances in which entities that have a functional structure that includes other functional classifications conduct joint activities, all costs of those joint activities should be charged to fund raising (or the category in which fund raising is reported—see the following two parenthetical sentences), unless the purpose, audience, and content of those joint activities are appropriate for achieving those other functions. (An example of an entity that reports fund raising in a category other than fund raising is a state and local governmental entity applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8. As discussed in paragraph D.5 of this SOP [paragraph .24], those entities are required to report fund raising as part of the "institutional support" function. See also footnote # to paragraph D.5.) [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

.02 External users of financial statements—including contributors, creditors, accreditation agencies, and regulators—want assurance that fund-raising costs, as well as program costs and management and general costs, are stated fairly.

.03 In 1987, the AICPA issued Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*.<sup>4</sup> SOP 87-2 required that all circumstances concerning informational materials and activities that include a fund-raising appeal be considered in accounting for **joint costs** of those materials and activities and that certain criteria be applied in determining whether joint costs of those materials and activities should be charged to fund raising or allocated to program or management and general. Those criteria include requiring verifiable indications of the reasons for conducting the activity, such as the content, audience, and action, if any, requested of the participant, as well as other corroborating evidence. Further, SOP 87-2 required that all joint costs of those materials and activities be charged to fund raising unless the appeal is designed to motivate its audience to action other than providing financial support to the organization.

.04 The provisions of SOP 87-2 have been difficult to implement and have been applied inconsistently in practice. (Appendix B [paragraph .22], "Background," discusses this further.)

.05 This SOP establishes financial accounting standards for accounting for **costs of joint activities**. In addition, this SOP requires financial statement disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. Appendix F [paragraph .26] provides explanations and illustrations of some acceptable allocation methods.

## Scope

.06 This SOP applies to all nongovernmental NPOs and all state and local governmental entities that solicit **contributions**.

## Conclusions

### Accounting for Joint Activities

.07 If the criteria of purpose, audience, and content are met, the costs of a **joint activity** that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs

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<sup>4</sup> In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*. The Guide supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*. *Not-for-Profit Organizations* applies to all nongovernmental NPOs other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*. Also, SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*.

of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.

### **Purpose**

**.08** The purpose criterion is met if the purpose of the joint activity includes accomplishing program or management and general functions. (Paragraphs .09 and .10 provide guidance that should be considered in determining whether the purpose criterion is met. Paragraph .09 provides guidance pertaining to program functions only. Paragraph .10 provides guidance pertaining to both program and management and general functions.)

**.09 Program functions.** To accomplish program functions, the activity should call for specific action by the audience that will **help accomplish the entity's mission**. For purposes of applying the guidance in this SOP, the following are examples of activities that do and do not call for specific action by the audience that will help accomplish the entity's mission:

- An entity's mission includes improving individuals' physical health. For that entity, motivating the audience to take specific action that will improve their physical health is a call for specific action by the audience that will help accomplish the entity's mission. An example of an activity that motivates the audience to take specific action that will improve their physical health is sending the audience a brochure that urges them to stop smoking and suggests specific methods, instructions, references, and resources that may be used to stop smoking.
- An entity's mission includes educating individuals in areas other than the causes, conditions, needs, or concerns that the entity's programs are designed to address (referred to hereafter in this SOP as "causes"). For that entity, educating the audience in areas other than causes or motivating the audience to otherwise engage in specific activities that will educate them in areas other than causes is a call for specific action by the audience that will help accomplish the entity's mission. Examples of entities whose mission includes educating individuals in areas other than causes are universities and possibly other entities. An example of an activity motivating individuals to engage in education in areas other than causes is a university inviting individuals to attend a lecture or class in which the individuals will learn about the solar system.
- Educating the audience about causes or motivating the audience to otherwise engage in specific activities that will educate them about causes is not a call for specific action by the audience that will help accomplish the entity's mission. Such activities are considered in support of fund raising. (However, some educational activities that might otherwise be considered as educating the audience about causes may implicitly call for specific action by the audience that will help accomplish the entity's mission. For example, activities that educate the audience about environmental problems caused by not recycling implicitly call for that audience to increase recycling. If the need for and benefits of the specific action are clearly evident from the educational message, the message is considered to include an implicit call for specific action by the audience that will help accomplish the entity's mission.)

- Asking the audience to make contributions is not a call for specific action by the audience that will help accomplish the entity's mission.

If the activity calls for specific action by the audience that will help accomplish the entity's mission, the guidance in paragraph .10 should also be considered in determining whether the purpose criterion is met.

**.10 Program and management and general functions.** The following factors should be considered, in the order in which they are listed,<sup>5</sup> to determine whether the purpose criterion is met:

- Whether **compensation or fees** for performing the activity are based on contributions raised.* The purpose criterion is *not* met if a majority of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.<sup>6,7</sup>
- Whether a similar program or management and general activity is conducted separately and on a similar or greater scale.* The purpose criterion is met if either of the following two conditions is met:

(1) *Condition 1:*

- The program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and
- A similar program component is conducted without the fund-raising component using the same **medium** and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.<sup>8</sup>

(2) *Condition 2:*

A management and general activity that is similar to the management and general component of the joint activity being accounted for is conducted without the fund-raising component using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising

<sup>5</sup> In considering the guidance in paragraph .10, the factor in paragraph .10a (the compensation or fees test) is the preeminent guidance. If the factor in paragraph .10a is not determinative, the factor in paragraph .10b (whether a similar program or management and general activity is conducted separately and on a similar or greater scale) should be considered. If the factor in paragraph .10b is not determinative, the factor in paragraph .10c (other evidence) should be considered.

<sup>6</sup> Some compensation contracts provide that compensation for performing the activity is based on a factor other than contributions raised, but not to exceed a specified portion of contributions raised. For example, a contract may provide that compensation for performing the activity is \$10 per contact hour, but not to exceed 60 percent of contributions raised. In such circumstances, compensation is not considered based on amounts raised, unless the stated maximum percentage is met. In circumstances in which it is not yet known whether the stated maximum percentage is met, compensation is not considered based on amounts raised, unless it is probable that the stated maximum percentage will be met.

<sup>7</sup> The *compensation or fees test* is a negative test in that it either (a) results in failing the purpose criterion or (b) is not determinative of whether the purpose criterion is met. Therefore, if the activity fails the purpose criterion based on this factor (the compensation or fees test), the activity fails the purpose criterion and the factor in paragraph .10b should not be considered. If the purpose criterion is not failed based on this factor, this factor is not determinative of whether the purpose criterion is met and the factor in paragraph .10b should be considered.

<sup>8</sup> Determining the scale on which an activity is conducted may be a subjective determination. Factors to consider in determining the scale on which an activity is conducted may include dollars spent, the size of the audience reached, and the degree to which the characteristics of the audience are similar to the characteristics of the audience of the activity being evaluated.

If the purpose criterion is met based on the factor in paragraph .10b, the factor in paragraph .10c should not be considered.

- c. *Other evidence.* If the factors in paragraph .10a or .10b do not determine whether the purpose criterion is met, other evidence may determine whether the criterion is met. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

.11 The following are examples of indicators that provide evidence for determining whether the purpose criterion is met:

- a. Evidence that the purpose criterion may be met includes—
- *Measuring program results and accomplishments of the activity.* The facts may indicate that the purpose criterion is met if the entity measures program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes).
  - *Medium.* The facts may indicate that the purpose criterion is met if the program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and if the entity conducts the program component without a significant fund-raising component in a different medium. Also, the facts may indicate that the purpose criterion is met if the entity conducts the management and general component of the joint activity without a significant fund-raising component in a different medium.
- b. Evidence that the purpose criterion may not be met includes—
- *Evaluation or compensation.* The facts may indicate that the purpose criterion is not met if (a) the evaluation of any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity or (b) some, but less than a majority, of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.
- c. Evidence that the purpose criterion may be either met or not met includes—
- *Evaluation of measured results of the activity.* The entity may have a process to evaluate measured program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes). If the entity has such a process, in evaluating the effectiveness of the joint activity, the entity may place significantly greater weight on the activity's effectiveness in accomplishing program goals or may place significantly greater weight on the activity's effectiveness in raising contributions. The former may indicate that the purpose criterion is met. The latter may indicate that the purpose criterion is not met.
  - *Qualifications.* The qualifications and duties of those performing the joint activity should be considered.

- If a third party, such as a consultant or contractor, performs part or all of the joint activity, such as producing brochures or making telephone calls, the third party's experience and the range of services provided to the entity should be considered in determining whether the third party is performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity.
- If the entity's employees perform part or all of the joint activity, the full range of their job duties should be considered in determining whether those employees are performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity. For example, (a) employees who are not members of the fund-raising department and (b) employees who are members of the fund-raising department but who perform non-fund-raising activities are more likely to perform activities that include program or management and general functions than are employees who otherwise devote significant time to fund raising.
- *Tangible evidence of intent.* Tangible evidence indicating the intended purpose of the joint activity should be considered. Examples of such tangible evidence include
  - The entity's written mission statement, as stated in its fund-raising activities, bylaws, or annual report.
  - Minutes of board of directors', committees', or other meetings.
  - Restrictions imposed by donors (who are not related parties) on gifts intended to fund the joint activity.
  - Long-range plans or operating policies.
  - Written instructions to other entities, such as script writers, consultants, or list brokers, concerning the purpose of the joint activity, audience to be targeted, or method of conducting the joint activity.
  - Internal management memoranda.

### Audience

**.12** A rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for one or more of the reasons in paragraph .13a, .13b, or .13c. In determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for one or more of the reasons in paragraph .13a, .13b, or .13c. For example, if the audience's ability or likelihood to contribute is a significant factor in its selection and it has a need for the action related to the program component of the joint activity, but having that need is an insignificant factor in its selection, the presumption would not be overcome.

**.13** In circumstances in which the audience includes no prior donors and is not otherwise selected based on its ability or likelihood to contribute to the entity, the audience criterion is met if the audience is selected for one or more of the following reasons:

- a. The audience's need to use or reasonable potential for use of the specific action called for by the program component of the joint activity
- b. The audience's ability to take specific action to assist the entity in meeting the goals of the program component of the joint activity
- c. The entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component

### Content

**.14** The content criterion is met if the joint activity supports program or management and general functions, as follows:

- a. *Program.* The joint activity calls for specific action by the recipient that will help accomplish the entity's mission. If the need for and benefits of the action are not clearly evident, information describing the action and explaining the need for and benefits of the action is provided.
- b. *Management and general.* The joint activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity.<sup>9</sup>

**.15** Information identifying and describing the entity, causes, or how the contributions provided will be used is considered in support of fund raising.

### Allocation Methods

**.16** The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances.

### Incidental Activities

**.17** Some fund-raising activities conducted in conjunction with program or management and general activities are incidental to such program or management and general activities. For example, an entity may conduct a fund-raising activity by including a generic message, "Contributions to Organization X may be sent to [address]" on a small area of a message that would otherwise be considered a program or management and general activity based on its purpose, audience, and content. That fund-raising activity likely would be considered incidental to the program or management and general activity being conducted. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. For example, an entity may conduct a program activity by including a generic program message such as "Continue to pray for [a particular cause]" on a small area of a message that would otherwise be considered

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<sup>9</sup> Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. For purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities.

fund raising based on its purpose, audience, and content. That program activity would likely be considered incidental to the fund-raising activity being conducted. Similarly, an entity may conduct a management and general activity by including a brief management and general message—"We recently changed our phone number. Our new number is 123-4567"—on a small area of a message that would otherwise be considered a program or fund-raising activity based on its purpose, audience, and content. That management and general activity would likely be considered incidental to the program or fund-raising activity being conducted. In circumstances in which a fund-raising, program, or management and general activity is conducted in conjunction with another activity and is incidental to that other activity, and the conditions in this SOP for allocation are met, joint costs are permitted but not required to be allocated and may therefore be charged to the functional classification related to the activity that is not the incidental activity. However, in circumstances in which the program or management and general activities are incidental to the fund-raising activities, it is unlikely that the conditions required by this SOP to permit allocation of joint costs would be met.

## Disclosures

.18 Entities that allocate joint costs should disclose the following in the notes to their financial statements:

- a. The types of activities for which joint costs have been incurred
- b. A statement that such costs have been allocated
- c. The total amount allocated during the period and the portion allocated to each functional expense category

.19 This SOP encourages, but does not require, that the amount of joint costs for each kind of joint activity be disclosed, if practical.

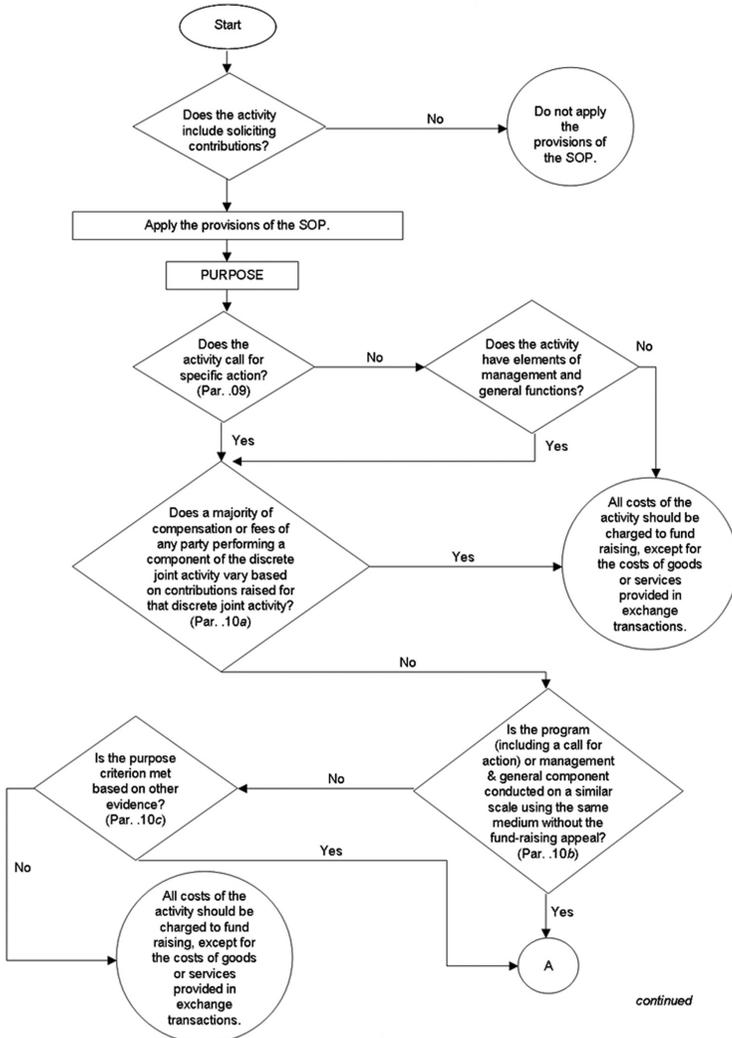
## Effective Date

.20 This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

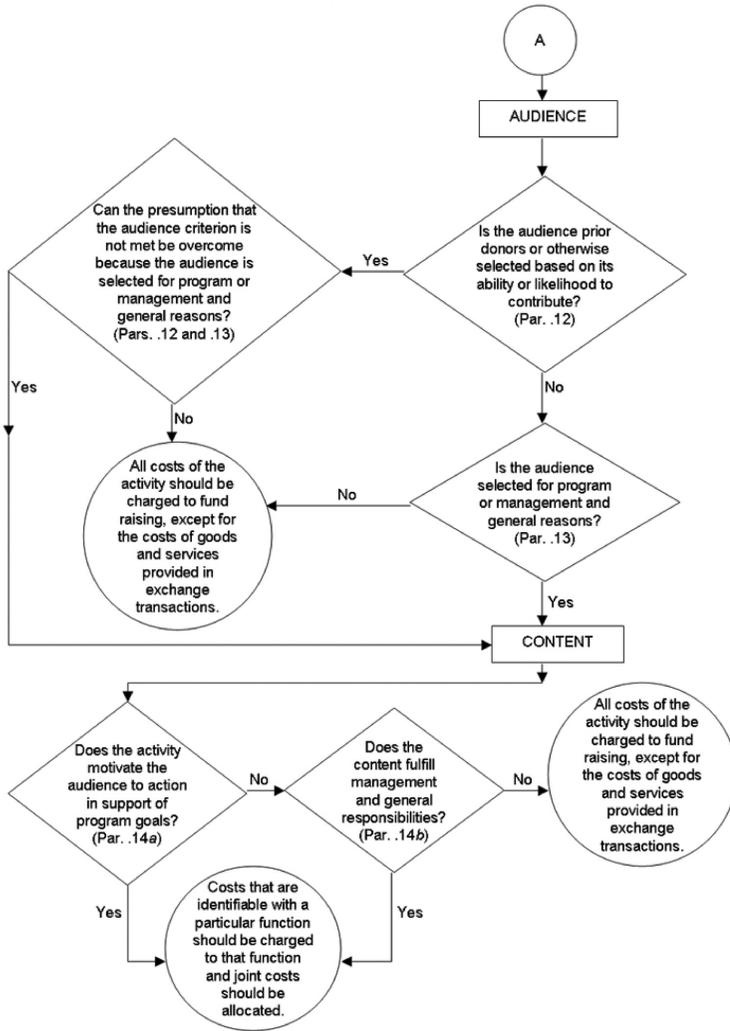
*The provisions of this Statement of Position need not be applied to immaterial items.*

# Flowchart: Appendix A

## Flowchart: Accounting for Joint Activities<sup>10</sup>



<sup>10</sup> *Note:* This flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.



## Appendix B

### Background

**B.1.** As stated in paragraph .04, the provisions of Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, have been difficult to implement and applied inconsistently in practice. That difficulty has been due in part to the following:

- The second sentence of paragraph 1 of SOP 87-2 stated that "some of the costs incurred by such organizations are clearly identifiable with fundraising, such as the cost of fund-raising consulting services." It is unclear whether activities that would otherwise be considered program activities should be characterized as program activities if they are performed or overseen by professional fund raisers. Also, it is unclear whether activities would be reported differently (for example, as program rather than fund raising) depending on whether the fund-raising consultant is compensated by a predetermined fee or by some other method, such as a percentage of contributions raised.
- SOP 87-2 was unclear about whether allocation of costs to fund-raising expense is required if the activity for which the costs were incurred would not have been undertaken without the fund-raising component.
- SOP 87-2 defined joint costs through examples, and it is therefore unclear what kinds of costs were covered by SOP 87-2. For example, it is unclear whether salaries and indirect costs can be joint costs.
- Some believe the guidance in SOP 87-2 was inadequate to determine whether joint activities, such as those that request contributions and also list the warning signs of a disease, are designed to motivate their audiences to action other than to provide contributions to the entity. It is unclear what attributes the targeted audience should possess in order to conclude that a program function is being conducted.

**B.2.** In 1992, the Accounting Standards Executive Committee (AcSEC) undertook a project to supersede SOP 87-2, to provide clearer guidance than that provided by SOP 87-2, as well as to provide guidance that would improve on the guidance in SOP 87-2. In September 1993, AcSEC released an exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, for public comment. AcSEC received more than 300 comment letters on the exposure draft. AcSEC redeliberated the issues based on the comments received.

**B.3.** In 1996, after redeliberating the issues based on the comments received and making certain revisions to the draft SOP, AcSEC conducted a field test of the draft SOP. The objectives of the field test were to determine whether the provisions of the draft SOP were sufficiently clear and definitive to generate consistent and comparable application of the SOP. Based on the field test results, AcSEC concluded that the provisions of the draft SOP, with certain revisions,

were sufficiently clear and definitive to generate consistent and comparable application of the SOP.

**B.4.** Some respondents who commented on the exposure draft, as well as some interested parties who followed the project through its due process subsequent to the exposure draft, commented that the SOP should be reexposed for public comment. Reasons cited include:

- Approximately three years had passed between the end of the comment period and AcSEC's decision to issue the SOP.
- AcSEC made significant revisions to the SOP subsequent to releasing the exposure draft for comment.

Considering whether a proposed standard should be reexposed for public comment is inherently a subjective process. Factors that AcSEC considered include—

- The significance of changes made to the exposure draft and whether those changes result in guidance that the public did not have an opportunity to consider.
- Whether the scope was revised in such a way that affected entities did not have an opportunity to comment.
- New information about or changes in the nature of the transactions being considered, practice, or other factors.

AcSEC believes that the length of time between exposure and final issuance is not pertinent to whether the SOP should be reexposed for public comment.

**B.5.** Based on consideration of the factors identified, AcSEC believes that the SOP should not be reexposed for public comment. AcSEC notes that although the SOP has been revised based on comments received on the exposure draft, those revisions do not change the overall model in the SOP. Those revisions were made primarily to clarify the SOP and improve its operationality. Further, AcSEC believes that the project received a high level of attention from interested parties. AcSEC provided working drafts to interested parties and those parties provided input throughout the process, up to and including the Financial Accounting Standard Board's and the Governmental Accounting Standards Board's clearance of the SOP for issuance.

**B.6.** Appendix C [paragraph .23] discusses the key issues in the exposure draft and comments received on those issues, as well as the basis for AcSEC's conclusions on those and certain other issues.

## Appendix C

### Basis for Conclusions

**C.1.** This section discusses considerations that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

### Overall Framework

**C.2.** This SOP uses the model in SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, as a starting point and clarifies guidance that was unclear, provides more detailed guidance, revises some guidance, and expands the scope of costs covered to include all costs of joint activities. The model established by SOP 87-2 was to account for joint costs as fund raising unless an entity could demonstrate that a program or management and general function had been conducted. SOP 87-2 used verifiable indications of the reasons for conducting the activity, such as content, audience, the action requested, if any, and other corroborating evidence as a basis for determining whether a program or management and general function had been conducted.

**C.3.** On an overall basis, the majority of respondents who commented on the September 1993 exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, opposed it, for various reasons, including the following:

- The guidance in SOP 87-2 is operational, results in sound financial reporting, and should be retained.
- The guidance in SOP 87-2 should be retained but clarified.
- The guidance proposed in the exposure draft should be revised. (Some commented that it overstates fund raising; others commented that it understates fund raising.)

**C.4.** AcSEC concluded that it supports the model in the exposure draft, subject to certain revisions. AcSEC believes that this SOP provides clear, detailed accounting guidance that, when applied, will increase comparability of financial statements. Those statements will also include more meaningful disclosures without incurring increased costs.

**C.5.** Some respondents commented that the model in the exposure draft would adversely affect entities both financially and operationally. Various reasons were given, including the following:

- It would inhibit the ability of entities, particularly small entities and entities that raise contributions through direct solicitations, to generate the necessary revenue to perform their program services.
- Most entities would not meet the criteria in this SOP for reporting costs of joint activities as program or management and general,

because they must combine their mission statements, public information and education, and fund-raising appeals due to a lack of resources. Some noted that this may result in unsatisfactory ratings from public watchdog groups.

AcSEC did not find these arguments compelling. This SOP provides accounting guidance; it provides no guidance concerning how entities should undertake their activities. Also, this SOP does not prohibit allocation merely because activities carrying out different functions are combined. In fact, this SOP provides guidance for reporting costs as program or management and general in circumstances in which those activities are combined with fund-raising. Moreover, actions taken by financial statement users are not the direct result of the requirements of this SOP. Rather, those actions may result from more relevant and useful information on which to base decisions.

**C.6.** Some respondents commented that the exposure draft is biased toward reporting expenses as fund raising. AcSEC believes that determining whether the costs of joint activities should be classified as program, management and general, or fund raising sometimes is difficult, and such distinctions sometimes are subject to a high degree of judgment. AcSEC believes that external financial statement users focus on and have perceptions about amounts reported as program, management and general, and fund raising. That focus and those perceptions provide incentives for entities to report expenses as program or management and general rather than fund raising. Therefore, in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. The criteria in this SOP provide guidance for entities to overcome that presumption.

## Accounting for Joint Activities

**C.7.** This SOP requires that if any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund raising, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising. (This SOP expands on the model established by SOP 87-2 by including all costs of joint activities other than costs of goods or services provided in exchange transactions, rather than merely joint costs.) AcSEC believes that the criteria of purpose, audience, and content are each relevant in determining whether a joint activity should be reported as fund raising, program, or management and general because each provides significant evidence about the benefits expected to be obtained by undertaking the activity.

**C.8.** Some respondents commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising is misleading and that the scope of the SOP should include only joint costs of joint activities. Some commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising conflicts with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, which defines fund raising, program, and management and general and requires not-for-profit organizations (NPOs) to report information about expenses using those functional classifications.

**C.9.** AcSEC believes that the purpose for which costs other than joint costs are incurred may be fund raising, program, or management and general, depending on the context in which they are used in the activity undertaken. For example, a program-related pamphlet may be sent to an audience in need of the program. In that context, the pamphlet is used for program purposes. However, in order to demonstrate to potential donors that the entity's programs are worthwhile, that same pamphlet may be sent to an audience that is likely to contribute, but that has no need or reasonable potential for use of the program. In that context, the pamphlet is used for fund raising. AcSEC believes this broader scope will result in more comparability and more meaningful financial reporting by covering all costs of activities that include fund raising and by assigning those costs to the function for which they are incurred, consistent with the guidance in Statement No. 117.

**C.10.** AcSEC believes that costs of goods or services provided in exchange transactions should not be charged to fund raising because those costs are incurred in exchange for revenues other than contributions.

## Criteria of Purpose, Audience, and Content

### *Call For Action*

**C.11.** The definition of *program* in FASB Statement No. 117 includes public education. As noted in paragraph C.6, AcSEC believes that in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. AcSEC believes that in order to overcome that presumption, it is not enough that (a) the purpose of the activity include educating the public about causes, (b) the audience has a need or reasonable potential for use of any educational component of the activity pertaining to causes, or (c) the audience has the ability to assist the entity in meeting the goals of the program component of the activity by becoming educated about causes. Therefore, AcSEC concluded that for purposes of this SOP, in order to conclude that the criteria of purpose, audience, and content are met program activities are required to call for specific action by the recipient (other than becoming educated about causes) that will help accomplish the entity's mission. As discussed in paragraph .09, in certain circumstances educational activities may call for specific action by the recipient that will help accomplish the entity's mission.

### *Purpose*

**C.12.** AcSEC believes meeting the purpose criterion demonstrates that the purpose of the activity includes accomplishing program or management and general functions. Inherent in the notion of a joint activity is that the activity has elements of more than one function. Accordingly, the purpose criterion provides guidance for determining whether the purpose of the activity includes accomplishing program or management and general functions in addition to fund raising.

### *Compensation and Evaluation Tests*

**C.13.** The exposure draft proposed that all costs of the joint activity should be charged to fund raising if (a) substantially all compensation or fees for performing the activity are based on amounts raised or (b) the evaluation of the party performing the activity is based on amounts raised. Some respondents commented that basing the method of compensation or evaluating the performance

of the party performing the activity based on contributions raised should not lead to the conclusion that all costs of the activity should be charged to fund raising. Others commented that the method of compensation is unrelated to whether the purpose criterion is met. The reasons given included the following:

- It is counterintuitive to imply that those performing multipurpose activities that include fund raising would not be compensated or evaluated based on amounts raised.
- Such guidance would create a bias toward entities that use employees to raise contributions and against entities that hire professional fund raisers and public relations firms and is therefore not neutral.

Some respondents gave examples of circumstances in which substantially all compensation is based on contributions raised and asserted that the activity was nevertheless a program activity. In each of those examples, AcSEC considered all the facts presented and concluded that the activity was fund raising.

**C.14.** AcSEC continues to support the spirit of the proposed guidance, because AcSEC believes that basing a majority of compensation on funds raised is persuasive evidence that the activity is a fund-raising activity. Nevertheless, AcSEC believes that the proposed guidance was unclear and would be difficult to implement, primarily because of the broad definition of "based on contributions raised" included in the glossary of the exposure draft. In connection with that issue, AcSEC was concerned that any joint activities performed by a fund-raising department or by individuals whose duties include fund raising, such as executive officers of small NPOs who are employed based on their ability to raise contributions, would be required to be reported as fund raising because the compensation of the parties performing those activities is based on amounts raised. Also, AcSEC had concerns that it would be difficult to determine whether fixed contract amounts were negotiated based on expected contributions. Therefore, AcSEC concluded that the compensation test should be revised to provide that the purpose criterion is not met if a majority of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity. AcSEC believes that guidance is sound and is operational.

**C.15.** AcSEC believes that the guidance in paragraph .10a is not biased against entities that hire professional fund raisers, because it applies to the entity's employees as well as professional fund raisers. For example, if a majority of an employee's compensation or fees for performing a component of a discrete joint activity varies based on contributions raised for that discrete joint activity, the purpose criterion is not met.

### ***Similar Function-Similar Medium Test***

**C.16.** Some respondents misinterpreted the exposure draft as providing that, in order to meet the purpose criterion, the program or management and general activity must be conducted without the fund-raising component, using the same medium and on a scale that is similar to or greater than the program or management and general component of the activity being accounted for. That was not a requirement proposed by the exposure draft. The exposure draft proposed that meeting that condition would result in meeting the purpose criterion. Failing the criterion merely leads to consideration of other evidence, such as the indicators in paragraph .11. AcSEC has revised the SOP to state this more clearly.

### **Other Evidence**

**C.17.** The compensation test and the similar function-similar medium test may not always be determinative because the attributes that they consider may not be present. Therefore, this SOP includes indicators that should be considered in circumstances in which the compensation test and the similar function-similar medium test are not determinative. The nature of those indicators is such that they may be present in varying degrees. Therefore, all available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

### **Audience**

**C.18.** The exposure draft proposed that if the audience for the materials or activities is selected principally on its ability or likelihood to contribute, the audience criterion is not met and all the costs of the activity should be charged to fund raising. Further, the exposure draft proposed that if the audience is selected principally based on its need for the program or because it can assist the entity in meeting its program goals other than by financial support provided to the entity, the audience criterion is met. Some respondents commented that that audience criterion is too narrow, because it is based on the principal reason for selecting the audience. They asserted that for some activities no principal reason exists for selecting an audience; entities select the audience for those activities for multiple reasons, such as both the audience's ability to contribute and its ability to help meet program goals. Some commented that for some activities, entities select audiences that have provided past financial support because, by providing financial support, those audiences have expressed an interest in the program.

**C.19.** AcSEC believes that meeting the audience criterion should demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions. Therefore, the reasons for selecting the audience should be consistent with the program or management and general content of the activity. However, AcSEC believes it is inherent in the notion of joint activities that the activity has elements of more than one function, including fund raising, and acknowledges that it may be difficult to determine the principal reason for selecting the audience. Accordingly, AcSEC concluded that if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute, a rebuttable presumption should exist that the audience was selected to raise funds. AcSEC believes that the reasons for selecting the audience that can overcome that presumption, which are included in paragraph .13 of this SOP, demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions based on the program or management and general content of the activity.

### **Content**

**C.20.** AcSEC believes that meeting the content criterion demonstrates that the content of the activity supports program or management and general functions. AcSEC believes that accounting guidance should not impose value judgments about whether the entity's mission, programs, and responsibilities are worthwhile. Therefore, whether the content criterion is met depends on the relationship of the content to the entity's mission, programs, and management and general responsibilities.

**C.21.** Paragraph .14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish

the entity's mission. The exposure draft proposed that slogans, general calls to prayer, and general calls to protest do not meet the content criterion; some respondents disagreed. AcSEC concluded that this SOP should be silent concerning whether slogans, general calls to prayer, and general calls to protest are calls to action that meet the content criterion. AcSEC believes that determining whether those items are calls to action that meet the content criterion requires judgments based on the particular facts and circumstances.

**C.22.** Some respondents commented that educating the public about causes without calling for specific action should satisfy the content criterion. They noted that this is particularly relevant for NPOs subject to Internal Revenue Code (IRC) Section 501(c)4, because those NPOs are involved in legislative reform. Also, some noted that it may be the entity's mission or goal to educate the public about causes. They believe that, in those cases, the NPO's program is to educate the public about causes without necessarily calling for specific action by the recipient.

**C.23.** As discussed in paragraph C.11, AcSEC concluded that education that does not motivate the audience to action is in fact done in support of fund raising. However, this SOP acknowledges that some educational messages motivate the audience to specific action, and those messages meet the content criterion. AcSEC believes that that provision will result in the activities of some NPOs subject to IRC Section 501(c)4 (and some other entities, whose mission or goal is to educate the public) meeting the content criterion.

**C.24.** Paragraph .13c provides that one way that the audience criterion is met is if the entity is required to direct the management and general component of the activity to the particular audience. Further, as discussed in paragraph D.13, in *Discussion of Conclusions*, an audience that includes prior donors and is selected because the entity is required to send them certain information to comply with requirements of the Internal Revenue Service (IRS) is an example of an audience that is selected because the entity is required to direct the management and general component of the activity to that audience. Paragraph .14b provides that one way that the content criterion is met is if the activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity. However, footnote 9 to paragraph .14b provides that disclosures made when soliciting contributions to comply with requirements of states or other regulatory bodies are considered fund-raising activities, and are not considered management and general activities. AcSEC considered whether it is inconsistent to conclude both that (a) activities conducted to comply with requirements of regulatory bodies concerning contributions that have been received are management and general activities, and that (b) activities conducted to comply with requirements of regulatory bodies concerning soliciting contributions are fund-raising activities. AcSEC believes that those provisions are not inconsistent. AcSEC believes there is a distinction between (a) requirements that must be met as a result of receiving contributions and (b) requirements that must be met in order to solicit contributions. AcSEC believes that activities that are undertaken as a result of receiving contributions are management and general activities while activities that are undertaken in order to solicit contributions are fund-raising activities.

## Incidental Activities

**C.25.** Many entities conduct fund-raising activities in conjunction with program or management and general activities that are incidental to such program or management and general activities. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising

activities that are incidental to such fund-raising activities. Such efforts may be a practical and efficient means for entities to conduct activities, although the principal purpose of the activity may be to fulfill either fund-raising, program, or management and general functions. The exposure draft proposed that incidental activities need not be considered in applying this SOP. Some respondents disagreed with that guidance, while others commented that it was confusing. AcSEC continues to support that guidance. AcSEC believes that guidance is necessary to avoid requiring complex allocations in circumstances in which the criteria of purpose, audience, and content are met but the activity is overwhelmingly either fund raising, program, or management and general.

## Allocation Methods

**C.26.** Respondents had various comments concerning allocation methods, including the following:

- The SOP should focus on allocation methods rather than on circumstances in which entities should allocate.
- The SOP should prescribe allocation methods.
- The approach taken in the SOP—discussing, rather than requiring or prohibiting allocation methods—is sound.
- Certain allocation methods should be prohibited.
- The SOP should set maximum allocation percentages.

AcSEC believes that no particular allocation method or methods are necessarily more desirable than other methods in all circumstances. Therefore, this SOP neither prescribes nor prohibits any particular allocation methods. AcSEC believes entities should apply the allocation methods that result in the most reasonable cost allocations for their activities. Appendix F [paragraph .26] of this SOP illustrates several allocation methods, any one of which may result in a reasonable or unreasonable allocation of costs in particular circumstances. The methods illustrated are not the only acceptable methods. However, AcSEC believes that the methods illustrated in this SOP are among those most likely to result in meaningful cost allocations.

**C.27.** Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, states in paragraph 7 that "the term *accounting principle* includes not only accounting principles and practices but also the methods of applying them." APB Opinion 20 also states in paragraphs 15 and 16 that

...In the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type....The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle [*allocation method*] on the basis that it is preferable.

A change in cost allocation methodology may be a change in accounting principle for entities covered by this SOP. Accordingly, paragraph .16 of this SOP provides that the cost allocation methodology used should be applied consistently, given similar facts and circumstances.

## Disclosures

**C.28.** Respondents made various comments concerning the required and encouraged disclosures, including recommendations for additional disclosures and

recommendations that certain disclosures be deleted. AcSEC was not persuaded that the costs of the other disclosures recommended by respondents are justified by their benefits. AcSEC believes that, with the exception of one disclosure, the disclosures prescribed by the exposure draft provide relevant information about the kinds of activities for which joint costs have been incurred and the manner in which those costs are reported in the financial statements. In considering disclosures proposed by the exposure draft about the allocation method, AcSEC observed that there are no requirements to disclose methods of allocating other expenses and questioned the utility of disclosing the allocation method in this circumstance. AcSEC concluded that the requirement to disclose the allocation method should be deleted.

**C.29.** Paragraph .19 encourages, but does not require, certain disclosures. AcSEC believes those disclosures provide useful information but that they should be encouraged rather than required because the costs of making them may not be justified by the benefits in all cases.

### **Effective Date**

**C.30.** Some respondents commented that the effective date should be deferred. AcSEC believes that the accounting systems required to implement this SOP are already in place and that implementation should be relatively straightforward. However, AcSEC acknowledges that some entities may change their operations based on the reporting that would result from this SOP. Therefore, AcSEC concluded that this SOP should be effective for financial statements for years beginning on or after December 15, 1998.

### **Cost-Benefit**

**C.31.** Some respondents commented that the guidance would increase record keeping costs. AcSEC believes that implementing this SOP will not significantly increase record keeping costs, which are primarily the costs of documenting reasons for undertaking joint activities. Further, AcSEC believes that the costs of making the disclosures required by this SOP should be minimal, because entities should already have the information that is required to be disclosed. AcSEC believes that implementing this SOP will result in more relevant, meaningful, and comparable financial reporting and that the cost of implementing this SOP will be justified by its benefits.

## Appendix D

### Discussion of Conclusions

#### Scope

**D.1.** This Statement of Position (SOP) applies only to costs of joint activities. It does not address allocations of costs in other circumstances.

#### Reporting Models and Related Requirements

**D.2.** Paragraph 26 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities. Paragraph 13.34 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* provides that the financial statements of not-for-profit organizations (NPOs) should disclose the total fund-raising expenses. [Revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

**D.3.** Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, provides that governmental entities should not change their accounting and financial reporting to apply the provisions of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made*, and No. 117. GASB Statement No. 29 permits governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* modified by all applicable FASB pronouncements issued through November 30, 1989, and by most applicable GASB pronouncements) to continue to do so, pending GASB pronouncements on the accounting and financial reporting model for governmental entities. Alternatively, those governmental entities are permitted to change to the current governmental financial reporting model.<sup>‡</sup>

**D.4.** GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, requires governmental colleges and universities to use one of two accounting and financial reporting models. One model, referred to as the "AICPA College Guide Model," encompasses the accounting and financial reporting guidance in the 1973 AICPA Industry Audit Guide *Audits of*

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<sup>‡</sup> GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, supersedes the provisions of GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, relating to the use of the AICPA Not-for-Profit model. See GASB Statement No. 34, including paragraph 147. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this SOP to state and local governments. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statement No. 34.]

*Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements. (The other model, referred to as the "Governmental Model," is based on the pronouncements of the National Council on Governmental Accounting [NCGA] and the GASB.)<sup>||</sup>

**D.5.** For state and local governmental entities, some are required to report expenses by function using the functional classifications of program, management and general, and fund raising. Other state and local governmental entities that report expenses or expenditures by function have a functional structure that does not include fund raising, program, or management and general. Still other state and local governmental entities do not report expenses or expenditures by function. Examples of those various reporting requirements are as follows:<sup>#</sup>

- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*, as well as those that follow SOP 78-10 and that receive significant amounts of contributions from the public, are required to report separately the costs of the fund-raising, program, and management and general functions.
- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, are required to report fund raising as part of the "institutional support" function.

**D.6.** As discussed in footnote 3 to paragraph .01 of this SOP, this SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. Rather, those functional classifications are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Entities that do not use the functional classifications of fund raising, program, and management and general should apply the guidance in this SOP for purposes of accounting for joint activities, using their reporting model. For example, some entities may conduct membership-development activities. As discussed in the Glossary [paragraph .30] of this SOP, if there are no significant benefits or duties connected with membership, the substance of the membership-development activities may, in fact, be fund raising. In such circumstances, the costs of those activities should be charged to fund raising. To the extent that member benefits are received, membership is an exchange transaction. In circumstances in which membership development is in part soliciting revenues from exchange transactions and in part soliciting contributions and the purpose, audience, and content of the activity are appropriate for achieving membership development, joint costs should be allocated between fund raising and the exchange transaction.

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<sup>||</sup> GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*, supersedes GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*. See GASB Statements No. 34 and No. 35. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this SOP to governmental (public) colleges and universities. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statement No. 35.]

<sup>#</sup> This discussion is no longer applicable. See footnotes ‡ and || in paragraphs D.3 and D.4, respectively. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

## Assigning Costs of Joint Activities

**D.7.** Paragraph .07 provides: "If the criteria of purpose, audience, and content are met, the costs of a joint activity that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity..." For example, if the criteria are met, the costs of materials that accomplish program goals and that are unrelated to fund raising, such as the costs of a program-related pamphlet included in a joint activity, should be charged to program, while joint costs, such as postage, should be allocated between fund raising and program. However, if the pamphlet is used in fund-raising packets and the criteria are not met, the costs of the pamphlets used in the fund-raising packets, as well as the joint costs, should be charged to fund raising. (If some pamphlets are used in program activities that include no fund raising, the cost of the pamphlets used in those separate program activities that include no fund raising should be charged to program.)

## Educational Activities

**D.8.** Some entities have missions that include educating the public (students) in areas other than causes. Paragraph .09 provides that, for those entities, educating the audience in areas other than causes or motivating the audience to engage in specific activities, such as attending a lecture or class, that will educate them in areas other than causes is considered a call for specific action by the recipients that will help accomplish the entity's mission. Educating the audience about causes or motivating the audience to engage in specific activities that will educate them about causes without educating them in other subjects is not considered a call for specific action by the audience that will help accomplish the entity's mission. An example of a lecture or class that will educate students in an area other than causes is a lecture on the nesting habits of the bald eagle, given by the Save the Bald Eagle Society, an NPO whose mission is to save the bald eagle from extinction and educate the public about the bald eagle. An example of a lecture or class that will address particular causes is a lecture by the Bald Eagle Society on the potential extinction of bald eagles and the need to raise contributions to prevent their extinction. For purposes of applying the guidance in this SOP, motivating the audience to attend a lecture on the nesting habits of the bald eagle is a call for specific action that will help accomplish the entity's mission. If the lecture merely addresses the potential extinction of bald eagles and the need to raise contributions to prevent their extinction, without addressing the nesting habits of the bald eagle, motivating the audience to attend the lecture is not considered a call for specific action by the recipient that will help accomplish the entity's mission.

**D.9.** AcSEC notes that most transactions in which a student attends a lecture or class are exchange transactions and are not joint activities. Such transactions are joint activities only if the activity includes fund raising.

## Audience

**D.10.** Paragraph .12 provides that a rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for the program

or management and general reasons specified in paragraph .13. Further, paragraph .12 provides that in determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for the reasons that may overcome that presumption. Some organizations conduct joint activities that are special events, such as symposia, dinners, dances, and theater parties, in which the attendee receives a direct benefit (for example, a meal or theater ticket) and for which the admission price includes a contribution. For example, it may cost \$500 to attend a dinner with a fair value of \$50. In that case, the audience is required to make a \$450 contribution in order to attend. In circumstances in which the audience is required to make a contribution to participate in a joint activity, such as attending a special event, the audience's ability or likelihood to contribute is a significant factor in its selection. Therefore, in circumstances in which the audience is required to make a contribution to participate in a joint activity, the extent to which the audience is selected for the program or management and general reasons in paragraph .13 must be overwhelmingly significant in order to rebut the presumption that the audience criterion is not met.

**D.11.** The source of the names and the characteristics of the audience should be considered in determining the reason for selecting the audience. Some entities use lists compiled by others to reach new audiences. The source of such lists may indicate the purpose or purposes for which they were selected. For example, lists acquired from entities with similar or related programs are more likely to meet the audience criterion than are lists acquired from entities with dissimilar or unrelated programs. Also, the characteristics of those on the lists may indicate the purpose or purposes for which they were selected. For example, a list based on a consumer profile of those who buy environmentally friendly products may be useful to an entity whose mission addresses environmental concerns and could therefore indicate that the audience was selected for its ability to take action to assist the entity in meeting program goals. However, a list based on net worth would indicate that the audience was selected based on its ability or likelihood to contribute, unless there was a correlation between net worth and the program or management and general components of the activity.

**D.12.** Some audiences may be selected because they have an interest in or affinity to the program. For example, homeowners may have an interest in the homeless because they are sympathetic to the plight of the homeless. Nevertheless, including homeowners in the audience of a program activity to provide services to the homeless would not meet the audience criterion, because they do not have a need or reasonable potential for use of services to the homeless.

**D.13.** Paragraph .13c provides that the audience criterion is met if the entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component. An example of a joint activity in which the audience is selected because the entity is required to direct the management and general component of the joint activity to the particular audience is an activity in which the entity sends a written acknowledgment or other information to comply with requirements of the Internal Revenue Service to prior donors and includes a request for contributions. An example of a joint activity in which the audience is selected because the audience has reasonable potential for use of the management and general component is an activity in which the entity sends its annual report to prior donors and includes a request for contributions.

## Content

**D.14.** Paragraph .14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. As discussed in the Glossary [paragraph .30], the action should benefit the recipient or society. Examples of actions that benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or society (such as by addressing societal problems) include the following:

- a. Actions that benefit the recipient:
  - *Stop smoking.* Specific methods, instructions, references, and resources should be suggested.
  - *Do not use alcohol or drugs.* Specific methods, instructions, references, and resources should be suggested.
- b. Actions that benefit society:
  - *Write or call.* The party to communicate with and the subject matter to be communicated should be specified.
  - *Complete and return the enclosed questionnaire.* The results of the questionnaire should help the entity achieve its mission. For example, if the entity discards the questionnaire, it does not help the entity achieve its mission.
  - *Boycott.* The particular product or company to be boycotted should be specified.

**D.15.** Paragraph .14b provides that to meet the content criterion, management and general functions are required to fulfill one or more of the entity's management and general responsibilities through a component of the joint activity. Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. Paragraph .14, footnote 9, of this SOP provides that for purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities. Some examples of such disclosures include the following:

- Information filed with the attorney general concerning this charitable solicitation may be obtained from the attorney general of [*the state*] by calling 123-4567. Registration with the attorney general does not imply endorsement.
- A copy of the registration and financial information may be obtained from the Division of Consumer Services by calling toll-free, within [*the state*], 1-800-123-4567. Registration does not imply endorsement, approval, or recommendation by [*the state*].
- Information about the cost of postage and copying, and other information required to be filed under [*the state*] law, can be obtained by calling 123-4567.
- The organization's latest annual report can be obtained by calling 123-4567.

## Allocation Methods

**D.16.** Paragraph .16 of this SOP states, "The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs

that is reasonable, and it should be applied consistently given similar facts and circumstances." The allocation of joint costs should be based on the degree to which costs were incurred for the functions to which the costs are allocated (that is, program, management and general, or fund raising). For purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities, facts and circumstances that may be considered include factors related to the content and relative costs of the components of the activity. The audience should not be considered in determining whether the facts and circumstances are similar for purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities.

### **Practicability of Measuring Joint Costs**

**D.17.** The Glossary [paragraph .30] of this SOP includes a definition of joint costs. Some costs, such as utilities, rent, and insurance, commonly referred to as indirect costs, may be joint costs. For example, the telephone bill for a department that, among other things, prepares materials that include both fund-raising and program components may commonly be referred to as an indirect cost. Such telephone bills may also be joint costs. However, for some entities, it is impracticable to measure and allocate the portion of the costs that are joint costs. Considerations about which joint costs should be measured and allocated, such as considerations about materiality and the costs and benefits of developing and providing the information, are the same as considerations about cost allocations in other circumstances.

## Appendix E

### Illustrations of Applying the Criteria of Purpose, Audience, and Content to Determine Whether a Program or Management and General Activity Has Been Conducted

#### Illustration 1

##### *Facts*

**E.1.** Entity A's mission is to prevent drug abuse. Entity A's annual report states that one of its objectives in fulfilling that mission is to assist parents in preventing their children from abusing drugs.

**E.2.** Entity A mails informational materials to the parents of all junior high school students explaining the prevalence and dangers of drug abuse. The materials encourage parents to counsel children about the dangers of drug abuse and inform them about how to detect drug abuse. The mailing includes a request for contributions. Entity A conducts other activities informing the public about the dangers of drug abuse and encouraging parents to counsel their children about drug abuse that do not include requests for contributions and that are conducted in different media. Entity A's executive director is involved in the development of the informational materials as well as the request for contributions. The executive director's annual compensation includes a significant bonus if total annual contributions exceed a predetermined amount.

##### *Conclusion*

**E.3.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.4.** The activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. (Although Entity A's executive director's annual compensation varies based on annual contributions, the executive director's compensation does not vary based on contributions raised for this discrete joint activity.) Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the program component of this activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse) that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (b) performing such programs helps accomplish Entity A's mission. (Note that had Entity A conducted the activity using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions, the purpose criterion would have been met under paragraph .10b.)

**E.5.** The audience criterion is met because the audience (parents of junior high school students) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**E.6.** The content criterion is met because the activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission (assisting parents in preventing their children from abusing drugs), and it explains the need for and benefits of the action (the prevalence and dangers of drug abuse).

## Illustration 2

### Facts

**E.7.** Entity B's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity B's objectives in fulfilling that mission is to inform the public about the effects and early warning signs of the disease and specific action that should be taken to prevent the disease.

**E.8.** Entity B maintains a list of its prior donors and sends them donor renewal mailings. The mailings include messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it. That information is also sent to a similar-sized audience but without the request for contributions. Also, Entity B believes that recent donors are more likely to contribute than nondonors or donors who have not contributed recently. Prior donors are deleted from the mailing list if they have not contributed to Entity B recently, and new donors are added to the list. There is no evidence of a correlation between recent contributions and participation in the program component of the activity. Also, the prior donors' need to use or reasonable potential for use of the messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it is an insignificant factor in their selection.

### Conclusion

**E.9.** The purpose and content criteria are met. The audience criterion is not met.<sup>11</sup> All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, should be charged to fund raising.

**E.10.** The activity calls for specific action by the recipient (action that should be taken to prevent ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (to reduce the incidence of illness from the disease), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (a similar mailing is done without the request for contributions, to a similar-sized audience).

**E.11.** The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is not

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<sup>11</sup> Paragraph .07 of this SOP provides that all costs of joint activities, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should be charged to fund raising if any of the criteria of purpose, audience, or content are not met. Accordingly, if one or more criteria are not met, the other criteria need not be considered. However, the illustrations in this Appendix provide conclusions about whether each of the criteria would be met in circumstances in which one or more criteria are not met in order to provide further guidance.

overcome in this illustration. Although the audience has a need to use or reasonable potential for use of the program component, that was an insignificant factor in its selection.

**E.12.** The content criterion is met because the activity calls for specific action by the recipient (actions to prevent ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

### Illustration 3

#### **Facts**

**E.13.** Entity C's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity C's objectives in fulfilling that mission is to increase governmental funding for research about ABC disease.

**E.14.** Entity C maintains a list of its prior donors and its employees call them on the telephone reminding them of the effects of ABC disease, asking for contributions, and encouraging them to contact their elected officials to urge increased governmental funding for research about ABC disease. The callers are educated about ABC, do not otherwise perform fund-raising functions, and are not compensated or evaluated based on contributions raised. Entity C's research indicates that recent donors are likely to contact their elected officials about such funding while nonrecent donors are not. Prior donors are deleted from the calling list if they have not contributed to Entity C recently, and new donors are added to the list.

#### **Conclusion**

**E.15.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.16.** The activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the callers are educated about ABC and do not otherwise perform fund-raising functions), (b) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised), and (c) performing such programs helps accomplish Entity C's mission.

**E.17.** The audience criterion is met because the audience (recent donors) is selected based on its ability to assist Entity C in meeting the goals of the program component of the activity (recent donors are likely to contact their elected officials about such funding while nonrecent donors are not).

**E.18.** The content criterion is met because the activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

## Illustration 4

### Facts

**E.19.** Entity D's mission is to improve the quality of life for senior citizens. One of Entity D's objectives included in that mission is to increase the physical activity of senior citizens. One of Entity D's programs to attain that objective is to send representatives to speak to groups about the importance of exercise and to conduct exercise classes.

**E.20.** Entity D mails a brochure on the importance of exercise that encourages exercise in later years to residents over the age of sixty-five in three zip code areas. The last two pages of the four-page brochure include a perforated contribution remittance form on which Entity D explains its program and makes an appeal for contributions. The content of the first two pages of the brochure is primarily educational; it explains how seniors can undertake a self-supervised exercise program and encourages them to undertake such a program. In addition, Entity D includes a second brochure on various exercise techniques that can be used by those undertaking an exercise program.

**E.21.** The brochures are distributed to educate people in this age group about the importance of exercising, to help them exercise properly, and to raise contributions for Entity D. These objectives are documented in a letter to the public relations firm that developed the brochures. The audience is selected based on age, without regard to ability to contribute. Entity D believes that most of the recipients would benefit from the information about exercise.

### Conclusion

**E.22.** The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the second brochure should be charged to program because all the costs of the brochure are identifiable with the program function.)

**E.23.** The activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) performing such programs helps accomplish Entity D's mission, and (b) the objectives of the program are documented in a letter to the public relations firm that developed the brochure.

**E.24.** The audience criterion is met because the audience (residents over sixty-five in certain zip codes) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**E.25.** The content criterion is met because the activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission (increasing the physical activity of senior citizens), and the need for and benefits of the action are clearly evident (explains the importance of exercising).

## Illustration 5

### Facts

**E.26.** The facts are the same as those in Illustration 4, except that Entity E employs a fund-raising consultant to develop the first brochure and pays that consultant 30 percent of contributions raised.

## Conclusion

**E.27.** The content and audience criteria are met. The purpose criterion is not met, however, because a majority of compensation or fees for the fund-raising consultant varies based on contributions raised for this discrete joint activity (the fund-raising consultant is paid 30 percent of contributions raised). All costs should be charged to fund raising, including the costs of the second brochure and any other costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity.

## Illustration 6

### Facts

**E.28.** Entity F's mission is to protect the environment. One of Entity F's objectives included in that mission is to take action that will increase the portion of waste recycled by the public.

**E.29.** Entity F conducts a door-to-door canvass of a community that recycles a low portion of its waste. The purpose of the activity is to help increase recycling by educating the community about environmental problems created by not recycling, and to raise contributions. Based on the information communicated by the canvassers, the need for and benefits of the action are clearly evident. The ability or likelihood of the residents to contribute is not a basis for communities selected, and all neighborhoods in the geographic area are covered if their recycling falls below a predetermined rate. The canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns. The canvassers have not previously participated in fund-raising activities.

### Conclusion

**E.30.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.31.** The activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns), and (b) performing such programs helps accomplish Entity F's mission (to protect the environment).

**E.32.** The audience criterion is met because the audience (neighborhoods whose recycling falls below a predetermined rate) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**E.33.** The content criterion is met because the activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help

accomplish the entity's mission (to protect the environment), and the need for and benefits of the action are clearly evident (increased recycling will help alleviate environmental problems).

## Illustration 7

### Facts

**E.34.** Entity G's mission is to provide summer camps for economically disadvantaged youths. Educating the families of ineligible youths about the camps is not one of the program objectives included in that mission.

**E.35.** Entity G conducts a door-to-door solicitation campaign for its camp programs. In the campaign, volunteers with canisters visit homes in middle-class neighborhoods to collect contributions. Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute. The volunteers explain the camp's programs, including why the disadvantaged children benefit from the program, and distribute leaflets to the residents regardless of whether they contribute to the camp. The leaflets describe the camp, its activities, who can attend, and the benefits to attendees. Requests for contributions are not included in the leaflets.

### Conclusion

**E.36.** The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

**E.37.** The activity does not include a call for specific action because it only educates the audience about causes (describing the camp, its activities, who can attend, and the benefits to attendees). Therefore, the purpose criterion is not met.

**E.38.** The audience criterion is not met, because the audience is selected based on its ability or likelihood to contribute, rather than based on (a) its need to use or reasonable potential for use of the action called for by the program component, or (b) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute.)

**E.39.** The content criterion is not met because the activity does not call for specific action by the recipient. (The content educates the audience about causes that the program is designed to address without calling for specific action.)

## Illustration 8

### Facts

**E.40.** Entity H's mission is to educate the public about lifesaving techniques in order to increase the number of lives saved. One of Entity H's objectives in fulfilling that mission, as stated in the minutes of the board's meetings, is to produce and show television broadcasts including information about lifesaving techniques.

**E.41.** Entity H conducts an annual national telethon to raise contributions and to reach the American public with lifesaving educational messages, such as summary instructions concerning dealing with certain life-threatening situations. Based on the information communicated by the messages, the need for and benefits of the action are clearly evident. The broadcast includes segments describing Entity H's services. Entity H broadcasts the telethon to the entire country, not merely to areas selected on the basis of giving potential or prior

fund raising results. Also, Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising.

### **Conclusion**

**E.42.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.43.** The activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish Entity H's mission (to save lives by educating the public), and (b) a similar program activity is conducted without the fund raising using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the appeal (Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising).

**E.44.** The audience criterion is met because the audience (a broad segment of the population) is selected based on its need to use or reasonable potential for use of the action called for by the program activity.

**E.45.** The content criterion is met because the activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission (to save lives by educating the public), and the need for and benefits of the action are clearly evident (saving lives is desirable).

## **Illustration 9**

### **Facts**

**E.46.** Entity I's mission is to provide food, clothing, and medical care to children in developing countries.

**E.47.** Entity I conducts television broadcasts in the United States that describe its programs, show the needy children, and end with appeals for contributions. Entity I's operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries and to raise contributions. The employees producing the programs are trained in audiovisual production and are familiar with Entity I's programs. Also, the executive producer is paid \$25,000 for this activity, with a \$5,000 bonus if the activity raises over \$1,000,000.

### **Conclusion**

**E.48.** The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

**E.49.** The activity does not include a call for specific action because it only educates the audience about causes (describing its programs and showing the needy children). Therefore, the purpose criterion is not met. (Also, note that if the factor in paragraph .10a were considered, it would not be determinative of whether the purpose criterion is met. Although the executive producer will be paid \$5,000 if the activity raises over \$1,000,000, that amount would not be a majority of the executive producer's total compensation for this activity, because \$5,000 would not be a majority of the executive producer's total compensation of \$30,000 for this activity. Also, note that if other evidence, such as the indicators in paragraph .11, were considered, the purpose criterion would not be met based

on the other evidence. Although the qualifications and duties of the personnel performing the activity indicate that the employees producing the program are familiar with Entity I's programs, the facts that some, but less than a majority, of the executive producer's compensation varies based on contributions raised, and that the operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries [with no call for specific action by recipients] and to raise contributions, indicate that the purpose is fund raising.)

**E.50.** The audience criterion is not met because the audience is selected based on its ability or likelihood to contribute, rather than based on (a) its need to use or reasonable potential for use of the action called for by the program component, or (b) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (The audience is a broad segment of the population of a country that is not in need of or has no reasonable potential for use of the program activity.)

**E.51.** The content criterion is not met because the activity does not call for specific action by the recipient that will help accomplish the entity's mission. (The content educates the audience about the causes without calling for specific action.)

## Illustration 10

### Facts

**E.52.** Entity J is a university that distributes its annual report, which includes reports on mission accomplishments, to those who have made significant contributions over the previous year, its board of trustees, and its employees. The annual report is primarily prepared by management and general personnel, such as the accounting department and executive staff. The activity is coordinated by the public relations department. Internal management memoranda indicate that the purpose of the annual report is to report on how management discharged its stewardship responsibilities, including the university's overall performance, goals, financial position, cash flows, and results of operations. Included in the package containing the annual report are requests for contributions and donor reply cards.

### Conclusion

**E.53.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.54.** The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the employees performing the activity are not members of the fund-raising department and perform other non-fund-raising activities and (b) internal management memoranda indicate that the purpose of the annual report is to fulfill one of the university's management and general responsibilities.

**E.55.** The audience criterion is met because the audience is selected based on its reasonable potential for use of the management and general component. Although the activity is directed primarily at those who have previously made significant contributions, the audience was selected based on its presumed interest in Entity J's annual report (prior donors who have made significant

contributions are likely to have an interest in matters discussed in the annual report).

**E.56.** The content criterion is met because the activity (distributing annual reports) fulfills one of the entity's management and general responsibilities (reporting concerning management's fulfillment of its stewardship function).

## Illustration 11

### Facts

**E.57.** Entity K is an NPO. In accordance with internal management memoranda documenting its policies requiring it to comply with Internal Revenue Service (IRS) regulations, it mails prior donors who have made quid pro quo payments in excess of \$75 documentation required by the IRS. The documentation is included on a perforated piece of paper. The information above the perforation line pertains to the documentation required by the IRS. The information below the perforation line includes a request for contributions and may be used as a donor reply card.

### Conclusion

**E.58.** The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the information below the perforation line are identifiable with fund raising and therefore should be charged to fund raising.)

**E.59.** The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because internal management memoranda indicate that the purpose of the activity is to fulfill one of Entity K's management and general responsibilities.

**E.60.** The audience criterion is met because the entity is required to direct the management and general component of the activity to the particular audience. Although the activity is directed at those who have previously contributed, the audience was selected based on its need for the documentation.

**E.61.** The content criterion is met because the activity (sending documentation required by the IRS) fulfills one of the entity's management and general responsibilities (complying with IRS regulations).

## Illustration 12

### Facts

**E.62.** Entity L is an animal rights organization. It mails a package of material to individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own. In addition to donor response cards and return envelopes, the package includes (a) materials urging recipients to contact their legislators and urge the legislators to support legislation to protect those rights, and (b) postcards addressed to legislators urging support for legislation restricting the use of animal testing for cosmetic products. The mail campaign is part of an overall strategy that includes magazine advertisements and the distribution of similar materials at various community events, some of which are undertaken without

fund-raising appeals. The advertising and community events reach audiences similar in size and demographics to the audience reached by the mailing.

### **Conclusion**

**E.63.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.64.** The activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the program component of this activity calls for specific action by the recipient that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (b) performing such programs helps accomplish Entity L's mission.

**E.65.** The audience criterion is met because the audience (individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own) is selected based on its ability to take action to assist the entity in meeting the goals of the program component of the activity.

**E.66.** The content criterion is met because the activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission (to protect animal rights), and the need for and benefits of the action are clearly evident (to protect animal rights).

## **Illustration 13**

### **Facts**

**E.67.** Entity M is a performing arts organization whose mission is to make the arts available to residents in its area. Entity M charges a fee for attending performances and sends advertisements, including subscription forms, for the performances to residents in its area. These advertisements include a return envelope with a request for contributions. Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received. In performing that evaluation, Entity M places more weight on the number of subscriptions sold than on the contributions received. Also, Entity M advertises the performances on local television and radio without a request for contributions but on a smaller scale than the mail advertising.

### **Conclusion**

**E.68.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.69.** The activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the entity measures program results and accomplishments of the joint activity and

in evaluating the effectiveness of the activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received and places more weight on the number of subscriptions sold than on the contributions received), (b) it otherwise conducts the program activity without a request for contributions, and (c) performing such programs helps accomplish Entity M's mission (to make the arts available to residents in its area).

**E.70.** The audience criterion is met because the audience (a broad segment of the population in Entity M's area) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**E.71.** The content criterion is met because the activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission (making the arts available to area residents), and the need for and benefits of the action are clearly evident (attending the performance is a positive cultural experience). (Note that the purchase of subscriptions is an exchange transaction and, therefore, is not a contribution.)

## Illustration 14

### Facts

**E.72.** Entity N is a university whose mission is to educate the public (students) in various academic pursuits. Entity N's political science department holds a special lecture series in which prominent world leaders speak about current events. The speakers command relatively high fees and, in order to cover costs and make a modest profit, the university sets a relatively expensive fee to attend. However, the tickets are priced at the fair value of the lecture and no portion of the ticket purchase price is a contribution. Entity N advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. At some of the lectures, including the lecture being considered in this illustration, deans and other faculty members of Entity N solicit significant contributions from attendees. Other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions. Entity N's records indicate that historically 75 percent of the attendees have attended prior lectures. Of the 75 percent who have attended prior lectures, 15 percent have made prior contributions to Entity N. Of the 15 percent who have made prior contributions to Entity N, 5 percent have made contributions in response to solicitations made at the events. (Therefore, one-half of one percent of attendees make contributions in response to solicitations made at the events. However, those contributions are significant.) Overall, the audience's ability or likelihood to contribute is an insignificant factor in its selection. Entity N evaluates the effectiveness of the activity based on the number of tickets sold, as well as contributions received. In performing that evaluation, Entity N places more weight on the number of tickets sold than on the contributions received.

### Conclusion

**E.73.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.74.** The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in

paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions).

**E.75.** The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is overcome in this illustration because the audience (those who have shown prior interest in the lecture series, prior donors, a broad segment of the population in Entity N's area, and those attending the lecture) is also selected for its reasonable potential for use of the program component (attending the lecture). Although the audience may make significant contributions, that was an insignificant factor in its selection.

**E.76.** The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph .07 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.<sup>12</sup>)

## Illustration 15

### Facts

**E.77.** Entity O is a university whose mission is to educate the public (students) in various academic pursuits. Entity O's political science department holds a special lecture series in which prominent world leaders speak about current events. Admission is priced at \$250, which is above the \$50 fair value of the lecture and, therefore, \$200 of the admission price is a contribution. Therefore, the audience's likelihood to contribute to the entity is a significant factor in its selection. Entity O advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. Entity O presents similar lectures that are priced at the fair value of those lectures.

### Conclusion

**E.78.** The purpose and content criteria are met. The audience criterion is not met. All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, except for the costs of the direct donor benefit (the lecture), should be charged to fund raising.

**E.79.** The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in

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<sup>12</sup> Paragraphs 13.21-13.26 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events. [Footnote revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without including a contribution in the admission price.)

**E.80.** The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute to the entity is not overcome in this illustration. The fact that the \$250 admission price includes a \$200 contribution leads to the conclusion that the audience's ability or likelihood to contribute is an overwhelmingly significant factor in its selection, whereas there is no evidence that the extent to which the audience is selected for its need to use or reasonable potential for use of the action called for by the program component (attending the lecture) is overwhelmingly significant.

**E.81.** The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph .07 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.<sup>13</sup>)

## Illustration 16

### Facts

**E.82.** Entity P's mission is to reduce the incidence of illness from ABC disease, which primarily afflicts people over sixty-five years of age. One of Entity P's objectives in fulfilling that mission is to have all persons over sixty-five screened for ABC disease.

**E.83.** Entity P rents space at events attended primarily by people over sixty-five years of age and conducts free screening for ABC disease. Entity P's employees, who are educated about ABC disease and screening procedures and do not otherwise perform fund-raising functions, educate interested parties about the effects of ABC disease and the ease and benefits of screening for it. Entity P also solicits contributions at the events. The effectiveness of the activity is evaluated primarily based on how many screening tests are performed, and only minimally based on contributions raised. The employees are not compensated or evaluated based on contributions raised.

### Conclusion

**E.84.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

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<sup>13</sup> Paragraphs 13.21-13.26 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events. [Footnote revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

**E.85.** The activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) a process exists to evaluate measured program results and accomplishments and in evaluating the effectiveness of the joint activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity P evaluates the effectiveness of the activity based on the number of screening tests conducted as well as contributions received and places more weight on the number of tests conducted than on the contributions received); (b) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the employees are educated about ABC disease and the testing procedures and do not otherwise perform fund-raising functions); (c) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised); and (d) performing such programs helps accomplish Entity P's mission (to prevent ABC disease).

**E.86.** The audience criterion is met because the audience (people over sixty-five years of age) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**E.87.** The content criterion is met because the activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

## Illustration 17

### Facts

**E.88.** Entity Q's mission is to provide cultural and educational television programming to residents in its area. Entity Q owns a public television station and holds a membership drive in which it solicits new members. The drive is conducted by station employees and consists of solicitations that are shown during long breaks between the station's regularly scheduled programs. Entity Q's internal management memoranda state that these drives are designed to raise contributions. Entity Q evaluates the effectiveness of the activity based on the amount of contributions received. Entity Q shows the programs on a similar scale, without the request for contributions. The audience is members of the general public who watch the programs shown during the drive. Station member benefits are given to those who contribute and consist of tokens of appreciation with a nominal value.

### Conclusion

**E.89.** The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that there would be few, if any, joint costs. Costs associated with the fund-raising activities, such as costs of airtime, would be separately identifiable from costs of the program activities, such as licensing costs for a particular television program. Also, note that because no significant benefits or duties are associated with membership, member dues are contributions. Therefore, the substance of the membership-development activities is, in fact, fund raising.)

**E.90.** The activity calls for specific action by the recipient (watching the television program) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission, and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (Entity Q shows the television programs on a similar scale, without the request for contributions).

**E.91.** The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute is overcome in this illustration because the audience (members of the general public who watch the television programs shown during the drive) is also selected for its reasonable potential for use of the program component (watching the television programs). Although the audience may make contributions, that was an insignificant factor in its selection.

**E.92.** The content criterion is met because the activity calls for specific action by the recipient (watching the television programs) that will help accomplish the entity's mission (providing cultural and educational television programming to residents in its area), and the need for and benefits of the action are clearly evident (watching the programs is a positive cultural and educational experience).

## Appendix F

### Illustrations of Allocation Methods

**F.1.** Some commonly used cost allocation methods follow.

#### Physical Units Method

**F.2.** Joint costs are allocated to materials and activities in proportion to the number of units of output that can be attributed to each of the materials and activities. Examples of units of output are lines, square inches, and physical content measures. This method assumes that the benefits received by the fund-raising, program, or management and general component of the materials or activity from the joint costs incurred are directly proportional to the lines, square inches, or other physical output measures attributed to each component of the activity. This method may result in an unreasonable allocation of joint costs if the units of output, for example, line counts, do not reflect the degree to which costs are incurred for the joint activity. Use of the physical units method may also result in an unreasonable allocation if the physical units cannot be clearly ascribed to fund raising, program, or management and general. For example, direct mail and telephone solicitations sometimes include content that is not identifiable with fund raising, program, or management and general; or the physical units of such content are inseparable.

#### *Illustration*

**F.3.** Assume a direct mail campaign is used to conduct programs of the entity and to solicit contributions to support the entity and its programs. Further, assume that the appeal meets the criteria for allocation of joint costs to more than one function.

**F.4.** The letter and reply card include a total of one hundred lines. Forty-five lines pertain to program because they include a call for action by the recipient that will help accomplish the entity's mission, while fifty-five lines pertain to the fund-raising appeal. Accordingly, 45 percent of the costs are allocated to program and 55 percent to fund-raising.

#### Relative Direct Cost Method

**F.5.** Joint costs are allocated to each of the components on the basis of their respective direct costs. Direct costs are those costs that are incurred in connection with the multipurpose materials or activity and that are specifically identifiable with a function (program, fund raising, or management and general). This method may result in an unreasonable allocation of joint costs if the joint costs of the materials and activity are not incurred in approximately the same proportion and for the same reasons as the direct costs of the materials and activity. For example, if a relatively costly booklet informing the reader about the entity's mission (including a call for action by the recipient that will help accomplish the entity's mission) is included with a relatively inexpensive fund-raising letter, the allocation of joint costs based on the cost of these pieces may be unreasonable, particularly if the booklet and letter weigh approximately the same and therefore contribute equally to the postage costs.

**Illustration**

**F.6.** The costs of a direct mail campaign that can be specifically identified with program services are the costs of separate program materials and a postcard which calls for specific action by the recipient that will help accomplish the entity's mission. They total \$20,000. The direct costs of the fund-raising component of the direct mail campaign consist of the costs to develop and produce the fund-raising letter. They total \$80,000. Joint costs associated with the direct mail campaign total \$40,000 and would be allocated as follows under the relative direct cost method:

$$\begin{aligned} \text{Program } & \$20,000/\$100,000 \times \$40,000 = \$8,000 \\ \text{Fund raising } & \$80,000/\$100,000 \times \$40,000 = \$32,000 \end{aligned}$$

**Stand-Alone Joint-Cost-Allocation Method**

**F.7.** Joint costs are allocated to each component of the activity based on a ratio that uses estimates of costs of items included in joint costs that would have been incurred had the components been conducted independently. The numerator of the ratio is the cost (of items included in joint costs) of conducting a single component independently; the denominator is the cost (of items included in joint costs) of conducting all components independently. This method assumes that efforts for each component in the stand-alone situation are proportionate to the efforts actually undertaken in the joint cost situation. This method may result in an unreasonable allocation because it ignores the effect of each function, which is performed jointly with other functions, on other such functions. For example, the programmatic impact of a direct mail campaign or a telemarketing phone message may be significantly lessened when performed in conjunction with a fund-raising appeal.

**Illustration**

**F.8.** Assume that the joint costs associated with a direct mail campaign including both program and fund-raising components are the costs of stationery, postage, and envelopes at a total of \$100,000. The costs of stationery, postage, and envelopes to produce and distribute each component separately would have been \$90,000 for the program component and \$70,000 for the fund-raising component. Under the stand-alone joint-cost-allocation method, the \$100,000 in joint costs would be allocated as follows:  $\$90,000/\$160,000 \times \$100,000 = \$56,250$  to program services and  $\$70,000/\$160,000 \times \$100,000 = \$43,750$  to fund raising.

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## Appendix G

### Illustrations of Disclosures

**G.1.** The disclosures discussed in paragraphs .18 and .19 are illustrated below. Alternative 1 reports the required and encouraged information in narrative format. Alternative 2 reports that information in tabular format, as well as information concerning joint costs incurred for each kind of activity by functional classification, which is neither required nor encouraged, but which is not prohibited.

#### Alternative 1

##### Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included requests for contributions, as well as program and management and general components. Those activities included direct mail campaigns, special events, and a telethon. The costs of conducting those activities included a total of \$310,000 of joint costs, which are not specifically attributable to particular components of the activities (joint costs). [*Note to reader: The following sentence is encouraged but not required.*] Joint costs for each kind of activity were \$50,000, \$150,000, and \$110,000 respectively. These joint costs were allocated as follows:

Fund raising	\$180,000
Program A	80,000
Program B	40,000
Management and general	<u>10,000</u>
Total	<u><u>\$310,000</u></u>

#### Alternative 2

##### Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included appeals for contributions and incurred joint costs of \$310,000. These activities included direct mail campaigns, special events, and a telethon. Joint costs were allocated as follows:

	<u>Direct Mail</u>	<u>Special Events</u>	<u>Telethon</u>	<u>Total</u>
Fund raising	\$40,000	\$50,000	\$90,000	\$180,000
Program A	10,000	65,000	5,000	80,000
Program B		25,000	15,000	40,000
Management and general		10,000		10,000
Total	<u>\$50,000</u>	<u>\$150,000</u>	<u>\$110,000</u>	<u>\$310,000</u>

*[Note to reader: Shading is used to highlight information that is neither required nor encouraged, but which is not prohibited. However, entities may prefer to disclose it. Disclosing the total joint costs for each kind of activity (\$50,000, \$150,000, and \$110,000) is encouraged but not required.]*

## Appendix H

### Contrast of Guidance in This SOP With the Guidance in SOP 87-2<sup>14, \*\*</sup>

<u><i>This SOP</i></u>	<u><i>SOP 87-2</i></u>
Applies to all entities that solicit contributions, including state and local governments.	Applied to entities that follow the AICPA Industry Audit Guide <i>Audits of Voluntary Health and Welfare Organizations</i> or SOP 78-10. (SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board Statement No. 29, <i>The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities.</i> )
Covers <i>all</i> costs of joint activities. (Costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event [for example, a meal], should be charged to fund raising unless the criteria in the SOP are met.)	Covers only joint costs of joint activities.
Criteria of purpose, audience, and content should all be met in order to charge costs of the activity to program or management and general.	Unclear concerning whether all criteria should be met in order to charge costs of the activity to program or management and general.
Neither prescribes nor prohibits any allocation methods. Includes a discussion to help users determine whether an allocation is reasonable, and provides some illustrations.	Neither prescribes nor prohibits any allocation methods. No illustrations are provided.
Requires note disclosures about the types of activities for which joint costs have been incurred, amounts allocated during the period, and amounts allocated to each functional expense or expenditure category.	Requires less extensive note disclosures: total amount allocated during the period and amounts allocated to each functional expense category.

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<sup>14</sup> In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*, which superseded SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the guidance in SOP 87-2 is incorporated into paragraphs 13.36 to 13.45 of the Guide. Also, *Not-for-Profit Organizations* superseded the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* and SOP 78-10. *Not-for-Profit Organizations* applies to all nongovernmental not-for-profit organizations other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. Therefore, incorporating the guidance in SOP 87-2 into *Not-for-Profit Organizations* broadened the scope of the guidance previously included in SOP 87-2 to all not-for-profit organizations other than those required to follow *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*, except that the guidance in *Not-for-Profit Organizations* applies to all not-for-profit organizations other than those required to follow *Health Care Organizations*.

\*\* See footnotes ‡ and || in paragraphs D.3 and D.4, respectively. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

## Appendix I

### Effects on Other Guidance

**I.1.** For nongovernmental organizations, this Statement of Position (SOP) amends the AICPA Audit and Accounting Guide *Health Care Organizations* and paragraphs 13.35 to 13.44 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. [Revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

**I.2.** Also, this SOP amends the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* to clarify that costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund-raising. In particular, paragraphs 13.21, 13.23, and 13.24 of *Not-for-Profit Organizations* are amended as follows:

**13.21** Some organizations conduct joint activities <sup>fn 9</sup> that are special events, including special social and educational events (such as symposia, dinners, dances, and theater parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). FASB Statement No. 117 requires the reporting of the gross amounts of revenues and expenses from special events and other fund-raising activities that are ongoing major or central activities, but permits (but does not require) reporting net amounts if the receipts and related costs result from special events that are peripheral or incidental activities.

**13.23** For example, assume that an organization has a special event that is an ongoing and major activity with a ticket price of \$100. Assume that the activity does not meet the audience criterion in SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, and, therefore, all costs of the activity, other than the direct donor benefits, should be reported as fund raising. The event includes a dinner that costs the organization \$25 and that has a fair value of \$30. (Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses the appropriate reporting if the meal or other items of value are donated to the organization for resale.) In addition, the organization incurs other direct costs of the event in connection with promoting and conducting the event, including incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. Those other direct costs, which include (a) \$5 that otherwise might be considered management and general costs if they had been incurred in a different activity, and (b) fund-raising costs of \$10, are unrelated to the direct benefits to donors and, accordingly, should not be included as costs of benefits to donors. In addition, the organization has the following transactions, which are unrelated to the special event: unrestricted contributions of \$200, program expenses of \$60, management and general expenses of \$20, and fund-raising expenses of \$20.

**13.24** Some ways in which the organization could display the results of the special event as part of its statement of activities are illustrated as follows:

Illustration 1

Changes in unrestricted net assets:		
Contributions		\$200
Special event revenue	100	
Less: Costs of direct benefits to donors	<u>(25)</u>	
Net revenues from special events		<u>75</u>
Contributions and net revenues from special events		275
Other expenses:		
Program		60
Management and general		20
Fund raising		<u>35</u>
Total other expenses		<u>115</u>
Increase in unrestricted net assets		<u>\$160</u>

Illustration 2

Changes in unrestricted net assets:		
Revenues:		
Contributions		\$200
Special event revenue		<u>100</u>
Total revenues		300
Expenses:		
Program		60
Costs of direct benefits to donors		25
Management and general		20
Fund raising		<u>35</u>
Total expenses		<u>140</u>
Increase in unrestricted net assets		<u>\$160</u>

Illustration 3

Changes in unrestricted net assets:		
Contributions		\$270
Dinner sales		30
Less: Costs of direct benefits to donors		<u>(25)</u>
Gross profit on special events		<u>5</u>
Contributions and net revenues from special events		275
Other expenses:		
Program		60
Management and general		20
Fund raising		<u>35</u>
Total other expenses		<u>115</u>
Increase in unrestricted net assets		<u>\$160</u>

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<sup>fn 9</sup> See footnote 1.

[Revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

**I.3.** For governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable Financial Accounting Standards Board [FASB] pronouncements issued through November 30, 1989, and by most applicable Governmental Accounting Standards Board [GASB] pronouncements) in conformity with GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, this SOP amends the principles—based on SOP 78-10 and *Audits of Voluntary Health and Welfare Organizations*, as modified—that those entities apply. For governmental entities that have applied the accounting and financial reporting principles in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements in conformity with GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, this SOP amends the principles—based on *Audits of Colleges and Universities*, as amended and modified—that those entities apply. For other governmental organizations, this SOP amends the Audit and Accounting Guide *Audits of State and Local Governmental Units*.<sup>††</sup>

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<sup>††</sup> See footnotes ‡ and || in paragraphs D.3 and D.4, respectively. Also, the AICPA Audit and Accounting Guide *State and Local Governments* supersedes the 1994 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and subsequent editions of that Guide with conforming changes made by the AICPA staff. The AICPA Audit and Accounting Guide *State and Local Governments*, provides guidance on the application of this SOP to state and local governments. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34, No. 35, and the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*.]

## Glossary

**Activities.** Activities are efforts to accomplish specific objectives. Some activities include producing and distributing materials. For example, if an entity undertakes a mass mailing that includes a letter and a pamphlet, producing and distributing the letter and pamphlet are part of the activity. Other activities may include no materials, such as an annual dinner or a radio commercial.

**Compensation or fees.** Reciprocal transfers of cash or other assets in exchange for services performed.

**Contributions.** Contributions are unconditional transfers of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

**Costs of joint activities.** Costs of joint activities are costs incurred for a joint activity. Costs of joint activities may include joint costs and costs other than joint costs. Costs other than joint costs are costs that are identifiable with a particular function, such as fund raising, program, management and general, and cost of sales. For example, some costs incurred for printing, paper, professional fees, and salaries to produce donor cards are not joint costs, although they may be incurred in connection with conducting joint activities.

**Fund-raising activities.** Fund-raising activities are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others.

**Help accomplish the entity's mission.** Actions that help accomplish the entity's mission are actions that either benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or benefit society (by addressing societal problems).

**Joint activity.** A joint activity is an activity that is part of the fund-raising function and has elements of one or more other functions, such as program, management and general, membership development, or any other functional category used by the entity.

**Joint costs.** Joint costs are the costs of conducting joint activities that are not identifiable with a particular component of the activity. For example, the cost of postage for a letter that includes both fund-raising and program components is a joint cost. Joint costs may include the costs of salaries, contract labor, consultants, professional fees, paper, printing, postage, event advertising, telephones, airtime, and facility rentals.

**Management and general activities.** Management and general activities are those that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. They include oversight, business management, general recordkeeping, budgeting, financing, soliciting revenue from exchange transactions, such as

government contracts and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. Disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, and the annual report, among other activities, are management and general activities, as are soliciting funds other than contributions, including exchange transactions (whether program-related or not).

**Medium.** A medium is a means of mass communication, such as direct mail, direct response advertising, or television.

**Membership-development activities.** Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising.

**Program activities.** Program activities are the activities that result in goods or services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs. For example, a large university may have programs for student instruction, research, and patient care, among others. Similarly, a health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others.

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## AR Cross-References to SSARSs

### Statements on Standards for Accounting and Review Services \*

<i>No.</i>	<i>Date Issued</i>	<i>Title</i>	<i>Section</i>
1	Dec. 1978	Compilation and Review of Financial Statements [Superseded, December 2010, by SSARS No. 19.]	
<b>2</b>	<b>Oct. 1979</b>	<b>Reporting on Comparative Financial Statements</b>	<b>200</b>
<b>3</b>	<b>Dec. 1981</b>	<b>Compilation Reports on Financial Statements Included in Certain Prescribed Forms<sup>1</sup></b>	<b>300</b>
<b>4</b>	<b>Dec. 1981</b>	<b>Communications Between Predecessor and Successor Accountants<sup>2</sup></b>	<b>400</b>
5	July 1982	Reporting on Compiled Financial Statements [Deleted, November 1992, by SSARS No. 7.] <sup>3</sup>	
<b>6</b>	<b>Sept. 1986</b>	<b>Reporting on Personal Financial Statements Included in Written Personal Financial Plans</b>	<b>600</b>
<b>7</b>	<b>Nov. 1992</b>	<b>Omnibus Statement on Standards for Accounting and Review Services—1992<sup>4</sup></b>	
8	Oct. 2000	Amendment to Statement on Standards for Accounting and Review Services No. 1, <i>Compilation and Review of Financial Statements</i>	
<b>9</b>	<b>Nov. 2002</b>	<b>Omnibus Statement on Standards for Accounting and Review Services—2002<sup>5</sup></b>	
10	May 2004	Performance of Review Engagements	
11	May 2004	Standards for Accounting and Review Services [Superseded, December 2010, by SSARS No. 19.] <sup>6</sup>	

(continued)

\* Pronouncements in effect are indicated in **boldface** type.

<sup>1</sup> SSARS No. 3 amends section 200.02.

<sup>2</sup> SSARS No. 4 amends section 200.16.

<sup>3</sup> The provisions of SSARS No. 5 have been incorporated into section 300

<sup>4</sup> SSARS No. 7 has been integrated to amend sections 200, 300, and 400; SSARS No. 7 also deletes SSARS No. 5.

<sup>5</sup> SSARS No. 9 amends sections 400.01–.06 and 400.08–.10, deletes section 400.07, and adds sections 400.11–.12.

<sup>6</sup> SSARS No. 11 amends section 200.17.

**1984**      **Statements on Standards for Accounting and Review Services**

<i>No.</i>	<i>Date Issued</i>	<i>Title</i>	<i>Section</i>
<b>12</b>	<b>July 2005</b>	<b>Omnibus Statement on Standards for Accounting and Review Services—2005<sup>7</sup></b>	
<b>13</b>	<b>July 2005</b>	<b>Compilation of Specified Elements, Accounts, or Items of a Financial Statement</b>	<b>110</b>
<b>14</b>	<b>July 2005</b>	<b>Compilation of Pro Forma Financial Information</b>	<b>120</b>
<b>15</b>	<b>July 2007</b>	<b>Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services<sup>8</sup></b>	
16	Dec. 2007	Defining Professional Requirements in Statements on Standards for Accounting and Review Services [Superseded, December 2010, by SSARS No. 19.]	
<b>17</b>	<b>Feb. 2008</b>	<b>Omnibus Statement on Standards for Accounting and Review Services—2008<sup>9</sup></b>	
18	Feb. 2009	Applicability of Statements on Standards for Accounting and Review Services	
<b>19</b>	<b>Dec. 2009</b>	<b>Compilation and Review Engagements<sup>10</sup></b>	<b>60, 80, and 90</b>
<b>20</b>	<b>Feb. 2011</b>	<b>Revised Applicability of Statements on Standards for Accounting and Review Services<sup>11</sup></b>	

<sup>7</sup> SSARS No. 12 amends sections 200.25–26 and adds section 200.27 (subsequent paragraphs and footnotes have been renumbered accordingly).

<sup>8</sup> SSARS No. 15 amends section 200.05, section 300.01, and section 400.09.

<sup>9</sup> SSARS No. 17 amends section 110.15; section 120.18; sections 200.01, .29, and .33; sections 300.01–.03; and section 400.01.

<sup>10</sup> SSARS No. 19 supersedes sections 20, 50, and 100.

<sup>11</sup> SSARS No. 20 amends section 90.01.

## Sources of Sections in Current Text

<i>AR Section</i>	<i>Contents</i>	<i>Source</i>
60	Framework for Performing and Reporting on Compilation and Review Engagements	SSARS No. 19
80	Compilation of Financial Statements	SSARS No. 19
90	Review of Financial Statements	SSARS No. 19
110	Compilation of Specified Elements, Accounts, or Items of a Financial Statement	SSARS No. 13
120	Compilation of Pro Forma Financial Information	SSARS No. 14
200	Reporting on Comparative Financial Statements	SSARS No. 2
300	Compilation Reports on Financial Statements Included in Certain Prescribed Forms	SSARS No. 3
400	Communications Between Predecessor and Successor Accountants	SSARS No. 4
600	Reporting on Personal Financial Statements Included in Written Personal Financial Plans	SSARS No. 6

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**AR Section**

**STATEMENTS ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES**

Statements on Standards for Accounting and Review Services (SSARSs) are issued by the AICPA Accounting and Review Services Committee (ARSC), the senior committee of the AICPA designated to issue pronouncements in connection with the unaudited financial statements or other unaudited financial information of a nonpublic entity. Council has designated ARSC as a body to establish technical standards under the "Compliance With Standards Rule" of the AICPA Code of Professional Conduct (ET sec. 1.310.001).

Interpretations are issued to provide guidance on the application of SSARSs. Interpretations are issued after all members of ARSC have been provided an opportunity to consider and comment on whether the proposed interpretation is consistent with SSARSs. An interpretation is not as authoritative as a SSARS, but members should be aware that they may have to justify a departure from an interpretation if the quality of their work is questioned.

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## AR Section 20

# ***Defining Professional Requirements in Statements on Standards for Accounting and Review Services***

Superseded, December 2010, by the issuance of SSARS No. 19.

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## AR Section 50

# *Standards for Accounting and Review Services*

Superseded, December 2010, by the issuance of SSARS No. 19.

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## AR Section 60

# *Framework for Performing and Reporting on Compilation and Review Engagements*

Issue date, unless otherwise indicated: December 2009

Source: SSARS No. 19

## Introduction

**.01** This section provides a framework and defines and describes the objectives and elements of compilation and review engagements. This section also sets forth the meaning of certain terms used in Statements on Standards for Accounting and Review Services (SSARSs) issued by the Accounting and Review Services Committee (ARSC) in describing the professional requirements imposed on accountants performing compilation and review engagements.

**.02** The following is an overview of this section:

- "Relevant Definitions." This section defines various terms used throughout SSARSs.
- "Objectives and Limitations of Compilation and Review Engagements." This section sets forth the objectives and limitations of compilation and review engagements and identifies the differences between each engagement.
- "Professional Requirements." This section sets forth the meaning of certain terms used in SSARSs in describing the professional requirements imposed on accountants performing a compilation or review engagement.
- "Hierarchy of Compilation and Review Standards and Guidance." This section sets forth the hierarchy of SSARSs literature.
- "Elements of a Compilation or Review Engagement." This section identifies and discusses five engagement elements: a three party relationship involving management, an accountant, and intended users; an applicable financial reporting framework; financial statements; evidence (in a review engagement); and a written communication or report. It explains important distinctions between compilation engagements in which the accountant obtains no assurance and review engagements that are designed to obtain limited assurance.
- "Materiality." This section discusses the concept of materiality in the context of the preparation and presentation of financial statements.

**.03** This section is intended to help accountants better understand their professional responsibilities when engaged to compile or review financial statements or financial information. Additional standards of SSARSs have been established to set forth specific performance and reporting requirements. Such

additional standards are based on the framework provided by this standard, and any requirements created by this standard also have been incorporated into the additional standards of SSARs.

## Relevant Definitions

.04 Terms defined for purposes of SSARs are as follows:

**Applicable financial reporting framework.** The financial reporting framework adopted by management and, when appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

**Assurance engagement.** An engagement in which an accountant issues a report designed to enhance the degree of confidence of third parties and management about the outcome of an evaluation or measurement of financial statements (subject matter) against an applicable financial reporting framework (criteria).

**Attest engagement.** An engagement that requires independence, as defined in *AICPA Professional Standards*.

**Financial reporting framework.** A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements.

**Financial statements.** A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources and obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term *financial statements* ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement or financial statements without notes.

**Management.** The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance (for example, executive members of a governance board or an owner-manager).

**Nonissuer.** All entities except for those 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.

**Other comprehensive basis of accounting (OCBOA).** A definite set of criteria, other than accounting principles generally accepted in the United States of America or International Financial Reporting Standards (IFRSs), having substantial support underlying the preparation of financial statements prepared pursuant to that basis.

Examples of an OCBOA are as follows:

- a. A basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a

- governmental regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the rules of a state insurance commission).
- b. A basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.
  - c. 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.

**Review evidence.** Information used by the accountant to provide a reasonable basis for the obtaining of limited assurance.

**Submission of financial statements.** Presenting to management financial statements that an accountant has prepared.\*

**Third party.** All persons, including those charged with governance, except for members of management.

**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. Those charged with governance are specifically excluded from management, unless they perform management functions.

## Objectives and Limitations of Compilation and Review Engagements

**.05** A compilation is a service, the objective of which is to assist management in presenting financial information in the form of financial statements<sup>1</sup> without undertaking to obtain or provide any 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 the applicable financial reporting framework. Although a compilation is not an assurance engagement, it is an attest engagement.

**.06** 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

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\* In January 2013, the Professional Ethics Executive Committee adopted a provision in the "Scope and Applicability of Nonattest Services" interpretation (ET sec. 1.295.010) under the "Independence Rule" (ET sec. 1.200.001) of the AICPA Code of Professional Conduct. This provision provides, among other things, that financial statement preparation is considered outside the scope of the attest engagement and, therefore, constitutes a nonattest service subject to the requirements of the "Nonattest Services" subtopic (ET sec. 1.295). The provision is effective for engagements covering periods beginning on or after December 15, 2014. [Footnote added, October 2013, to reflect conforming changes necessary due to the revision of Ethics Interpretation No. 101-3. Footnote revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

<sup>1</sup> For purposes of the Statements on Standards for Accounting and Review Services, with respect to compilation engagements, references to "financial statements" include, when applicable, other specified elements, accounts, or items of a financial statement and pro forma financial information.

control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or 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 obtaining or providing any assurance regarding the financial statements.

**.07** A review is a service, the objective of which is to obtain 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 the applicable financial reporting framework. In a review engagement, the accountant should accumulate review evidence to obtain a limited level of assurance. A review engagement is an assurance engagement as well as an attest engagement.

**.08** A review differs significantly from an audit of financial statements in which the auditor obtains a high level of assurance (expressed in the auditor's report as obtaining reasonable assurance) that the financial statements are free of material misstatement. A review does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, in a review, the accountant does not obtain assurance that he or she will become aware of all significant matters that would be disclosed in an audit. Therefore, a review is designed to obtain only 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 the applicable financial reporting framework.

## **Professional Requirements**

### **Requirements**

**.09** SSARSs contain professional requirements, together with related guidance, in the form of explanatory material. Accountants performing a compilation or review have a responsibility to consider the entire text of a SSARS in carrying out their work on an engagement and in understanding and applying the professional requirements of the relevant SSARSs.

**.10** Not every paragraph of a SSARS carries a professional requirement that the accountant is expected to fulfill. Rather, the professional requirements are communicated by the language and the meaning of the words used in SSARSs.

**.11** SSARSs use two categories of professional requirements identified by specific terms to describe the degree of responsibility they impose on accountants. 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 also is 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.

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 specific terms used to define professional requirements are not intended to apply to interpretative publications issued under the authority of the ARSC because interpretative publications are not SSARSs.

## Explanatory Material

**.12** *Explanatory material* is defined as the text within a SSARS (excluding any related appendixes or interpretations) that may do the following:

- Provide further explanation and guidance on the professional requirements
- Identify and describe other procedures or actions relating to the activities of the accountant

**.13** 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 (when not otherwise self-evident); it explains why the accountant might consider or employ particular procedures, depending on the circumstances; and it provides additional information for the accountant to consider in exercising professional judgment in performing the engagement.

**.14** Explanatory material that identifies and describes other procedures or actions relating to the activities of the accountant is not intended to impose a professional requirement for the accountant to perform the suggested procedures or actions. Rather, these procedures or actions require the accountant's attention and understanding; how and whether the accountant carries out such procedures or actions in the engagement 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.

## Hierarchy of Compilation and Review Standards and Guidance

### Compilation and Review Standards

**.15** An accountant must perform a compilation or review engagement of a nonissuer in accordance with SSARSs, except for certain reviews of interim financial information as discussed in paragraph .01 of section 90, *Review of Financial Statements*. SSARSs provide a measure of quality and the objectives to be achieved in both a compilation and review engagement.

**.16** The "Compliance With Standards Rule" (ET sec. 1.310.001), requires an AICPA member who performs compilations or reviews to comply with standards promulgated by the 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 SSARs, and a formal vote. Finalized SSARs are codified. [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

.17 The nature of SSARs requires an accountant to exercise professional judgment in applying them.

### **Interpretative Publications**

.18 Interpretative publications consist of compilation and review interpretations of SSARs; appendixes to SSARs; 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 SSARs in specific circumstances, including engagements for entities in specialized industries. An interpretative publication is issued under the authority of the ARSC after all ARSC members have been provided an opportunity to consider and comment on whether the proposed interpretative publication is consistent with SSARs.

.19 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 provisions of SSARs addressed by such guidance.

### **Other Compilation and Review Publications**

.20 Other compilation and review publications include AICPA accounting and review publications not referred to previously; the 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 the AICPA's *The CPA Letter*; continuing professional education programs and other instructional 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 SSARs. An accountant is not expected to be aware of the full body of other compilation and review publications.

.21 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 that has not been reviewed by the AICPA Audit and Attest Standards staff is appropriate, the accountant may wish to consider the degree to which the publication is recognized as being helpful in understanding and applying SSARs 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.

### **Ethical Principles and Quality Control Standards**

.22 In addition to SSARs, AICPA members who perform compilation and review engagements are governed by

- a.* the AICPA's Code of Professional Conduct (code), which expresses the profession's recognition of its responsibilities to the public, to clients, and to colleagues. The principles of the code guide members in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. The principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage.
- b.* Statements on Quality Control Standards (SQCSs), which establish standards and provide guidance on a firm's system of quality control.

**.23** The code sets out the fundamental ethical principles that all AICPA members are required to observe. When performing a compilation or review engagement, the code requires an accountant to maintain objectivity and integrity and comply with all other applicable provisions.

**.24** 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 reasonable assurance that personnel comply with SSARs in compilation and review 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.

**.25** SSARs relate to the conduct of individual compilation and review engagements; SQCSs relate to the conduct of a firm's accounting practice. Thus, SSARs 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 SSARs.

## Elements of a Compilation or Review Engagement

**.26** The following elements of a compilation and review engagement are discussed in this section:

- a.* A three party relationship involving management, an accountant, and intended users
- b.* An applicable financial reporting framework
- c.* Financial statements or financial information
- d.* In a review, sufficient appropriate review evidence
- e.* A written communication or report

## Three Party Relationship

**.27** A compilation or review engagement involves three parties: management (or the responsible party); an accountant in public practice, as defined by the AICPA code; and intended users of the financial statements or financial information. [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

.28 In some cases, management and the intended users may be the same. Intended users may be from different entities (for example, a banker or potential investor) or the same entity.

.29 If an accountant is not in public practice, the issuance of a written communication or report under SSARs would be inappropriate. [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

### **Management (Responsible Party)**

.30 Management responsibilities include taking responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and taking responsibility for designing, implementing, and maintaining internal control.<sup>2</sup>

.31 A basic premise underlying the performance of a compilation or review engagement is that the accountant is performing an attest service on subject matter that is the responsibility of the client's management. Therefore, an accountant is precluded from issuing an unmodified compilation report or a review report on financial statements when management is unwilling to accept responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework or to take responsibility for the design, implementation, and maintenance of internal control.

.32 As part of their responsibility for the preparation and presentation of the financial statements, management and, when appropriate, those charged with governance, are responsible for the identification of the applicable financial reporting framework and the preparation and presentation of the financial statements in accordance with that framework.

.33 During the performance of a compilation or review engagement, the accountant may make suggestions about the form or content of the financial statements or prepare them, in whole or in part, based on information that is the representation of management.\*

### **Accountant in Public Practice**

.34 The accountant should possess a level of knowledge of the accounting principles and practices of the industry in which the entity operates that will enable him or her to compile or review financial statements that are appropriate in form for an entity operating in that industry. As addressed in the firm's quality control system, an accountant should not accept an engagement if preliminary knowledge of the engagement circumstances indicates that ethical

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<sup>2</sup> The Committee of Sponsoring Organizations of the Treadway Commission defines *internal control* as a process effected by management (or those charged with governance and other personnel) designed to provide reasonable assurance about the achievement of the entity's objectives. 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 enables 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.

\* See footnote \* in paragraph .04 in this chapter.

requirements regarding professional competence will not be satisfied. In some cases, this requirement can be satisfied by the accountant using the work of persons from other professional disciplines, referred to as *experts*. In such cases, the accountant should be satisfied that those persons carrying out aspects of the engagement possess the requisite skills and knowledge and that the accountant has an adequate level of involvement in the engagement and understanding of the work for which any expert is used. [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

### ***Intended Users of the Financial Statements or Financial Information***

**.35** The intended users are the person(s) or class of persons who understand the limitations of the compilation or review engagement and financial statements. The accountant has no responsibility to identify the intended users.

**.36** In some cases, intended users (for example, bankers and regulators) may impose a requirement on or request the client to arrange for additional procedures to be performed for a specific purpose. For example, a banker may request that certain agreed-upon procedures be performed with respect to the entity's accounts receivable in addition to the financial statements being compiled. An accountant may perform additional services in conjunction with the compilation or review, as long as he or she adheres to professional standards with respect to those additional services.

## **An Applicable Financial Reporting Framework**

**.37** Management and, when applicable, those charged with governance are responsible for the selection of the entity's applicable financial reporting framework, as well as individual accounting policies when the financial reporting framework contains acceptable alternatives. The financial reporting framework encompasses financial accounting standards established by an authorized or recognized standards setting organization.

**.38** The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficiently broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

**.39** Examples of financial reporting frameworks include accounting principles generally accepted in the United States of America, as promulgated by the Financial Accounting Standards Board, the Governmental Accounting Standards Board, or the Federal Accounting Standards Advisory Board; IFRSs issued by the International Accounting Standards Board; and OCBOA.

## **Financial Statement or Financial Information**

**.40** An accountant may be engaged to compile or review a complete set of financial statements or an individual financial statement (for example, balance sheet only). The financial statements may be for an annual period or for a shorter or longer period, depending on management's needs.

**.41** The requirements of the applicable financial reporting framework determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the financial position, financial performance, and cash flows of an

entity. For example, a complete set of financial statements might include a balance sheet, an income statement, a statement of retained earnings, a cash flow statement, and related notes. For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements.

.42 The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

## **Evidence**

.43 When performing a compilation engagement, the accountant has no responsibility to obtain any evidence about the accuracy or completeness of the financial statements. As a result, a compilation does not provide a basis for obtaining any level of assurance on the financial statements being compiled.

.44 When performing a review engagement, the accountant should perform procedures designed to accumulate review evidence that will provide a reasonable basis for obtaining limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. The accountant should apply professional judgment in determining the specific nature, timing, and extent of review procedures. Such procedures should be tailored based on the accountant's understanding of the industry in which the client operates and the accountant's knowledge of the entity. The nature, timing, and extent of procedures for gathering review evidence are deliberately limited relative to an audit.

.45 Review evidence obtained through the performance of analytical procedures and inquiries ordinarily will provide the accountant with a reasonable basis for obtaining limited assurance.

## **Compilation and Review Reports**

.46 If the accountant performs a compilation, a report or written communication is required unless the accountant withdraws from the engagement.<sup>3</sup> If the accountant is not independent, he or she may issue a compilation report, provided that the accountant complies with the compilation standards. In making a judgment about whether he or she is independent, the accountant should be guided by the AICPA's Code of Professional Conduct.

.47 If the accountant performs a review, a written review report is required unless the accountant withdraws from the engagement.

## **Materiality**

.48 Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that

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<sup>3</sup> As further described in paragraphs .22–.24 of section 80, *Compilation of Financial Statements*, an accountant may be associated with the submission of financial statements not expected to be used by a third party. Such service does not require the accountant to issue a report on the financial statements.

- misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement or a combination of both; and
- judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

**.49** Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the accountant in determining whether there are any 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. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph .48 provide the accountant with such a frame of reference.

**.50** The accountant's determination of materiality is a matter of professional judgment and is affected by the accountant's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the accountant to assume that users

- a.* have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- b.* understand that financial statements are prepared, presented, and reviewed to levels of materiality;
- c.* recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and
- d.* make reasonable economic decisions on the basis of the information in the financial statements.

## Effective Date

**.51** This section is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2010.

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## AR Section 80

# Compilation of Financial Statements

Issue date, unless otherwise indicated: December 2009

See section 9080 for interpretations of this section.

Source: SSARS No. 19

**.01** This section establishes standards and provides guidance on compilations of financial statements. The accountant is required to comply with the provisions of this section whenever he or she is engaged to report on compiled financial statements or submits financial statements to a client or to third parties.

### Establishing an Understanding

**.02** The accountant should establish an understanding with management regarding the services to be performed for compilation engagements<sup>1</sup> and should document the understanding through a written communication with management. Such an understanding reduces the risks that either the accountant or management may misinterpret the needs or expectations of the other party. For example, it reduces the risk that management may inappropriately rely on the accountant to protect the entity against certain risks or to perform certain functions that are management's responsibility. The accountant should ensure that the understanding includes the objectives of the engagement, management's responsibilities, the accountant's responsibilities, and the limitations of the engagement. In some cases, the accountant may establish such understanding with those charged with governance.

**.03** An understanding with management and, if applicable, those charged with governance, regarding a compilation of financial statements should include the following matters:

- The objective of a compilation is to assist management in presenting financial information in the form of financial statements.
- The accountant utilizes information that is the representation of management (owners) without undertaking to obtain or provide any 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 the applicable financial reporting framework.
- Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
- Management is responsible for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
- Management is responsible to prevent and detect fraud.

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<sup>1</sup> See paragraph .29 of QC section 10, *A Firm's System of Quality Control*. [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SQCS No. 8.]

- Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
- Management is responsible for making all financial records and related information available to the accountant.
- The accountant is responsible for conducting the engagement in accordance with Statements on Standards for Accounting and Review Services (SSARs) issued by the AICPA.
- 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; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, the accountant will not express an opinion or provide any assurance regarding the financial statements.
- The engagement cannot be relied upon to disclose errors, fraud,<sup>2</sup> or illegal acts.<sup>3</sup>
- 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 procedures that fraud or an illegal act may have occurred.<sup>4</sup> The accountant need not report any matters regarding illegal acts that may have occurred that are clearly inconsequential and may reach agreement in advance with the entity on the nature of any such matters to be communicated.
- The effect of any independence impairments on the expected form of the accountant's compilation report, if applicable.

These matters should be communicated in the form of an engagement letter. Examples of engagement letters for a compilation of financial statements are presented in Compilation Exhibit A, "Illustrative Engagement Letters."

**.04** An understanding with management or, if applicable, those charged with governance, also may include other matters, such as the following:

- Fees and billings

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<sup>2</sup> For purposes of the SSARs, *fraud* is an intentional act that results in a misstatement in compiled financial statements.

<sup>3</sup> For purposes of the SSARs, *illegal acts* are violations of laws or government regulations, excluding fraud.

<sup>4</sup> 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 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 about 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.

- Any limitation of or other arrangements regarding the liability of the accountant or the client, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements)
- Conditions under which access to compilation documentation may be granted to others
- Additional services to be provided relating to regulatory requirements

**.05** If the compiled financial statements are not expected to be used by a third party and the accountant does not expect to issue a compilation report on the financial statements, the accountant should include in the engagement letter an acknowledgment of management's representation and agreement that the financial statements are not to be used by a third party. The engagement letter also should address the following additional matters if applicable:

- Material departures from the applicable financial reporting framework may exist, and the effects of those departures, if any, on the financial statements may not be disclosed.
- Substantially all disclosures (and statement of cash flows, if applicable) required by the applicable financial reporting framework may be omitted.
- Reference to supplementary information.

## Compilation Performance Requirements

### Understanding of the Industry

**.06** The accountant should possess an understanding of the industry in which the client operates, including the accounting principles and practices generally used in the industry sufficient to enable the accountant to compile financial statements that are appropriate in form for an entity operating in that industry.

**.07** The requirement that the accountant possess a level of knowledge of the industry in which the client operates does not prevent the accountant from accepting a compilation engagement for an entity in an industry with which the accountant has no previous experience. It does, however, place upon the accountant a responsibility to obtain the required level of knowledge. The accountant may do so, for example, by consulting AICPA guides, industry publications, financial statements of other entities in the industry, textbooks and periodicals, appropriate continuing professional education, or individuals knowledgeable about the industry.

### Knowledge of the Client

**.08** The accountant should obtain knowledge about the client, including

- an understanding of the client's business and
- an understanding of the accounting principles and practices used by the client.

**.09** In obtaining an understanding of the client's business, the accountant should have a general understanding of the client's organization; its operating

characteristics; and the nature of its assets, liabilities, revenues, and expenses. The accountant's understanding of the entity's business is ordinarily obtained through experience with the entity or its industry and inquiry of the entity's personnel.

**.10** The accountant should obtain an understanding of the accounting principles and practices used by the client in measuring, recognizing, recording, and disclosing all significant accounts and disclosures in the financial statements. The accountant's understanding also may include matters such as changes in accounting practices and principles and differences in the client's business model as compared with normal practices within the industry.

**.11** In obtaining this understanding of the client's accounting policies and practices, the accountant should be alert to unusual accounting policies and procedures that come to the accountant's attention as a result of his or her knowledge of the industry.

## **Reading the Financial Statements**

**.12** Before submission, the accountant should read the financial statements and consider whether such financial statements appear to be appropriate in form and free from obvious material errors. In this context, the term *error* refers to mistakes in the preparation of financial statements, including arithmetical or clerical mistakes, and mistakes in the application of accounting principles, including inadequate disclosure.

## **Other Compilation Procedures**

**.13** The accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. However, the accountant may have made inquiries or performed other procedures. The results of such inquiries or procedures, knowledge gained from prior engagements, or the financial statements on their face may cause the accountant to become aware that information supplied by the entity 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 these matters on the financial statements and communicate the results of such consideration to the accountant. Additionally, the accountant should consider the effect of management's conclusions regarding these matters on the accountant's compilation report. In circumstances when the accountant believes that the financial statements may be materially misstated, the accountant should obtain additional or revised information. If the entity refuses to provide additional or revised information, the accountant should withdraw from the engagement.

## **Documentation in a Compilation Engagement**

**.14** The accountant should prepare documentation in connection with each compilation engagement in sufficient detail to provide a clear understanding of the work performed. Documentation provides the principal support for the representation in the accountant's compilation report that the accountant performed the compilation in accordance with SSARs.

The accountant is not precluded from supporting the compilation report by other means in addition to the compilation documentation. Such other means might include written documentation contained in other engagement files or

quality control files (for example, consultation files) and, in limited situations, oral explanations.

.15 The form, content, and extent of documentation depend on the circumstances of the engagement, the methodology and tools used, and the accountant's professional judgment. The accountant's documentation should include the following:

- a. The engagement letter documenting the understanding with the client
- b. Any findings or issues that, in the accountant's judgment, are significant (for example, the results of compilation procedures that indicate that the financial statements could be materially misstated, including actions taken to address such findings and, to the extent that the accountant had any questions or concerns as a result of his or her compilation procedures, how those issues were resolved)
- c. Communications, whether oral or written, to the appropriate level of management regarding fraud or illegal acts that come to the accountant's attention

## Reporting on the Financial Statements

.16 When the accountant is engaged to report on compiled financial statements or submits financial statements that are reasonably expected to be used by a third party, the financial statements should be accompanied by a written report. The accountant's objective in reporting on the financial statements is to prevent misinterpretation of the degree of responsibility the accountant is assuming when his or her name is associated with the financial statements.

.17 The basic elements of the report are as follows:

- a. *Title.* The accountant's compilation report should have a title that clearly indicates that it is the accountant's compilation report. The accountant may indicate that he or she is independent in the title, if applicable. Appropriate titles would be "Accountant's Compilation Report" or "Independent Accountant's Compilation Report."
- b. *Addressee.* The accountant's report should be addressed as appropriate in the circumstances of the engagement.
- c. *Introductory paragraph.* The introductory paragraph in the accountant's report should
  - i. identify the entity whose financial statements have been compiled;
  - ii. state that the financial statements have been compiled;
  - iii. identify the financial statements that have been compiled;
  - iv. specify the date or period covered by the financial statements; and
  - v. include a statement that the accountant has not audited or reviewed the financial statements and, accordingly, does not express an opinion or provide any assurance about whether the financial statements are in accordance with the applicable financial reporting framework.
- d. *Management's responsibility for the financial statements and for internal control over financial reporting.* A statement that

management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

- e. *Accountant's responsibility.* A statement that the accountant's responsibility is to conduct the compilation in accordance with SSARs issued by the AICPA.  
A statement that the objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.
- f. *Signature of the accountant.* The manual or printed signature of the accounting firm or the accountant, as appropriate.
- g. *Date of the accountant's report.* The date of the compilation report (the date of completion of the compilation should be used as the date of the accountant's report).

Procedures that the accountant might have performed as part of the compilation engagement should not be described in the report.

See Compilation Exhibit B, "Illustrative Compilation Reports," for illustrative compilation reports.

**.18** Each page of the financial statements compiled by the accountant should include a reference, such as "See accountant's compilation report" or "See independent accountant's compilation report."

**.19** Financial statements prepared in accordance with an other comprehensive basis of accounting (OCBOA) are not considered appropriate in form unless the financial statements include

- a. a description of the OCBOA, including a summary of significant accounting policies and a description of the primary differences from generally accepted accounting principles (GAAP). The effects of the differences need not be quantified.
- b. informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

## Reporting on Financial Statements That Omit Substantially All Disclosures

**.20** An entity may request the accountant to compile financial statements that omit substantially all the disclosures required by an applicable financial reporting framework, including disclosures that might appear in the body of the financial statements.<sup>5</sup> The accountant may compile such financial statements, provided that the omission of substantially all disclosures is not, to his or her knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements. When reporting

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<sup>5</sup> See paragraphs .27–.29 for the accountant's responsibilities when he or she is aware of other departures from an applicable financial reporting framework. However, see section 300, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms*, for guidance when such financial statements are included in a prescribed form, and the prescribed form or related instructions do not request the disclosures required by an applicable financial reporting framework.

on financial statements that omit substantially all disclosures, the accountant should include, after the paragraph describing the accountant's responsibility, a paragraph in the compilation report that includes the following elements:

- a. A statement that management has elected to omit substantially all the disclosures (and the statement of cash flows, if applicable) required by the applicable financial reporting framework (or ordinarily included in the financial statements if the financial statements are prepared in accordance with an OCBOA)
- b. A statement that if the omitted disclosures (and statement of cash flows, if applicable) 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 (or equivalent for presentations other than accounting principles generally accepted in the United States of America)
- c. A statement that, accordingly, the financial statements are not designed for those who are not informed about such matters

When the entity wishes to include disclosures about only a few matters in the form of notes to such financial statements, such disclosures should be labeled "Selected Information—Substantially All Disclosures Required by [*identify the applicable financial reporting framework (for example "Accepted Accounting Principles Generally Accepted in the United States of America")*] Are Not Included."

See Compilation Exhibit B for examples of compilation reports when substantially all disclosures required by an applicable financial reporting framework are omitted.

## Reporting When the Accountant Is Not Independent

.21 When the accountant is issuing a report with respect to a compilation of financial statements for an entity, with respect to which the accountant is not independent, the accountant's report should be modified. In making a judgment about whether he or she is independent, the accountant should be guided by the AICPA's Code of Professional Conduct. The accountant should indicate his or her lack of independence in a final paragraph of the accountant's compilation report. An example of such a disclosure would be

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

The accountant is not precluded from disclosing a description about the reason(s) that his or her independence is impaired. The following are examples of descriptions the accountant may use:

- a. I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (a member of the engagement team) had a direct financial interest in XYZ Company;
- b. I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because an individual of my immediate family (an immediate family member of one of the members of the engagement team) was employed by XYZ Company; or
- c. I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (we) performed certain accounting services (the accountant may include a specific description of those services) that impaired my (our) independence.

If the accountant elects to disclose a description about the reasons his or her independence is impaired, the accountant should ensure that all reasons are included in the description.

See Compilation Exhibit B for illustrative examples of accountant's compilation reports when the accountant's independence has been impaired.

### **Accountant's Communications With the Client When the Compiled Financial Statements Are Not Expected to Be Used by a Third Party**

**.22** When the accountant submits compiled financial statements to his or her client that are not expected to be used by a third party, he or she is not required to issue a compilation report.

**.23** The accountant should include a reference on each page of the financial statements restricting their use, such as "Restricted for Management's Use Only," or "Solely for the information and use by the management of [*name of entity*] and not intended to be and should not be used by any other party."

**.24** If the accountant becomes aware that the financial statements have been distributed to third parties, the accountant should discuss the situation with the client and determine the appropriate course of action, including considering requesting that the client have the statements returned. If the accountant requests that the financial statements be returned and the client does not comply with that 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.

### **Emphasis of a Matter**

**.25** The 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 that the accountant may wish to emphasize are

- 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.
- accounting matters affecting the comparability of the financial statements with those of the preceding period.

**.26** Because an emphasis of matter paragraph should not be used in lieu of management disclosures, the accountant should not include an emphasis paragraph in a compilation report on financial statements that omit substantially all disclosures unless the matter is disclosed in the financial statements. The accountant should refer to paragraph .20 if he or she believes that a disclosure is necessary to keep the financial statements from being misleading.

## Departures From the Applicable Financial Reporting Framework

**.27** An accountant who is engaged to compile financial statements may become aware of a departure from the applicable financial reporting framework (including inadequate disclosure) that is material to the financial statements. Paragraph .20 provides guidance to the accountant when the departure relates to the omission of substantially all disclosures in the financial statements that he or she has compiled. section 300, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms*, provides guidance when the departure is called for by a prescribed form or related instructions. In all other circumstances, if the financial statements are not revised, the accountant should consider whether modification of the standard report is adequate to disclose the departure.

**.28** If the accountant concludes that modification of the standard report is appropriate, the departure should be disclosed in a separate paragraph of the report, including disclosure of the effects of the departure on the financial statements if such effects have been determined by management or are known as the result of the accountant's procedures. The accountant is not required to determine the effects of a departure if management has not done so, provided that the accountant states in the report that such determination has not been made.

See Compilation Exhibit B for examples of compilation reports that disclose departures from the applicable financial reporting framework.

**.29** If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements as a whole, the accountant should withdraw from the compilation engagement and provide no further services with respect to those financial statements. The accountant may wish to consult with his or her legal counsel in those circumstances.

## Restricting the Use of an Accountant's Compilation Report

### *General Use and Restricted Use Reports*

**.30** The term *general use* applies to accountants' reports that are not restricted to specified parties. Accountants' reports on financial statements prepared in conformity with an applicable financial reporting framework ordinarily are not restricted regarding use. However, nothing in this section precludes the accountant from restricting the use of any report.

**.31** The term *restricted use* applies to accountants' reports intended only for one or more specified third parties. The need for restriction on the use of a report may result from a number of circumstances, including, but not limited to, the purpose of the report and the potential for the report to be misunderstood when taken out of the context in which it was intended to be used.

**.32** The accountant should restrict the use of a report when the subject matter of the accountant's report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements<sup>6</sup> or regulatory provisions that are not in conformity with an applicable financial reporting framework.

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<sup>6</sup> A *contractual agreement*, as discussed in this section, is an agreement between the client and one or more third parties other than the accountant.

***Reporting on Subject Matter or Presentations Based on Measurement or Disclosure Criteria Contained in Contractual Agreements or Regulatory Provisions***

.33 When reports are issued on subject matter or presentations based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with an applicable financial reporting framework, the accountant should restrict the report because the basis, assumptions, or purpose of such presentations (contained in such agreements or regulatory provisions) are developed for, and directed only to, the parties to the agreement or regulatory agency responsible for the provisions. The report also should be restricted because the report, the subject matter, or the presentation may be misunderstood by those who are not adequately informed of the basis, assumptions, or purpose of the presentation.

***Combined Reports Covering Both Restricted Use and General Use Subject Matter or Presentations***

.34 If the accountant issues a single combined report covering both (a) subject matter or presentations that require a restriction on use to specified parties and (b) subject matter or presentations that ordinarily do not require such a restriction, the use of such a single combined report should be restricted to the specified parties.

***Inclusion of a Separate Restricted Use Report in the Same Document With a General Use Report***

.35 When required by law or regulation, a separate restricted use report may be included in a document that also contains a general use report. The inclusion of a separate restricted use report in a document that contains a general use report does not affect the intended use of either report. The restricted use report remains restricted regarding use, and the general use report continues for general use.

***Adding Other Specified Parties***

.36 Subsequent to the completion of an engagement resulting in a restricted use report, or in the course of such an engagement, the accountant may be asked to consider adding other parties as specified parties.

.37 If the accountant is reporting on subject matter or a presentation based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions, as described in paragraph .33, the accountant may agree to add other parties as specified parties based on the accountant's consideration of factors such as the identity of the other parties, their knowledge of the basis of the measurement or disclosure criteria, and the intended use of the report. If the accountant agrees to add other parties as specified parties, the accountant should obtain affirmative acknowledgment, preferably in writing, from the other parties of their understanding of the nature of the engagement, the measurement or disclosure criteria used in the engagement, and the related report. If the other parties are added after the accountant has issued his or her report, the report may be reissued, or the accountant may provide other written acknowledgment that the other parties have been added as specified parties. If the report is reissued, the report date should not be changed. If the accountant provides written acknowledgment that the other parties have been added as specified parties, such written acknowledgment ordinarily should state that no procedures have been performed subsequent to the date of the report.

### **Limiting the Distribution of Reports**

**.38** Because of the reasons presented in paragraph .31, the accountant should consider informing his or her client that restricted use reports are not intended for distribution to nonspecified parties, regardless of whether they are included in a document containing a separate general use report.<sup>7</sup> This section does not preclude the accountant, in connection with establishing the terms of the engagement, from reaching an understanding with the client that the intended use of the report will be restricted and from obtaining the client's agreement that the client and the specified parties will not distribute the report to parties other than those identified in the report. However, the accountant is not responsible for controlling a client's distribution of restricted use reports. Accordingly, a restricted use report should alert readers to the restriction on the use of the report by indicating that the report is not intended to be and should not be used by anyone other than the specified parties.

### **Report Language—Restricted Use**

**.39** An accountant's report that is restricted should contain a separate paragraph at the end of the report that includes the following elements:

- a. A statement indicating that the report is intended solely for the information and use of the specified parties.
- b. An identification of the specified parties to whom use is restricted. The report may list the specified parties or refer the reader to the specified parties listed elsewhere in the report.
- c. A statement that the report is not intended to be and should not be used by anyone other than the specified parties.

## **An Entity's Ability to Continue as a Going Concern**

**.40** During the performance of compilation procedures, evidence or information may come to the accountant's attention indicating that an uncertainty may exist 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 (hereinafter referred to as a *reasonable period of time*). In those circumstances, 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.

**.41** 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.

**.42** If the accountant determines that management's conclusions are unreasonable or 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 .27–.29 with respect to departures from an applicable financial reporting framework.

**.43** The accountant may emphasize an uncertainty about an entity's ability to continue as a going concern, provided that the uncertainty is disclosed in the

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<sup>7</sup> In some cases, restricted use reports filed with regulatory agencies are required by law or regulation to be made available to the public as a matter of public record. Also, a regulatory agency, as part of its oversight responsibility for an entity, may require access to restricted use reports in which they are not named as a specified party.

financial statements. In such circumstances, the accountant should follow the guidance in paragraphs .25–.26.

## Subsequent Events

.44 Evidence or information that a subsequent event that has a material effect on the compiled financial statements has occurred may come to the accountant's attention in the following ways:

- a. During the performance of compilation procedures
- b. Subsequent to the date of the accountant's compilation report but prior to the release of the report<sup>8</sup>

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.

.45 If the accountant determines that the subsequent event is not adequately accounted for in the financial statements or disclosed in the notes, he or she should follow the guidance in paragraphs .27–.29.

.46 Occasionally, a subsequent event has such a material impact on the entity that the accountant may wish to include in his or her compilation 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 .25–.26 for additional guidance with respect to emphasis of matter paragraphs.

## Subsequent Discovery of Facts Existing at the Date of the Report

.47 Subsequent to the date of the report on the financial statements that the accountant has compiled, he or she may become aware that facts may have existed at that date that might have caused him or her to believe that information supplied by the entity was incorrect, incomplete, or otherwise unsatisfactory had the accountant then been aware of such facts.<sup>9</sup> Because of the variety of conditions that might be encountered, some of the procedures contained in this section 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 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.

.48 After the date of the accountant's compilation report, the accountant has no obligation to perform other compilation 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), the

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<sup>8</sup> For purposes of this section, with respect to compiled financial statements in which the accountant does not report, the submission of the compiled financial statements is the equivalent of the accountant's compilation or review report date.

<sup>9</sup> See footnote 8.

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. The accountant should discuss the matter with his or her client at whatever management levels the accountant deems appropriate and request cooperation in whatever investigation may be necessary. In addition to management, the accountant may deem it appropriate to discuss the matter with those charged with governance. 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 report date and had not been reflected in the financial statements and (b) the accountant believes that persons are currently using or are likely to use the financial statements, and those persons would attach importance to the information, the accountant should obtain additional or revised information. Consideration should be given to, among other things, the time elapsed since the financial statements were issued.

**.49** When the accountant has concluded 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. For example

- a. if the effect of the subsequently discovered information on the accountant's report or the financial statements can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and, when applicable, the accountant's report. The reasons for the revision usually should be described in a note to the financial statements and, when applicable, referred to in the accountant's report. Generally, only the most recently issued compiled financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.
- 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).
- 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 the statements should not be used; that revised financial statements will be issued; and, when applicable, that the accountant's report will be issued as soon as practicable.

**.50** 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 .49.

**.51** If the client refuses to make the disclosures specified in paragraph .49, the accountant should notify the appropriate personnel at the highest levels within the entity, such as the manager (owner) or those charged with governance, of such refusal and of the fact that, in the absence of disclosure by the

client, the accountant will take steps as outlined subsequently 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 persons exist 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:

- 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.

**.52** The following guidelines should govern the content of any disclosure made by the accountant in accordance with paragraph .51, 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 the client has not cooperated with the accountant's attempt to substantiate information that has come to the accountant's attention and that, if the information is true, the accountant believes that the compilation 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 report should not be used.

## **Supplementary Information**

**.53** 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 or she is taking with respect to such information. 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 the purposes of additional analysis, and that the information has been compiled from information that is the representation of management, without audit or review, and that the accountant does not express an opinion or provide any assurance on such data.

## Communicating to Management and Others

**.54** 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, that matter should be brought to the attention of the appropriate level of management. The accountant need not report matters regarding illegal acts that are clearly inconsequential and may reach agreement in advance with the entity on the nature of such items to be communicated. When matters regarding fraud or an illegal act involve senior management, the accountant should report the matter to an individual or group at a higher level within the entity, such as the manager (owner) or those charged with governance. The communication may be oral or written. If the communication is oral, the accountant should document it. When matters regarding fraud or an illegal act involve an owner of the business, the accountant should consider resigning from the engagement. Additionally, the accountant should consider consulting with his or her legal counsel whenever any evidence or information comes to his or her attention during the performance of compilation procedures that fraud or an illegal act may have occurred, unless such illegal act is clearly inconsequential.

**.55** The disclosure of any evidence or information that comes to the accountant's attention during the performance of compilation procedures that fraud or an illegal act may have occurred to parties other than the client's senior management (or those charged with governance, if applicable) ordinarily is not part of the accountant's responsibility and, ordinarily, would be precluded by the accountant's ethical or legal obligations of confidentiality. The accountant should recognize, however, that in the following circumstances, a duty to disclose to parties outside of the entity may exist:

- a. To comply with certain legal and regulatory requirements
- b. To a successor accountant when the successor decides to communicate with the predecessor accountant in accordance with section 400, *Communications Between Predecessor and Successor Accountants*, regarding acceptance of an engagement to compile or review the financial statements of a nonissuer
- c. In response to a subpoena

Because potential conflicts between the accountant's ethical and legal obligations for confidentiality of client matters may be complex, the accountant may wish to consult with legal counsel before discussing matters covered by paragraph .54 with parties outside the client.

## Change in Engagement From Audit or Review to Compilation

**.56** The accountant who has been engaged to audit the financial statements of a nonissuer in accordance with auditing standards generally accepted in the United States of America or the accountant who has been engaged to review the financial statements of a nonissuer in accordance with SSARSs may, before the completion of the audit or review, be requested to change the engagement to a compilation of financial statements. A request to change the engagement may

result from a change in circumstances affecting the entity's requirement for an audit or review; a misunderstanding regarding the nature of an audit, review, or compilation; or a restriction on the scope of the audit or review, whether imposed by the client or caused by circumstances.

**.57** Before the accountant, who was engaged to perform an audit in accordance with auditing standards generally accepted in the United States of America or a review in accordance with SSARs, agrees to change the engagement to a compilation, at least the following should be considered:

- a. The reason given for the client's request, particularly the implications of a restriction on the scope of the audit or review, whether imposed by the client or by circumstances
- b. The additional audit or review effort required to complete the audit or review
- c. The estimated additional cost to complete the audit or review

**.58** A change in circumstances that affects the entity's requirement for an audit or review or a misunderstanding concerning the nature of an audit, review, or compilation would ordinarily be considered a reasonable basis for requesting a change in the engagement.

**.59** In considering the implications of a restriction on the scope of the audit or review, the accountant should evaluate the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory. Nevertheless, when the accountant has been engaged to audit an entity's financial statements and has been prohibited by the client from corresponding with the entity's legal counsel, the accountant ordinarily would be precluded from issuing a compilation report on the financial statements. If in an audit or a review engagement, a client does not provide the accountant with a signed representation letter, the accountant would ordinarily be precluded from issuing a compilation report on the financial statements.

**.60** In all circumstances, if the audit or review procedures are substantially complete or the cost to complete such procedures is relatively insignificant, the accountant should consider the propriety of accepting a change in the engagement.

**.61** If the accountant concludes, based upon his or her professional judgment, that reasonable justification exists to change the engagement, and if he or she complies with the standards applicable to a compilation engagement, the accountant should issue an appropriate compilation report. The report should not include reference to (a) the original engagement, (b) any audit or review procedures that may have been performed, or (c) scope limitations that resulted in the changed engagement.

## Effective Date

**.62** This section is effective for compilations of financial statements for periods ending on or after December 15, 2010. Early implementation of the requirements and guidance in paragraph .21 is permitted.

## Compilation Exhibit A—Illustrative Engagement Letters

### Standard Engagement Letter for a Compilation

*[Appropriate Salutation]*

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will compile, from information you provide, the annual [*and interim, if applicable*] financial statements of XYZ Company as of and for the year ended December 31, 20XX, and issue an accountant's report thereon in accordance with Statements on Standards for Accounting and Review Services (SSARSs) issued by the American Institute of Certified Public Accountants (AICPA).

The objective of a compilation is to assist you in presenting financial information in the form of financial statements. We will utilize information that is your representation without undertaking to obtain or provide any 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 [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*].

You are responsible for

- a. the preparation and fair presentation of the financial statements in accordance with [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*].
- b. designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
- c. preventing and detecting fraud
- d. identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
- e. making all financial records and related information available to us.

We are responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.

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; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion or provide any assurance regarding the financial statements being compiled.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts. However, 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 compilation procedures that fraud may have occurred.

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In addition, we will report to you any evidence or information that comes to our attention during the performance of our compilation procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

*If, during the period covered by the engagement letter, the accountant's independence is or will be impaired, insert the following:*

*We are not independent with respect to XYZ Company. We will disclose that we are not independent in our compilation report.*

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

Our fees for these services. . .

We will 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]

Acknowledged:

XYZ Company

\_\_\_\_\_  
President

\_\_\_\_\_  
Date

## Engagement Letter for a Compilation of Financial Statements Not Intended for Third Party Use

*[Appropriate Salutation]*

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will compile, from information you provide, the *[monthly, quarterly, or other frequency]* financial statements of XYZ Company as of and for the year ended December 31, 20XX.

The objective of a compilation is to assist you in presenting financial information in the form of financial statements. We will utilize information that is your representation without undertaking to obtain or provide any 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 *[the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]*.

You are responsible for

- a. the preparation and fair presentation of the financial statements in accordance with *[the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]*.
- b. designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
- c. preventing and detecting fraud.
- d. identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
- e. making all financial records and related information available to us.

We are responsible for conducting the engagement in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion or provide any assurance regarding the financial statements being compiled.

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

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The financial statements will not be accompanied by a report and are for management's use only and are not to be used by a third party.

*If, during the period covered by the engagement letter, the accountant's independence is or will be impaired, insert the following:*

*We are not independent with respect to XYZ Company.*

Our fees for these services. . .

We will 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]

Acknowledged:

XYZ Company

\_\_\_\_\_  
President

\_\_\_\_\_  
Date

## Compilation Exhibit B—Illustrative Compilation Reports

*Standard compilation report on financial statements prepared in accordance with accounting principles generally accepted in the United States of America*

### Accountant's Compilation Report

*[Appropriate Salutation]*

I (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. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

*Standard accountant's compilation report on financial statements prepared in accordance with the cash basis of accounting*

### Accountant's Compilation Report

*[Appropriate Salutation]*

I (we) have compiled the accompanying statement of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 20XX, and the related statement of revenue collected and expenses paid for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the cash basis of accounting.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the cash basis of accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

*Paragraph the accountant may add after the conclusion paragraph when management has elected to omit substantially all disclosures, but the financial statements are otherwise in conformity with accounting principles generally accepted in the United States of America*

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

*Paragraph the accountant may add after the conclusion paragraph when management has elected to omit substantially all disclosures, but the financial statements are otherwise in conformity with the income tax basis of accounting*

Management has elected to omit substantially all of the disclosures ordinarily included in financial statements prepared in accordance with 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, the financial statements are not designed for those who are not informed about such matters.

*Accountant's compilation report on financial statements prepared in accordance with accounting principles generally accepted in the United States of America when the accountant's independence has been impaired, and the accountant determines to not disclose the reason for the independence impairment*

### **Accountant's Compilation Report**

*[Appropriate Salutation]*

I (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. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

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

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

*Accountant's compilation report on financial statements prepared in accordance with accounting principles generally accepted in the United States of America when the accountant's independence has been impaired due to the accountant having a financial interest in the client, and the accountant decides to disclose the reason for the independence impairment*

### **Accountant's Compilation Report**

[Appropriate Salutation]

I (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. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

I am (we are) not independent with respect to XYZ Company as during the year ended December 31, 20XX, I (a member of the engagement team) had a direct financial interest in XYZ Company.

[Signature of accounting firm or accountant, as appropriate]

[Date]

*Accountant's compilation report on financial statements disclosing a departure from accounting principles generally accepted in the United States of America*

### **Accountant's Compilation Report**

[Appropriate Salutation]

I (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. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information

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in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements. During our compilation, I (we) did become aware of a departure (certain departures) from accounting principles generally accepted in the United States of America that is (are) described in the following paragraph.

As disclosed in Note X to the financial statements, accounting principles generally accepted in the United States of America 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 accounting principles generally accepted in the United States of America had been followed, the land account and stockholders' equity would have been decreased by \$500,000.

*or*

A statement of cash flows for the year ended December 31, 20XX, has not been presented. Accounting principles generally accepted in the United States of America require that such a statement be presented when financial statements purport to present financial position and results of operations.<sup>1</sup>

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

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<sup>1</sup> If a statement of cash flows is not presented, the first paragraph of the accountant's compilation report should be modified accordingly.

## AR Section 9080

# ***Compilation of Financial Statements: Accounting and Review Services Interpretations of Section 80***

### **1. Reporting When There Are Significant Departures From the Applicable Financial Reporting Framework**

**.01 Question**—When the financial statements include significant departures from the applicable financial reporting framework, may the accountant modify his or her standard report in accordance with paragraphs .27–.29 of section 80, *Compilation of Financial Statements*, to include a statement that the financial statements are not in conformity with the applicable financial reporting framework?

**.02 Interpretation**—No. Including such a statement in the accountant's compilation report would be tantamount to expressing an adverse opinion on the financial statements as a whole. Such an opinion can be expressed only in the context of an audit engagement.

**.03** However, paragraph .25 of section 80 states that an accountant may emphasize, in any report on financial statements, a matter disclosed in the financial statements. The accountant may wish, therefore, to emphasize the limitations of the financial statements in a separate paragraph of his or her compilation report, depending on his or her assessment of the possible dollar magnitude of the effects of the departures, the significance of the affected items to the entity, the pervasiveness and overall impact of the misstatements, and whether disclosure has been made of the effects of the departures. Such separate paragraph, which would follow the other modifications of his or her report (see illustrations in Compilation Exhibit B, "Illustrative Compilation Reports"), might read as follows (the illustration assumes that the accountant is reporting on financial statements in which there are significant departures from accounting principles generally accepted in the United States of America):

Because the significance and pervasiveness of the matters previously discussed makes it difficult to assess their impact on the financial statements 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 accounting principles generally accepted in the United States of America.

**.04 Interpretation**—Inclusion of such a separate paragraph in the accountant's compilation report is not a substitute for disclosure of the specific departures or the effects of such departures when they have been determined by management or are known as a result of the accountant's procedures.

[Issue Date: August 1981; Revised: November 2002; Revised: May 2004; Revised: July 2005; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 7 to section 100).]

## 2. Reporting on Tax Returns

**.05 Question**—May an accountant comply with a request from a nonissuer to issue a compilation report on financial information contained in a tax return, as in Form 1040, *U.S. Individual Income Tax Return*, or Form 1120, *U.S. Corporation Income Tax Return*, or in an information return, as in Form 990, *Return of Organization Exempt from Income Tax*; Form 1065, *U.S. Partnership Return of Income*; or Form 5500, *Return of Employee Benefit Plan*?

**.06 Interpretation**—Yes. Although paragraph .01 of section 80 states that the section establishes standards and provides guidance on compilations of financial statements and financial information included in a tax return is not included in the definition of financial statements, an accountant may decide to accept an engagement to issue a compilation report on such a return. In that case, the performance and reporting requirements of section 80 would apply.

[Issue Date: November 1982; Revised: February 2008; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 10 to section 100).]

## 3. Additional Procedures Performed in a Compilation Engagement

**.07 Question**—If an accountant performs procedures customarily performed in a review or audit but not in a compilation, is the accountant required to change the engagement to a review or an audit?

**.08 Interpretation**—No. Paragraph .13 of section 80 states that in a compilation engagement the accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. However, the accountant is not precluded from making inquiries or performing additional procedures.

**.09** The wording of confirmation requests or other communications related to additional procedures performed in the course of a compilation engagement should not use phrases such as "as part of an *audit* of the financial statements" (emphasis supplied).

[Issue Date: March 1983; Revised: October 2000; Revised: November 2002; Revised: May 2004; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 13 to section 100).]

## 4. Differentiating a Financial Statement Presentation From a Trial Balance

**.10 Question**—Paragraph .01 of section 80 states that the accountant is required to comply with the provisions of section 80 whenever he or she is engaged to report on compiled financial statements or submits financial statements to a client or third parties. What attributes should an accountant consider when differentiating a financial statement from a trial balance to determine if he or she is required to comply with the provisions of section 80?

**.11 Interpretation**—The accountant may consider, among other matters, the following attributes when determining whether a financial presentation is a financial statement or a trial balance:

- Generally, a financial statement features the combination of similar general ledger accounts to create classifications or account groupings with corresponding subtotals and totals of dollar amounts. Some examples of these classifications or account groupings are current assets, long-term debt, and revenues. In addition, contra accounts are generally netted against the related primary accounts in financial statement presentations (that is, "Accounts

Receivable Net of Allowance for Bad Debts"). In contrast, a trial balance consists of a listing of all of the general ledger accounts and their corresponding debit or credit balances.

- Financial statements generally contain titles that identify the presentation as one intended to present financial position, results of operations, or cash flows. Typical titles for financial statements include the following:
  - Balance Sheet
  - Statement of Income or Statement of Operations
  - 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 of Revenue and Expenses
  - Statement of Financial Position
  - Statement of Activities
  - Summary of Operations
  - Statement of Operations by Product Lines
  - Statement of Cash Receipts and Disbursements

Examples of typical titles for trial balance presentations are as follows:

- Trial Balance
- Working Trial Balance
- Adjusted Trial Balance
- Listing of General Ledger Accounts
- The balance sheet in a set of financial statements segregates asset, liability, and owners' equity accounts and presents these three elements based on the following basic example equation:

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

The elements of the income statement and their relationship to net income are presented based on the following basic example equation:

$$\text{Revenues} - \text{Expenses} + \text{Gains} - \text{Losses} = \text{Net Income}$$

In a trial balance, no attempt is made to establish a mathematical relationship among the elements except that total debits equal total credits.

- The income statement in a set of financial statements generally contains a caption such as "Net Income" or "Net Revenues Over Expenses" that identifies the net results of operations. Trial balance presentations generally do not contain similar captions.

- The balance sheet in a set of financial statements usually presents assets in the order of their liquidity and liabilities in the order of their maturity. In a trial balance, the accounts are generally listed in account number order as they appear in the general ledger.
- In a set of financial statements, the income statement articulates with the balance sheet because the net results of operations are added to or subtracted from opening retained earnings. In a trial balance, the net results of operations are generally not closed out to retained earnings.

**.12** The accountant's use of judgment is important when considering these attributes to determine whether the financial presentation constitutes a financial statement or a trial balance. When making this determination, the accountant may consider the preponderance of the attributes of the financial presentation. For example, a trial balance that contains one or two attributes of a financial statement may, in the accountant's judgment, still constitute a trial balance. When the presentation is deemed to be a financial statement, the accountant, at a minimum, should compile the financial statements in accordance with section 80 when he or she submits such financial statements to his or her client or third parties.

[Issue Date: September 1990; Revised: October 2000; Revised: February 2008; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 15 to section 100).]

## 5. Submitting Draft Financial Statements

**.13 Question**—Accountants frequently submit draft financial statements (a) because information needed to complete a compilation of the financial statements will not be available until a later date, or (b) to provide the client with the opportunity to read and analyze the financial statements prior to their final issuance. Is it permissible for the accountant to submit draft financial statements without intending to comply with the reporting provisions of section 80?

**.14 Interpretation**—Except in those instances in which the financial statements are not expected to be used by a third party, as permitted under paragraphs .22–.24 of section 80, an accountant is precluded from submitting draft financial statements unless he or she intends to submit those financial statements in final form accompanied by an appropriate compilation report prescribed by section 80. However, as long as the accountant intends to issue a compilation report on the financial statements in final form and labels each page of draft financial statements with words such as "Draft," "Preliminary Draft," "Draft—Subject to Changes," or "Working Draft," the accountant is not required to comply with the reporting provisions of section 80 with respect to those draft financial statements. In the rare circumstance in which the accountant intended to but never submitted final financial statements, the accountant may want to document the reasons why he or she was unable to submit financial statements in final form accompanied by an appropriate compilation report.

[Issue Date: September 1990; Revised: October 2000; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 17 to section 100).]

## 6. Reporting When Financial Statements Contain a Departure From Promulgated Accounting Principles That Prevents the Financial Statements From Being Misleading

**.15 Question**—The "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct states

A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

Paragraphs .27–.29 of section 80 do not address the "Accounting Principles Rule" circumstances. When the circumstances contemplated by the "Accounting Principles Rule" are present, how should the accountant report on the information described in the "Accounting Principles Rule?"

**.16 Interpretation**—The "Accounting Principles Rule" does not apply to engagements to report on a compiled financial statements. Accordingly, when the accountant is reporting on a compiled financial statements and is confronted with the circumstances contemplated by the "Accounting Principles Rule," the guidance in paragraphs .27–.29 of section 80 pertaining to departures from generally accepted accounting principles (GAAP) should be followed.

[Issue Date: February 1991; Revised: October 2000; Revised: November 2002;

Revised: May 2004; Revised: July 2005;

Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 19 to section 100); Revised: January 2015.]

## 7. Applicability of Statements on Standards for Accounting and Review Services to Litigation Services

**.17 Question**—When are litigation services excluded from the applicability of Statements on Standards for Accounting and Review Services (SSARSs)?

**.18 Interpretation**—SSARSs do not apply to financial statements submitted in conjunction with litigation services that involve pending or potential formal legal or regulatory proceedings before a "trier of fact" in connection with the resolution of a dispute between two or more parties when the

- a. service consists of being an expert witness.
- b. service consists of being a "trier of fact" or acting on behalf of one.
- c. accountant's work under the rules of the proceedings is subject to detailed analysis and challenge by each party to the dispute.
- d. accountant is engaged by an attorney to do work that will be protected by the attorney's work product privilege, and such work is not intended to be used for other purposes.

When performing such litigation services, the accountant should comply with the "General Standards Rule" (ET sec. 1.300.001).

**.19 Question**—When do SSARSs apply to litigation service engagements?

**.20 Interpretation**—SSARSs apply to litigation service engagements when the accountant

- a. submits unaudited financial statements of a nonissuer that are the representation of management (owners) to others who,

under the rules of the proceedings, do not have the opportunity to analyze and challenge the accountant's work, or

- b. is specifically engaged to submit, in accordance with SSARSs, financial statements that are the representation of management (owners).

[Issue Date: May 1991; Revised: October 2000; Revised: February 2008; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 20 to section 100); Revised: January 2015.]

## 8. Applicability of Statements on Standards for Accounting and Review Services When Performing Controllorship or Other Management Services

**.21 Question**—If the accountant is in public practice and provides an entity with controllorship or other management services that entail the submission of financial statements, is the accountant required to follow the requirements of section 80?

**.22 Interpretation**—If the accountant is in public practice as defined in ET section 0.400 of the AICPA Code of Professional 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 section 80, including any requirement to disclose a lack of independence.

**.23** If the accountant is in public practice and is also a stockholder, partner, director, officer, or employee of the entity, the accountant may either (a) comply with the requirements of section 80, or (b) communicate, preferably in writing, the accountant's relationship to the entity (for example, stockholder, partner, director, officer, or employee). The following is an example of the type of communication that may be used by the accountant:

The accompanying balance sheet of Company X as of December 31, 20XX, and the related statements of income and cash flows for the year then ended have been prepared by [name of accountant], CPA. I have prepared such financial statements in my capacity [describe capacity, for example, as a director] of Company X.

**.24** If an accountant is not in public practice, the issuance of a report under SSARSs would be inappropriate; however, the previously mentioned communication may be used.

[Issue Date: July 2002; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 21 to section 100); Revised: January 2015.]

## 9. Use of the Label "Selected Information—Substantially All Disclosures Required by [the applicable financial reporting framework] Are Not Included" in Compiled Financial Statements

**.25 Question**—Can an accountant label notes to the financial statements "Selected Information—Substantially All Disclosures Required by [identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)] Are Not Included" when the client includes more than a few required disclosures?

**.26 Interpretation**—No. As discussed in paragraph .20 of section 80, when the entity wishes to include disclosures about only a few matters in the form of notes to the financial statements, such disclosures should be labeled "Selected Information—Substantially All Disclosures Required by [identify the applicable financial reporting framework (for example "accounting principles generally accepted in the United States of America")] Are Not Included."

.27 When the financial statements include more than a few disclosures, this guidance is not appropriate. The omission of one or more notes, when substantially all other disclosures are presented, should be treated in a compilation report like any other departure from the applicable financial reporting framework, and the nature of the departure and its effects, if known, should be disclosed in accordance with paragraphs .27–.29 of section 80. The label "Selected Information—Substantially All Disclosures Required by [*identify the applicable financial reporting framework (for example "accounting principles generally accepted in the United States of America")*] Are Not Included" is not intended to be used for the omission of (intentionally or unintentionally) one or more specific disclosures. In determining whether use of the label is appropriate, the accountant needs to apply professional judgment to all the facts and circumstances.

[Issue Date: December 2002; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 22 to section 100).]

## 10. Omission of the Display of Comprehensive Income in Compiled Financial Statements

.28 *Question*—When an element of comprehensive income is present, can the display of comprehensive income be omitted when issuing a compilation report on financial statements that omit substantially all disclosures required by accounting principles generally accepted in the United States of America?

.29 *Interpretation*—Yes. Financial Accounting Standards Board (FASB) *Accounting Standards Codification (ASC) 220, Comprehensive Income*, requires the display of comprehensive income when a full set of financial statements is presented in conformity with accounting principles generally accepted in the United States of America. However, the display of comprehensive income may be omitted by identifying the omission in the compilation report or, if the engagement is to compile financial statements that are not expected to be used by a third party and the accountant does not report on those financial statements, in the engagement letter. The following is suggested modified wording (shown in *italic*) to the paragraph in the compilation report:

Management has elected to omit substantially all the disclosures, (the statement of cash flows, if applicable,) *and the display of comprehensive income* required by accounting principles generally accepted in the United States of America. If the omitted disclosures, (the statement of cash flows, if applicable,) *and the display of comprehensive income* 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.

.30 If the accountant compiles financial statements that include substantially all disclosures required by accounting principles generally accepted in the United States of America but omit the display of comprehensive income, the omission is a departure from accounting principles generally accepted in the United States of America.

.31 Additionally, if an element of comprehensive income has not been computed, for example, unrealized gains and losses arising from investments in marketable securities classified as "available for sale," then the accountant should consider a departure from accounting principles generally accepted in the United States of America and follow the guidance in paragraphs .27–.29 of section 80.

[Issue Date: September 2003; Revised: May 2004; Revised: July 2005; Revised: June 2009; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 25 to section 100).]

## 11. Special-Purpose Financial Statements to Comply With Contractual Agreements or Regulatory Provisions

**.32 Question**—An accountant may be asked to compile special-purpose financial statements prepared to comply with a contractual agreement or regulatory provision that specifies a special basis of presentation. In most circumstances, these financial statements are intended solely for the use of the parties to the agreement, regulatory bodies, or other specified parties. How should the accountant modify the standard compilation report when reporting on these compiled special-purpose financial statements?

**.33 Interpretation**—An accountant who is asked to compile special-purpose financial statements prepared to comply with a contractual agreement or a regulatory provision that specifies a special basis of presentation may issue a compilation report on those financial statements in accordance with section 80 as described in this interpretation. This interpretation describes reporting on

- a. special-purpose financial statements prepared in compliance with a contractual agreement or regulatory provision that does not constitute a complete presentation of the entity's assets, liabilities, revenues, and expenses, but is otherwise prepared in conformity with GAAP or an other comprehensive basis of accounting (OCBOA), or
- b. a special-purpose financial presentation (may be a complete set of financial statements or a single financial statement) prepared on a basis of accounting prescribed in an agreement that does not result in a presentation in conformity with GAAP or an OCBOA.

### ***Financial Statements Prepared on a Basis of Accounting Prescribed in a Contractual Agreement or Regulatory Provision That Results in an Incomplete Presentation but One That Is Otherwise in Conformity With GAAP or an OCBOA***

**.34** An entity may engage an accountant to compile a special-purpose financial statement prepared in compliance with a contractual agreement or regulatory provision that does not constitute a complete presentation of the entity's assets, liabilities, revenues, or expenses, but is otherwise prepared in conformity with GAAP or an OCBOA. For example, a governmental agency may require a statement of gross income and certain expenses of an entity's real estate operation in which income and expenses are measured in conformity with GAAP, but expenses are defined to exclude certain items such as interest, depreciation, and income taxes. Such a statement may also present the excess of gross income over defined expenses. Also, a buy-sell agreement may specify a statement of gross assets and liabilities of the entity measured in conformity with GAAP, but limited to the assets to be sold and liabilities to be transferred pursuant to the agreement.

**.35** When the accountant submits compiled special-purpose financial statements prepared on a basis of accounting prescribed in a contractual agreement or regulatory provision that results in an incomplete presentation but one that is otherwise prepared in conformity with GAAP or an OCBOA, the

accountant's report should be modified to include a separate paragraph with the following information:

- An explanation of what the financial statement is intended to present and a reference to the note to the special-purpose financial statement that describes the basis of presentation
- If the basis of presentation is in conformity with GAAP or an OCBOA, a statement that the presentation is not intended to be a complete presentation of the entity's assets, liabilities, revenues, and expenses
- A separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity, the parties to the contract or agreement, the regulatory agency with which the report is being filed, or those with whom the entity is negotiating directly, and is not intended to be and should not be used by anyone other than these specified parties

**.36** The following is an illustrative example of a compilation report on special-purpose financial statements:

I (we) have compiled the accompanying statement of net assets sold of XYZ Company as of December 31, 20X1. I (we) have not audited or reviewed the accompanying statement of net assets sold and, accordingly, do not express an opinion or provide any assurance about whether the statement of net assets sold is in accordance with the purchase agreement described in Note A.

Management (owners) is (are) responsible for the preparation and fair presentation of the statement of net assets sold in accordance with the purchase agreement described in Note A and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the statement of net assets sold.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

The accompanying statement was prepared for the purpose of presenting the net assets of XYZ Company sold to ABC Company pursuant to the purchase agreement described in Note A, and is not intended to be a complete presentation of XYZ Company's assets and liabilities.

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

***Financial Statements Prepared on a Basis of Accounting Prescribed in an Agreement That Results in a Presentation That Is Not in Conformity With GAAP or an OCBOA***

**.37** An entity may engage an accountant to compile a special-purpose financial statement prepared in conformity with a basis of accounting that departs from GAAP or an OCBOA. A loan agreement, for example, may require the borrower to prepare consolidated financial statements in which assets, such as inventory, are presented on a basis that is not in conformity with GAAP or an OCBOA. Also, an acquisition agreement may require the financial statements of the entity being acquired (or a segment of it) to be prepared in conformity with

GAAP except for certain assets, such as receivables, inventories, and properties for which a valuation basis is specified in the agreement.

**.38** Financial statements prepared under a basis of accounting as discussed in the preceding are not considered to be prepared in conformity with an OCBOA because the criteria used to prepare such financial statements do not meet the requirement of "having substantial support," even though the criteria are definite.

**.39** When the accountant submits compiled special-purpose financial statements prepared on a basis of accounting prescribed in an agreement that results in a presentation that is not in conformity with GAAP or an OCBOA, the accountant's report should be modified to include a separate paragraph with the following information:

- An explanation of what the presentation is intended to present and a reference to the note to the special-purpose financial statements that describes the basis of presentation.
- A statement that the financial statement is not intended to be a presentation in conformity with GAAP or an OCBOA.
- A description and the source of significant interpretations, if any, made by the company's management relating to the provisions of a relevant agreement.
- A separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity, the parties to the contract or agreement, the regulatory agency with which the report is being filed, or those with whom the entity is negotiating directly, and is not intended to be and should not be used by anyone other than these specified parties. For example, if the financial statements have been prepared for the specified purpose of obtaining bank financing, the report's use should be restricted to the various banks with whom the entity is negotiating the proposed financing.

**.40** The following is an illustrative example of a compilation report on special-purpose financial statements:

I (we) have compiled the special-purpose statement of assets and liabilities of XYZ Company as of December 31, 20X1, and the related special-purpose statements of revenue and expenses and of cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the acquisition agreement between ABC Company and XYZ Company as discussed in Note A.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the acquisition agreement between ABC Company and XYZ Company as described in Note A and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

The accompanying special-purpose financial statements were prepared for the purpose of complying with the acquisition agreement between ABC Company and XYZ Company as discussed in Note A, and are not intended to be a presentation in conformity with GAAP.

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

[Issue Date: December 2006; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 28 to section 100).]

## 12. Reporting on an Uncertainty, Including an Uncertainty About an Entity's Ability to Continue as a Going Concern

**.41 Question**—How should an accountant modify the standard compilation report when, during the performance of compilation 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?

**.42 Interpretation**—Disclosure requirements with respect to uncertainties are included in FASB ASC 275, *Risks and Uncertainties*; FASB ASC 450, *Contingencies*; and other authoritative accounting literature. However, the accounting literature does not provide specific guidance on disclosure of uncertainties caused by concern about an entity's ability to continue as a going concern. Continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. The accountant should follow the guidance in paragraphs .40–.43 of section 80 with respect to his or her consideration of the entity's ability to continue as a going concern during the performance of compilation procedures.

**.43** 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-matter paragraph with respect to the uncertainty in the accountant's compilation 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.

**.44 Question**—If the accountant, while performing a compilation, becomes aware of a material uncertainty other than a going concern uncertainty (for example, an uncertainty regarding pending or threatened litigation), what should the accountant consider in deciding whether a report modification is necessary?

**.45 Interpretation**—Disclosure requirements with respect to uncertainties are included in FASB ASC 275, 450, and other authoritative accounting literature. If the accountant determines that the disclosure of the uncertainty is not in accordance with the applicable financial reporting framework, he or she should follow the guidance in paragraphs .27–.29 of section 80.

**.46** If the accountant concludes that management's disclosure of the uncertainty is in accordance with the applicable financial reporting framework but further decides to include an emphasis-of-matter paragraph with respect to the uncertainty in the accountant's compilation report, he or she may use the following language (the following is assuming that the financial statements

were prepared in accordance with accounting principles generally accepted in the United States of America):

As discussed in Note X, the Company is currently named in a legal action. The Company has determined that it is not possible to predict the eventual outcome of the legal action but has determined that the resolution of the action will not result in an adverse judgment that would materially affect the financial statements. Accordingly, the accompanying financial statements do not include any adjustments related to the legal action under FASB ASC 450.

**.47 Question**—Paragraph .20 of section 80 allows the accountant, when he or she is requested to do so, to compile financial statements that omit substantially all of the disclosures required by an applicable financial reporting framework, provided the omission of substantially all disclosures was not, to the accountant's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements, and the accountant includes a paragraph in the accountant's compilation report regarding the omission of substantially all disclosures. Should disclosure of an uncertainty be considered so significant that it also could never be omitted?

**.48 Interpretation**—No. The user is adequately warned of the limitations of the financial statements by the report language required by paragraph .20 of section 80.

[Issue date: February 2007; Revised: February 2008; Amended: December 2008; Revised: June 2009; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 29 to section 100)]

### 13. Compilations of Financial Statements Prepared in Accordance With International Financial Reporting Standards

**.49 Question**—The International Accounting Standards Board (IASB) has been designated by the Council of the AICPA as the body to establish international financial reporting standards for both private and public entities pursuant to the "Compliance With Standards Rule" (ET sec. 1.310.001) and the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct as of May 18, 2008. As a result, how would an accountant apply the reporting guidance in section 80 when engaged to compile financial statements presented in accordance with International Financial Reporting Standards (IFRSs) as issued by the IASB?

**.50 Interpretation**—A report illustration of how an accountant would apply the reporting guidance in section 80 when reporting on financial statements presented in accordance with IFRSs is as follows:

#### Accountant's Compilation Report

*[Appropriate Salutation]*

I (we) have compiled the accompanying statements of financial position of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of comprehensive income, changes in equity, and cash flows for the years then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards

Board and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

When the accountant compiles financial statements that omit substantially all disclosures but are otherwise in conformity with IFRSs 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.

**.51 Question**—Unlike accounting principles generally accepted in the United States of America as issued by FASB, IFRSs require an entity to disclose comparative information in respect of the previous comparative period for all amounts presented in the current year's financial statements. When the accountant compiles financial statements that omit prior year information, should such omission be disclosed in the accountant's compilation report as a departure from IFRSs as issued by the IASB in accordance with paragraphs .27–.29 of section 80?

**.52 Interpretation**—Yes. Because IFRSs require an entity to disclose comparative information in respect of the previous comparative period for all amounts presented in the current year's financial statements, the failure to include such information in financial statements would be a departure from GAAP. An example of a paragraph that may be added to the accountant's compilation report is as follows:

Comparative information with respect to the year ended December 31, 20XX-1 has not been presented. International Financial Reporting Standards [or *IFRSs for SMEs*] as issued by the International Accounting Standards Board require an entity to disclose comparative information in respect of the previous comparative period for all amounts presented in the current year's financial statements.

When the accountant compiles financial statements that omit substantially all disclosures and comparative information in respect of the previous comparative period but are otherwise in conformity with IFRSs 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) and comparative financial information as of and for the year ended December 31, 20XX-1 required by International Financial Reporting Standards [or *IFRSs for SMEs*] as issued by the International Accounting Standards Board. If the omitted disclosures, statement, and comparative

financial information 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.

[Issue Date: May 2008; Revised: June 2010; Revised: August 2010; Revised: December 2010 (formerly Interpretation No. 30 to section 100); Revised: January 2015.]

#### **14. Compilations of Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country**

**.53 Question**—An accountant may be engaged to compile financial statements that have been prepared in conformity with a financial reporting framework generally accepted in another country (including financial statements prepared in accordance with a jurisdictional variation of IFRSs such that the entity's financial statements do not contain an explicit and unreserved statement of compliance with IFRSs as issued by the IASB). How should an accountant apply the reporting requirements of section 80 when reporting on those financial statements?

**.54 Interpretation**—If the financial statements are intended for use only outside of the United States of America, the accountant may report using the standard form of U.S. compilation report modified as appropriate to identify the applicable financial reporting framework, or alternatively, the accountant may report using the standard compilation report form and content of the other country. (See Interpretation No. 15 with respect to Considerations Related to Compilations Performed in Accordance with International Standard on Related Services [ISRS] 4410 (Revised), *Compilation Engagements*).

**.55** The standard compilation report used in another country, even when it appears similar to that used in the United States of America, may convey a different meaning and entail a different responsibility on the part of the accountant due to custom or culture. Issuing a standard compilation report of another country may require an understanding of local laws. When issuing the accountant's standard compilation report of another country, the accountant is required to obtain an understanding of applicable legal responsibilities, in addition to the compilation standards and accounting principles generally accepted in the other country, as indicated in paragraph .11 of section 80. Therefore, depending on the nature and extent of the accountant's knowledge and experience, the accountant may wish to consult with persons having expertise in the reporting practices of the other country and associated legal responsibilities to obtain the understanding needed to issue that country's standard compilation report.

**.56** If the accountant's report is intended for use in the United States of America, the reporting requirements described in paragraphs .16–.19 of section 80 would apply. Additionally, paragraph .31 of section 80 states that a need for restriction on the use of the report may result from a number of circumstances, including, but not limited to, the purpose of the report and the potential for the report to be misunderstood when taken out of context in which it was intended to be used. Because of the nature of the basis of presentation of the financial statements there is a presumption that the report would be misunderstood or taken out of context in which it was intended to be used. In such instances, the accountant may use the following form of report:

Accountant's Compilation Report

[Appropriate Salutation]

I (we) have compiled the accompanying balance sheets of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with [*the financial reporting framework generally accepted in another country, including identification of the nationality of the framework*].

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with [*the financial reporting framework generally accepted in another country, including identification of the nationality of the framework*] and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

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

[Signature of accounting firm or accountant, as appropriate]

[Date]

**.57** When the financial statements will be used both outside of the United States of America as well as in the United States of America, nothing precludes the accountant from issuing two reports—a report to be used only outside of the United States of America and another report to be used in the United States of America.

[Issue Date: May 2008; Revised: June 2010; Revised: August 2010; Revised: December 2010 (formerly Interpretation No. 30 to section 100); Revised: December 2012; Revised, February 2015.]

## **15. Considerations Related to Compilations Performed in Accordance With International Standard on Related Services 4410 (Revised), *Compilation Engagements*, Issued by the International Auditing and Assurance Standards Board**

**.58 Question**—May a U.S. accountant perform a compilation of historical financial statements of a U.S. entity<sup>1</sup> in accordance with ISRS 4410 (Revised) issued by the International Auditing and Assurance Standards Board (IAASB)? The financial statements may have been prepared in accordance with IFRSs or accounting principles generally accepted in the United States of America.

**.59 Interpretation**—Yes. An accountant performing a compilation of historical financial statements of a U.S. entity is required to follow the compilation standards as promulgated by the AICPA's Accounting and Review Services

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<sup>1</sup> A U.S. entity is an entity that is either organized or domiciled in the United States of America.

Committee. However, those standards do not prohibit an accountant from indicating that the compilation also was conducted in accordance with another set of compilation standards. In an engagement to compile the historical financial statements in accordance with ISRS 4410 (Revised), the accountant may perform the compilation in accordance with SSARs as well as ISRS 4410 (Revised). Such a compilation report may read as follows:

I (we) have compiled the accompanying balance sheets of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants and in accordance with the International Standard on Related Services (ISRS 4410 [Revised]) issued by the International Auditing and Assurance Standards Board applicable to compilation engagements. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

**.60** If the report is for use only outside of the United States of America, the accountant is still required to apply SSARs, except for requirements related to report form and content.

[Issue Date: May 2008; Revised: June 2010; Revised: August 2010; Revised: December 2010 (formerly Interpretation No. 30 to section 100); Revised: December 2012; Revised, January 2015.]

## 16. Preparation of Financial Statements for Use by an Entity's Auditors

**.61 Question**—Paragraph .22 of section 80 states "When the accountant submits compiled financial statements to his or her client that are not expected to be used by a third party, he or she is not required to issue a compilation report." In the situation in which 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, is the client's outside auditor deemed to be a third party using the financial statements?

**.62 Interpretation**—No. Although the client's outside auditor is a third party, the auditor is not deemed to be using the financial statements. The auditor's role is to apply auditing procedures to those statements in order to obtain sufficient appropriate audit evidence to support his or her opinion on those statements. Accordingly, the requirements in paragraphs .22–.24 of section 80 are applicable.

[Issue Date: December 2008; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 31 to section 100).]

## 17. Required Supplementary Information That Accompanies Compiled Financial Statements

**.63 Question**—Paragraph .53 of section 80 addresses situations when the basic financial statements are accompanied by information presented for supplementary analysis purposes. Certain information presented for supplementary analysis purposes is required by a body designated by the AICPA Council to establish GAAP pursuant to the "Compliance With Standards Rule" and the "Accounting Principles Rule"<sup>2</sup> (hereinafter referred to as "required supplementary information"). Examples of required supplementary information that may accompany compiled financial statements include the following:

- With respect to common interest realty associations, estimates of current or future costs of major repairs and replacements of common property that will be required in the future as required by FASB ASC 972-235-50-3
- Management's discussion and analysis and budgetary comparison statements as required by Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*.

Is the accountant required to apply procedures to required supplementary information that accompanies compiled financial statements?

**.64 Interpretation**—No. SSARSs do not require the accountant to apply procedures to any information presented for supplementary analysis purposes, including required supplementary information. However, nothing precludes the accountant from compiling the required supplementary information if engaged to do so.

**.65 Question**—Paragraph .53 of section 80 states that when the basic financial statements are accompanied by information presented for supplementary analysis purposes, the accountant should indicate the degree of responsibility, if any, he or she is taking with respect to such information. How may an accountant modify the accountant's compilation report to refer to the required supplementary information and explain the circumstances regarding its presentation?

**.66 Interpretation**—The accountant may modify the accountant's compilation report by including a separate paragraph that refers to the required supplementary information and explains the circumstances regarding its presentation. That separate paragraph would be presented after the paragraph describing the accountant's responsibility and may read as follows:

### ***The Required Supplementary Information Is Included and the Accountant Did Not Compile the Required Supplementary Information***

*[Identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)] require that*

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<sup>2</sup> The bodies designated by the AICPA Council to establish professional standards with respect to financial accounting and reporting principles pursuant to these rules are the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the Federal Accounting Standards Advisory Board, and the International Accounting Standards Board.

[*identify the required supplementary information*] on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by [*identify the designated accounting standard setter*] who considers it to be an essential part of financial reporting and for placing the basic financial statements in an appropriate operational, economic, or historical context. Such information was not audited, reviewed, or compiled by me (us) and, accordingly, I (we) do not express an opinion or provide any assurance on it.

***The Required Supplementary Information Is Included, the Accountant Compiled the Required Supplemental Information and No Material Departures From the Prescribed Guidelines Regarding the Required Supplementary Information Have Been Identified***

[*Identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*] require that [*identify the required supplementary information*] on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by [*identify the designated accounting standard setter*] who considers it to be an essential part of financial reporting and for placing the basic financial statements in an appropriate operational, economic, or historical context. Such information has been compiled by me (us) without audit or review and, accordingly, I (we) do not express an opinion or provide any assurance on it.

***All Required Supplementary Information Omitted***

Management has omitted [*describe the missing required supplementary information*] that [*identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*] require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by [*identify the designated accounting standard setter*] who considers it to be an essential part of financial reporting and for placing the basic financial statements in an appropriate operational, economic, or historical context.

***Some Required Supplementary Information is Omitted and Some Is Presented in Accordance With the Prescribed Guidelines Regarding the Required Supplementary Information***

[*Identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*] require that [*identify the included supplementary information*] be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by [*identify designated accounting standard setter*] who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Such information was not audited, reviewed, or compiled by me (us) and, accordingly, I (we) do not express an opinion or provide any assurance on it.

Management has omitted [*describe the missing required supplementary information*] that [*identify the applicable financial reporting framework*] require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by [*identify designated accounting standard setter*] who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context.

***Material Departures From the Prescribed Guidelines Regarding the Required Supplementary Information Were Identified While Compiling the Required Supplementary Information***

*[Identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)] require that the [identify the supplementary information] on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by [identify designated accounting standard setter] who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Such information was compiled by me (us) without audit or review and, accordingly, I (we) do not express an opinion or provide any assurance on it. However, during my (our) compilation, I (we) did become aware of the following material departures from the prescribed guidelines regarding the required supplementary information [identify the required supplementary information and describe the material departures from the prescribed guidelines regarding the required supplementary information].*

**.67 Question**—When required supplementary information is omitted from financial statements that omit substantially all the disclosures required by accounting principles generally accepted in the United States of America (U.S. GAAP), may the accountant combine the paragraph discussing the omission of substantially all the disclosures, as required by paragraph .20 of section 80, with the paragraph referring to the omission of the required supplementary information?

**.68 Interpretation**—No. Because required supplementary information is not a part of the basic financial statements and the omitted disclosures (and the statement of cash flows, if applicable) are required by U.S. GAAP to be included in the basic financial statements, the report elements required by paragraphs .20 and .53 of section 80 are not compatible.

[Issue Date: October 2011; Revised: January 2015.]

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## AR Section 90

### *Review of Financial Statements*

**Issue date, unless otherwise indicated: December 2009**

**See section 9090 for interpretations of this section.**

**Source: SSARS No. 19; SSARS No. 20.**

**.01** This section establishes standards and provides guidance on reviews of financial statements. The accountant is required to comply with the provisions of this section whenever he or she has been engaged to review financial statements, except for reviews of interim financial information if the following are true:

- a. The entity's latest annual financial statements have been audited by the accountant or a predecessor.
- b. The accountant either
  - i. has been engaged to audit the entity's current year financial statements, or
  - ii. audited the entity's latest annual financial statements and, when it is expected that the current year financial statements will be audited, the appointment of another accountant to audit the current year financial statements is not effective prior to the beginning of the period covered by the review.
- c. The entity prepares its interim financial information in accordance with the same financial reporting framework as that used to prepare the annual financial statements.

Accountants engaged to perform reviews of interim financial information when the conditions in (a)–(c) are met should perform such reviews in accordance with AU-C section 930, *Interim Financial Information*. [As amended, effective for reviews of financial statements for periods beginning after December 15, 2011, by SSARS No. 20. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

**.02** The accountant is precluded from performing a review engagement if the accountant's independence is impaired for any reason. In making a judgment about whether he or she is independent, the accountant should be guided by the AICPA's Code of Professional Conduct.

### **Establishing an Understanding**

**.03** The accountant should establish an understanding with management regarding the services to be performed for review engagements<sup>1</sup> and should document the understanding through a written communication with management. Such an understanding reduces the risk that either the accountant or

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<sup>1</sup> See paragraph .29 of QC section 10, *A Firm's System of Quality Control*. [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SQCS No. 8.]

management may misinterpret the needs or expectations of the other party. For example, it reduces the risk that management may inappropriately rely on the accountant to protect the entity against certain risks or to perform certain functions that are management's responsibility. The accountant should ensure that the understanding includes the objectives of the engagement, management's responsibilities, the accountant's responsibilities, and the limitations of the engagement. In some cases, the accountant may establish such understanding with those charged with governance.

**.04** An understanding with management and, if applicable, those charged with governance regarding a review of financial statements should include the following matters:

- The objective of a review is to obtain 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 the applicable financial reporting framework.
- Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
- Management is responsible for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
- Management is responsible 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.
- Management is responsible for making all financial records and related information available to the accountant.
- Management will provide the accountant, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.
- The accountant is responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.
- A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management.
- A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. A review does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, the accountant will not express an opinion regarding the financial statements as a whole.

- The engagement cannot be relied upon to disclose errors, fraud,<sup>2</sup> or illegal acts.<sup>3</sup>
- 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 review procedures that fraud or an illegal act may have occurred.<sup>4</sup> The accountant need not report any matters regarding illegal acts that may have occurred that are clearly inconsequential and may reach agreement in advance with the entity on the nature of any such matters to be communicated.

These matters should be communicated in the form of an engagement letter. An example of an engagement letter for a review of financial statements is presented in Review Exhibit A, "Illustrative Engagement Letter."

**.05** An understanding with management or, if applicable, those charged with governance also may include other matters, such as the following:

- Fees and billings
- Any limitation of or other arrangements regarding the liability of the accountant or the client, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements)
- Conditions under which access to review documentation may be granted to others
- Additional services to be provided relating to regulatory requirements

**.06** The engagement letter also should address the following additional matters if applicable:

- Material departures from the applicable financial reporting framework may exist, and the effects of those departures, if any, on the financial statements may not be disclosed.
- Reference to supplementary information.

## Review Performance Requirements

**.07** The performance of a review engagement requires that the accountant perform procedures designed to accumulate review evidence that will provide a reasonable basis for obtaining limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting

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<sup>2</sup> For purposes of this section, *fraud* is an intentional act that results in a misstatement in reviewed financial statements.

<sup>3</sup> For purposes of this section, *illegal acts* are violations of laws or government regulations, excluding fraud.

<sup>4</sup> 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 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.

framework. The accountant should apply professional judgment in determining the specific nature, timing, and extent of review procedures. Such procedures should be tailored based on the accountant's understanding of the industry in which the client operates and the accountant's knowledge of the entity. Review evidence obtained through the performance of analytical procedures and inquiry will ordinarily provide the accountant with a reasonable basis for obtaining limited assurance. However, the accountant should perform additional procedures if the accountant determines such procedures to be necessary to obtain limited assurance that the financial statements are not materially misstated.

## Understanding of the Industry

**.08** The accountant should possess an understanding of the industry in which the client operates, including the accounting principles and practices generally used in the industry sufficient to assist the accountant with determining the specific nature, timing, and extent of review procedures to be performed.

**.09** The requirement that the accountant possess a level of knowledge of the industry in which the entity operates does not prevent the accountant from accepting a review engagement for an entity in an industry with which the accountant has no previous experience. It does, however, place upon the accountant a responsibility to obtain the required level of knowledge. The accountant may do so, for example, by consulting AICPA guides, industry publications, financial statements of other entities in the industry, textbooks and periodicals, appropriate continuing professional education, or individuals knowledgeable about the industry.

## Knowledge of the Client

**.10** The accountant should obtain knowledge about the client sufficient to assist the accountant with determining the specific nature, timing, and extent of review procedures to be performed. That knowledge should include the following:

- An understanding of the client's business
- An understanding of the accounting principles and practices used by the client

**.11** In obtaining an understanding of the client's business, the accountant should have a general understanding of the client's organization; its operating characteristics; and the nature of its assets, liabilities, revenues, and expenses. The accountant's understanding of an entity's business is ordinarily obtained through experience with the entity or its industry and inquiry of the entity's personnel.

**.12** The accountant should understand the accounting principles and practices used by the client in measuring, recognizing, recording, and disclosing all significant accounts and disclosures in the financial statements. The accountant may obtain an understanding of the accounting policies and procedures used by management through inquiry, the review of client prepared documents, or experience with the client.

**.13** In obtaining this understanding of the client's accounting policies and practices, the accountant should be alert to unusual accounting policies and procedures that come to the accountant's attention as a result of his or her knowledge of the industry.

## Designing and Performing Review Procedures

### .14 Based on

- a. the accountant's understanding of the industry,
- b. his or her knowledge of the client, and
- c. his or her awareness of the risk that he or she may unknowingly fail to modify the accountant's review report on financial statements that are materially misstated,

the accountant should design and perform analytical procedures and make inquiries and perform other procedures, as appropriate, to accumulate review evidence in obtaining 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 the applicable financial reporting framework.

.15 The accountant should focus the analytical procedures and inquiries in those areas where the accountant believes there are increased risks of misstatements. The results of the accountant's analytical procedures and inquiries may modify the accountant's risk awareness. For example, the response to an inquiry that cash has not been reconciled for several months may revise the accountant's awareness of risks relative to the cash account.

## Analytical Procedures

.16 Understanding financial and nonfinancial relationships is essential in evaluating the results of analytical procedures, and generally requires knowledge of the client and the industry in which the client operates. An understanding of the purposes of analytical procedures and the limitations of those procedures also is 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 accountant.

.17 Analytical procedures involve comparisons of expectations developed by the accountant to recorded amounts or ratios developed from recorded amounts. The accountant develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the accountant's understanding of the industry in which the client operates and knowledge of the client. 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 (for example, payroll costs to number of employees)

Analytical procedures may be performed at the financial statement level or at the detailed account level. The nature, timing, and extent of the analytical procedures are a matter of professional judgment.

.18 If analytical procedures performed identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the accountant should investigate

these differences by inquiring of management and performing other procedures as necessary in the circumstances. Review evidence relevant to management's responses may be obtained by evaluating those responses, taking into account the accountant's understanding of the entity and its environment, along with other review evidence obtained during the course of the review. Although the accountant is not required to corroborate management's responses with other evidence, the accountant may need to perform other procedures when, for example, management is unable to provide an explanation, or the explanation, together with review evidence obtained relevant to management's response, is not considered adequate.

## Inquiries and Other Review Procedures

.19 The accountant should consider performing the following:

- a. Inquire of members of management who have responsibility for financial and accounting matters concerning the following:
  - i. Whether the financial statements have been prepared in conformity with the applicable financial reporting framework
  - ii. The entity's accounting principles and practices and the methods followed in applying them and the entity's procedures for recording, classifying, and summarizing transactions and accumulating information for disclosure in the financial statements
  - iii. Unusual or complex situations that may have an effect on the financial statements
  - iv. Significant transactions occurring or recognized near the end of the reporting period
  - v. The status of uncorrected misstatements identified during the previous engagement
  - vi. Questions that have arisen in the course of applying the review procedures
  - vii. Events subsequent to the date of the financial statements that could have a material effect on the financial statements
  - viii. 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)
  - ix. Significant journal entries and other adjustments
  - x. Communications from regulatory agencies

In addition to members of management who have responsibility for financial and accounting matters, the accountant may determine to direct inquiries to others within the entity and those charged with governance, if appropriate.

- b. Inquire concerning actions taken at meetings of stockholders, the board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements
- c. Read the financial statements to consider, on the basis of information coming to the accountant's attention, whether the financial statements appear to conform with the applicable financial reporting framework
- d. 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<sup>5</sup>

**.20** 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 client's business and the industry in which it operates.

### **Incorrect, Incomplete, or Otherwise Unsatisfactory Information**

**.21** During the performance of review procedures, the accountant may become aware that information coming to his or her attention is incorrect, incomplete, or otherwise unsatisfactory. In such instances, the accountant should request that management consider the effect of these matters on the financial statements and communicate the results of its consideration to the accountant. The accountant should consider the results communicated to the accountant by management and the effect, if any, on the accountant's review report. If the accountant believes the financial statements may be materially misstated, the accountant should perform additional procedures deemed necessary to obtain 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 the applicable financial reporting framework. If the accountant concludes that the financial statements are materially misstated, the accountant should follow the guidance in paragraphs .34–.36 with respect to departures from the applicable financial reporting framework.

### **Management Representations**

**.22** Written representations are required from management for all financial statements and periods covered by the accountant's review report. For example, if comparative financial statements are reported on, the representations obtained at the completion of the most recent review should address all periods being reported on. If current management was not present during all periods covered by the accountant's report, the accountant should nevertheless obtain written representations from current management for all such periods. 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. Written representations from management ordinarily

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<sup>5</sup> 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.

confirm representations explicitly or implicitly given to the accountant, 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. The accountant should request that management provide a written representation related to the following matters:

- a. Management's acknowledgment of its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
- b. Management's belief that the financial statements are fairly presented in accordance with the applicable financial reporting framework
- c. Management's acknowledgement of its responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements
- d. Management's acknowledgement of its responsibility to prevent and detect fraud
- e. 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
- f. Management's full and truthful response to all inquiries
- g. Completeness of information
- h. Information concerning subsequent events

The representation letter ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry.<sup>6</sup> An illustrative representation letter is presented in Review Exhibit B, "Illustrative Representation Letter."

**.23** Circumstances exist in which the 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 the 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 to reissue the 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.<sup>7</sup> 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. An illustrative updating management representation letter is contained in Review Exhibit C, "Illustrative Updating Management Representation Letter."

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<sup>6</sup> The accountant is not precluded from obtaining representations regarding services performed in addition to the review engagement.

<sup>7</sup> See paragraphs .20–.24 of section 200, *Reporting on Comparative Financial Statements*.

**.24** Because the accountant is concerned with events occurring through the date of the report that may require adjustment to or disclosure in the financial statements, management's representations set forth in the management representation letter should be made as of the date of the accountant's review report. The accountant need not be in physical receipt of the management representation letter as of the date of the accountant's review report, provided that management has acknowledged that they will sign the representation letter without modification and it is received prior to the release of the report. The management representation letter should be addressed to the accountant. The letter should be signed by those members of management whom the accountant believes are responsible for and knowledgeable about (directly or through others in the organization) the matters covered in the representation letter. Normally, the chief executive officer and chief financial officer or others with equivalent positions in the entity should sign the representation letter.

## Documentation in a Review Engagement

**.25** The accountant should prepare documentation in connection with each review engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of review procedures performed); the review evidence obtained and its source; and the conclusions reached. Documentation does the following:

- a.* Provides the principal support for the representation in the accountant's review report that the accountant performed the review in accordance with SSARs
- b.* Provides the principal support for the conclusion 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

**.26** The form, content, and extent of documentation depend on the circumstances of the engagement, the methodology and tools used, and the accountant's professional judgment. The accountant's documentation should include the following:

- The engagement letter documenting the understanding with the client.
- The analytical procedures performed, including the following:
  - The expectations, when the expectations are not otherwise readily determinable from the documentation of the work performed, and the factors considered in the development of the expectations
  - Results of the comparison of the expectations to the recorded amounts or ratios developed from recorded amounts
  - Management's responses to the accountant's inquiries regarding fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount
- Any additional review procedures performed in response to significant unexpected differences arising from analytical procedures and the results of such additional procedures.
- The significant matters covered in the accountant's inquiry procedures and the responses thereto. The accountant may document

the matters covered by the accountant's inquiry procedures and the responses thereto through a memorandum, checklist, or other means.

- 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).
- Significant 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.

The accountant is not precluded from supporting the review report by other means in addition to the review documentation. Such other means might include written documentation contained in other engagement files (for example, compilation or nonattest services) or quality control files (for example, consultation files) and, in limited situations, oral explanations. Oral explanations on their own do not represent sufficient support for the work the accountant performed or conclusions the accountant reached but may be used by the accountant to clarify or explain information contained in the documentation.

## Reporting on the Financial Statements

.27 Financial statements reviewed by an accountant should be accompanied by a written report. The accountant's objective in reporting on the financial statements is to prevent misinterpretation of the degree of responsibility the accountant is assuming when his or her name is associated with the financial statements.

.28 The basic elements of the report are as follows:

- a. *Title*. The accountant's review report should have a title that clearly indicates that it is the accountant's review report and includes the word *independent*. An appropriate title would be "Independent Accountant's Review Report."
- b. *Addressee*. The accountant's report should be addressed as required by the circumstances of the engagement.
- c. *Introductory paragraph*. The introductory paragraph in the accountant's report should
  - i. identify the entity whose financial statements have been reviewed;
  - ii. state that the financial statements have been reviewed;
  - iii. identify the financial statements; that have been reviewed;
  - iv. specify the date or period covered by the financial statements;
  - v. include a statement that a review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners); and

- vi. include 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 as a whole, and that, accordingly, the accountant does not express such an opinion.
- d. *Management's responsibility for the financial statements.* A statement that management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
- e. *Accountant's responsibility.* A statement that the accountant's responsibility is to conduct the review in accordance with SSARSS issued by the AICPA.

A statement that those standards require the accountant to perform the procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements.

A statement that the accountant believes that the results of his or her procedures provide a reasonable basis for his or her report.
- f. *Results of engagement.* A statement that, based on his or her review, 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, other than those modifications, if any, indicated in the report.
- g. *Signature of the accountant.* The manual or printed signature of the accounting firm or the accountant as appropriate.
- h. *Date of the accountant's report.* The date of the review report (the accountant's review report should not be dated earlier than the date on which the accountant has accumulated review evidence sufficient to provide a reasonable basis for concluding that the accountant has obtained 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 the applicable financial reporting framework).

See Review Exhibit D, "Illustrative Review Reports," for examples of review reports.

**.29** Each page of the financial statements reviewed by the accountant should include a reference, such as "See Independent Accountant's Review Report."

**.30** When the accountant is unable to perform the inquiry and analytical procedures he or she considers necessary to obtain 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 the applicable financial reporting framework, or the client does not provide the accountant with a representation letter, the review will be incomplete. A review that is incomplete does not provide an adequate basis for issuing a review report. In such a situation, the accountant should consider the matters discussed in paragraphs .56–.61 of section 80, *Compilation of Financial Statements*, in deciding whether it is appropriate to issue a compilation report on the financial statements.

**.31** The accountant may be asked to issue a review report on one financial statement, such as a balance sheet, and not on other related financial statements, such as the statements of income, retained earnings, and cash flows. The accountant may do so if the scope of his or her inquiry and analytical procedures has not been restricted.

**.32** Financial statements prepared in accordance with an OCBOA are not considered appropriate in form unless the financial statements include

- a description of the OCBOA, including a summary of significant accounting policies and a description of the primary differences from GAAP. The effects of the differences need not be quantified.
- informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

### Emphasis of a Matter

**.33** The 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 that the accountant may wish to emphasize are

- 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.
- accounting matters affecting the comparability of the financial statements with those of the preceding period.

### Departures From the Applicable Financial Reporting Framework

**.34** An accountant who is engaged to review financial statements may become aware of a departure from the applicable financial reporting framework (including inadequate disclosure) that is material to the financial statements. If the financial statements are not revised, the accountant should consider whether modification of the standard report is adequate to disclose the departure.

**.35** If the accountant concludes that modification of the standard report is appropriate, the departure should be disclosed in a separate paragraph of the report, including disclosure of the effects of the departure on the financial statements if such effects have been determined by management or are known as the result of the accountant's procedures. The accountant is not required to determine the effects of a departure if management has not done so, provided that the accountant states in the report that such determination has not been made.

See Review Exhibit D for examples of review reports that disclose departures from the applicable financial reporting framework.

**.36** If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements as a whole, the accountant should withdraw from the review engagement and provide no further services with respect to those financial statements. The accountant may wish to consult with his or her legal counsel in those circumstances.

## **Restricting the Use of an Accountant's Review Report**

### ***General Use and Restricted Use Reports***

**.37** The term *general use* applies to accountants' reports that are not restricted to specified parties. Accountants' reports on financial statements prepared in conformity with an applicable financial reporting framework ordinarily are not restricted regarding use. However, nothing in this section precludes the accountant from restricting the use of any report.

**.38** The term *restricted use* applies to accountants' reports intended only for one or more specified third parties. The need for restriction on the use of a report may result from a number of circumstances, including, but not limited to, the purpose of the report and the potential for the report to be misunderstood when taken out of the context in which it was intended to be used.

**.39** The accountant should restrict the use of a report when the subject matter of the accountant's report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements<sup>8</sup> or regulatory provisions that are not in conformity with an applicable financial reporting framework.

### ***Reporting on Subject Matter or Presentations Based on Measurement or Disclosure Criteria Contained in Contractual Agreements or Regulatory Provisions***

**.40** When reports are issued on subject matter or presentations based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with an applicable financial reporting framework, the accountant should restrict the report because the basis, assumptions, or purpose of such presentations (contained in such agreements or regulatory provisions) are developed for, and directed only to, the parties to the agreement or regulatory agency responsible for the provisions and because the report, subject matter, or presentation may be misunderstood by those who are not adequately informed of the basis, assumptions, or purpose of the presentation.

### ***Combined Reports Covering Both Restricted Use and General Use Subject Matter or Presentations***

**.41** If the accountant issues a single combined report covering both (a) subject matter or presentations that require a restriction on use to specified parties and (b) subject matter or presentations that ordinarily do not require such a restriction, the use of such a single combined report should be restricted to the specified parties.

### ***Inclusion of a Separate Restricted Use Report in the Same Document With a General-Use Report***

**.42** When required by law or regulation, a separate restricted use report may be included in a document that also contains a general use report. The

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<sup>8</sup> A *contractual agreement*, as discussed in this section, is an agreement between the client and one or more third parties other than the accountant.

inclusion of a separate restricted-use report in a document that contains a general use report does not affect the intended use of either report. The restricted use report remains restricted regarding use, and the general use report continues for general use.

### ***Adding Other Specified Parties***

.43 Subsequent to the completion of an engagement resulting in a restricted use report or in the course of such an engagement, the accountant may be asked to consider adding other parties as specified parties.

.44 If the accountant is reporting on subject matter or a presentation based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions, as described in paragraph .40, the accountant may agree to add other parties as specified parties based on the accountant's consideration of factors such as the identity of the other parties, their knowledge of the basis of the measurement or disclosure criteria, and the intended use of the report. If the accountant agrees to add other parties as specified parties, the accountant should obtain affirmative acknowledgment, preferably in writing, from the other parties of their understanding of the nature of the engagement, the measurement or disclosure criteria used in the engagement, and the related report. If the other parties are added after the accountant has issued his or her report, the report may be reissued, or the accountant may provide other written acknowledgment that the other parties have been added as specified parties. If the report is reissued, the report date should not be changed. If the accountant provides written acknowledgment that the other parties have been added as specified parties, such written acknowledgment ordinarily should state that no procedures have been performed subsequent to the date of the report.

### **Limiting the Distribution of Reports**

.45 Because of the reasons presented in paragraph .38, the accountant should consider informing his or her client that restricted use reports are not intended for distribution to nonspecified parties, regardless of whether they are included in a document containing a separate general use report.<sup>9</sup> This section does not preclude the accountant, in connection with establishing the terms of the engagement, from reaching an understanding with the client that the intended use of the report will be restricted, and from obtaining the client's agreement that the client and the specified parties will not distribute the report to parties other than those identified in the report. However, the accountant is not responsible for controlling a client's distribution of restricted use reports. Accordingly, a restricted use report should alert readers to the restriction on the use of the report by indicating that the report is not intended to be and should not be used by anyone other than the specified parties.

### ***Report Language—Restricted Use***

.46 An accountant's report that is restricted should contain a separate paragraph at the end of the report that includes the following elements:

- a. A statement indicating that the report is intended solely for the information and use of the specified parties.

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<sup>9</sup> In some cases, restricted use reports filed with regulatory agencies are required by law or regulation to be made available to the public as a matter of public record. Also, a regulatory agency as part of its oversight responsibility for an entity may require access to restricted use reports in which they are not named as a specified party.

- b. An identification of the specified parties to whom use is restricted. The report may list the specified parties or refer the reader to the specified parties listed elsewhere in the report.
- c. A statement that the report is not intended to be and should not be used by anyone other than the specified parties.

## An Entity's Ability to Continue as a Going Concern

**.47** During the performance of review procedures, evidence or information may come to the accountant's attention indicating 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 reviewed (hereinafter referred to as a *reasonable period of time*). In those circumstances, 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.

**.48** 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.

**.49** If the accountant determines that management's conclusions are unreasonable or 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 .34–.36 with respect to departures from the applicable financial reporting framework.

**.50** The accountant may emphasize an uncertainty about an entity's ability to continue as a going concern, provided that the uncertainty is disclosed in the financial statements. In such circumstances, the accountant should follow the guidance in paragraph .33.

## Subsequent Events

**.51** Evidence or information that a subsequent event that has a material effect on the reviewed financial statements has occurred may come to the accountant's attention in the following ways:

- a. During the performance of review procedures
- b. Subsequent to the date of the accountant's 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.

**.52** If the accountant determines that the subsequent event is not adequately accounted for in the financial statements or disclosed in the notes, he or she should follow the guidance in paragraphs .34–.36.

**.53** Occasionally, a subsequent event has such a material impact on the entity that the accountant may wish to include in his or her 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 paragraph .33 for additional guidance with respect to emphasis of matter paragraphs.

## Subsequent Discovery of Facts Existing at the Date of the Report

**.54** Subsequent to the date of the report on the financial statements that the accountant has reviewed, he or she may become aware that facts may have existed at that date that might have caused him or her to believe that information supplied by the entity was 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 contained in this section 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 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** After the date of the accountant's review report, the accountant has no obligation to perform other 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 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. The accountant should discuss the matter with his or her client at whatever management levels the accountant deems appropriate and request cooperation in whatever investigation may be necessary. In addition to management, the accountant may deem it appropriate to discuss the matter with those charged with governance. 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 review report date and had not been reflected in the financial statements and (b) the accountant believes that persons currently using or likely to use the financial statements exist who would attach importance to the information, the accountant should perform the additional procedures deemed necessary to obtain 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 the applicable financial reporting framework. Consideration should be given to, among other things, the time elapsed since the financial statements were issued.

**.56** When the accountant has concluded 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. For example

- a. if the effect of the subsequently discovered information on the accountant's report or the financial statements can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and, when applicable, the accountant's report. The reasons for the revision usually should be described in a note to the financial statements and, when applicable, referred to in the accountant's report. Generally, only the

most recently issued reviewed financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.

- 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).
- 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 the statements should not be used; that revised financial statements will be issued; and, when applicable, that 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 .56.

**.58** If the client refuses to make the disclosures specified in paragraph .56, the accountant should notify the appropriate personnel at the highest levels within the entity, such as the manager (owner) or those charged with governance, of such refusal and of the fact that, in the absence of disclosure by the client, the accountant will take steps as outlined here to prevent further use of the financial statements and the accountant's report. The steps that can appropriately be taken will depend upon the degree of certainty of the accountant's knowledge that persons exist who are currently using or who will use the financial statements and the accountant's report and who would attach importance to the information. The steps that can be taken also will depend on the accountant's ability as a practical matter to communicate with these persons. Unless the accountant's attorney recommends a different course of action, the accountant should take the following steps to the extent applicable:

- 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.

**.59** The following guidelines should govern the content of any disclosure made by the accountant, in accordance with paragraph .58, 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 the client has not cooperated with the accountant's attempt to substantiate information that has come to the accountant's attention and that, if the information is true, the accountant believes that the 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 review report should not be used.

## Supplementary Information

**.60** 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 or she is taking with respect to such information.

When the accountant has reviewed the basic financial statements, 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 a conclusion that there are no material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework and that either

- the other data accompanying the financial statements are presented only for purposes of additional analysis 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, or
- the other data accompanying the financial statements are presented only for purposes of additional analysis 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 provide any assurance on such data.

## Communicating to Management and Others

**.61** When evidence or information comes to the accountant's attention during the performance of review procedures that fraud or an illegal act may have occurred, that matter should be brought to the attention of the appropriate level of management. The accountant need not report matters regarding illegal acts that are clearly inconsequential and may reach agreement in advance with the entity on the nature of such items to be communicated. When matters regarding fraud or an illegal act involve senior management, the accountant should report the matter to an individual or group at a higher level within the entity, such as the manager (owner) or those charged with governance. The communication may be oral or written. If the communication is oral, the accountant should document it. When matters regarding fraud or an illegal act involve an owner of the business, the accountant should consider resigning from the

engagement. Additionally, the accountant should consider consulting with his or her legal counsel whenever any evidence or information comes to his or her attention during the performance of review procedures that fraud or an illegal act may have occurred, unless such illegal act is clearly inconsequential.

**.62** The disclosure of any evidence or information that comes to the accountant's attention during the performance of review procedures that fraud or an illegal act may have occurred to parties other than the client's senior management (or those charged with governance, if applicable) ordinarily is not part of the accountant's responsibility and, ordinarily, would be precluded by the accountant's ethical or legal obligations of confidentiality. The accountant should recognize, however, that in the following circumstances, a duty to disclose to parties outside of the entity may exist:

- a. To comply with certain legal and regulatory requirements
- b. To a successor accountant when the successor decides to communicate with the predecessor accountant, in accordance with section 400, *Communications Between Predecessor and Successor Accountants*, regarding acceptance of an engagement to compile or review the financial statements of a nonissuer
- c. In response to a subpoena

Because potential conflicts between the accountant's ethical and legal obligations for confidentiality of client matters may be complex, the accountant may wish to consult with legal counsel before discussing matters covered by paragraph .61 with parties outside the client.

## Change in Engagement From Audit to Review

**.63** The accountant who has been engaged to audit the financial statements of a nonissuer in accordance with auditing standards generally accepted in the United States of America may, before the completion of the audit, be requested to change the engagement to a review of financial statements. A request to change the engagement may result from a change in circumstances affecting the entity's requirement for an audit, a misunderstanding regarding the nature of an audit or review, or a restriction.

**.64** Before the accountant, who was engaged to perform an audit in accordance with auditing standards generally accepted in the United States of America, agrees to change the engagement to a review, at least the following should be considered:

- a. The reason given for the client's request, particularly the implications of a restriction on the scope of the audit, whether imposed by the client or by circumstances
- b. The additional audit effort required to complete the audit
- c. The estimated additional cost to complete the audit

**.65** A change in circumstances that affects the entity's requirement for an audit, or a misunderstanding concerning the nature of an audit or review would ordinarily be considered a reasonable basis for requesting a change in the engagement.

**.66** In considering the implications of a restriction on the scope of the audit, the accountant should evaluate the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory. Nevertheless, when the accountant has been engaged to audit an entity's financial statements and has been prohibited by the client from corresponding with

the entity's legal counsel, the accountant ordinarily would be precluded from issuing a review report on the financial statements.

**.67** In all circumstances, if the audit procedures are substantially complete or the cost to complete such procedures is relatively insignificant, the accountant should consider the propriety of accepting a change in the engagement.

**.68** If the accountant concludes, based upon his or her professional judgment, that there is reasonable justification to change the engagement and if he or she complies with the standards applicable to a review engagement, the accountant should issue an appropriate review report. The report should not include reference to (a) the original engagement, (b) any audit procedures that may have been performed, or (c) scope limitations that resulted in the changed engagement.

## Effective Date

**.69** This section is effective for reviews of financial statements for periods ending on or after December 15, 2010.

## Review Exhibit A—Illustrative Engagement Letter

[*Appropriate Salutation*]

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will review the financial statements of XYZ Company as of and for the year ended December 31, 20XX, and issue an accountant's report thereon in accordance with Statements on Standards for Accounting and Review Services (SSARs) issued by the American Institute of Certified Public Accountants (AICPA).

The objective of a review is to obtain 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 [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*].

You are responsible for

- a. the preparation and fair presentation of the financial statements in accordance with [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*].
- b. designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
- c. preventing and detecting fraud.
- d. identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
- e. making all financial records and related information available to us.
- f. providing us, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.

We are responsible for conducting the engagement in accordance with SSARs issued by the AICPA.

A review includes primarily applying analytical procedures to your financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. A review does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion regarding the financial statements as a whole.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts. However, 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, we will report to you any evidence or information that comes to our

attention during the performance of our review procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

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

Our fees for these services. . .

We will 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,

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*[Signature of accountant]*

Acknowledged:

XYZ Company

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President

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Date

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## Review Exhibit B—Illustrative Representation Letter

The following representation letter is included for illustrative purposes only. The accountant may decide, based on the circumstances of the review engagement or the industry in which the entity operates, that other matters should be specifically included in the letter or that some of the representations included in the illustrative letter are not necessary.

[Date]<sup>1</sup>

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 (for example, December 31, 20X1, and December 31, 20X2)] and for the [periods of review (for example, for the years then ended)] for the purpose of obtaining limited assurance that 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 (for example, accounting principles generally accepted in the United States of America)]. We confirm that we are responsible for the fair presentation of the financial statements in accordance with [the applicable financial reporting framework] and the selection and application of the accounting policies.

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.<sup>2</sup>

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 previously are fairly presented in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].
2. We have made the following available to you
  - 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. No material transactions exist that have not been properly recorded in the accounting records underlying the financial statements.
4. We acknowledge our responsibility for the preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

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<sup>1</sup> This date should be the date that the client presents and signs the letter. In no event should the letter be presented and signed prior to the date of the accountant's review report.

<sup>2</sup> The qualitative discussion of materiality used in this letter is adapted from Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*.

5. We acknowledge our responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
6. We acknowledge our responsibility to prevent and detect fraud.
7. 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.
8. We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.
9. No material losses exist (such as from obsolete inventory or purchase or sales commitments) that have not been properly accrued or disclosed in the financial statements.
10. None of the following exist:
  - 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*.<sup>3</sup>
  - c. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450.
11. The company has satisfactory title to all owned assets, and no liens or encumbrances on such assets exist, nor has any asset been pledged as collateral, except as disclosed to you and reported in the financial statements.
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.
13. 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*]

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<sup>3</sup> If management has not consulted a lawyer regarding litigation, claims, and assessments, the 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.

*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 the following for additional illustrative representations.]*

14. We are in agreement with the adjusting journal entries you have recommended, and they have been posted to the company's accounts (if applicable).
15. 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.<sup>4</sup>
16. We have responded fully and truthfully to all inquiries made to us by you during your review.

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*[Name of Owner or Chief Executive Officer and Title]*

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*[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.

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<sup>4</sup> If the accountant dual dates his or her report, the accountant should consider whether obtaining additional representations relating to the subsequent event is appropriate.

*General*

<i>Condition</i>	<i>Illustrative Examples</i>
The effect of a new accounting principle is not known.	We have not completed the process of evaluating the impact that will result from adopting Financial Accounting Standards Board (FASB) <i>Accounting Standards Codification</i> (ASC) [XXX, Title], as discussed in note [X]. The company is therefore unable to disclose the impact that adopting FASB ASC XXX will have on its financial position and the results of operations when such statement is adopted.
Justification exists for a change in accounting principles.	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].
Financial circumstances are strained, with disclosure of management's intentions and the entity's ability to continue as a going concern.	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.
The possibility exists that the value of specific significant long lived assets or certain identifiable intangibles may be impaired.	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.
The entity has a variable interest in another entity.	<p>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 accounting principles generally accepted in the United States of America.</p> <p>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.</p> <p>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 FASB ASC 810, <i>Consolidation</i>.</p>

*General*

<i>Condition</i>	<i>Illustrative Examples</i>
	<p>We have advised you of all transactions with identified VIEs, potential VIEs, or entities afforded the scope exceptions of FASB ASC 810.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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:</p> <ul style="list-style-type: none"> <li>• Whether the entity is a VIE</li> <li>• Whether the company is the primary beneficiary</li> <li>• The accounting required to consolidate the entity</li> </ul>
The work of a specialist has been used by the entity.	<p>We agree with the findings of specialists in evaluating the [<i>describe assertion</i>] 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.</p>

*(continued)*

*Assets*

<i>Condition</i>	<i>Illustrative Examples</i>
<p><i>Cash</i></p> <p>Disclosure is required of compensating balances or other arrangements involving restrictions on cash balances, lines of credit, or similar arrangements.</p>	<p>Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances, lines of credit, or similar arrangements have been properly disclosed.</p>
<p><i>Financial Instruments</i></p> <p>Management intends to and has the ability to hold to maturity debt securities classified as held-to-maturity.</p> <p>Management considers the decline in value of debt or equity securities to be temporary.</p> <p>Management has determined the fair value of significant financial instruments that do not have readily determinable market values.</p>	<p>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.</p> <p>We consider the decline in value of debt or equity securities classified as either available-for-sale or held-to-maturity to be temporary.</p> <p>The methods and significant assumptions used to determine fair values of financial instruments are as follows: [<i>describe methods and significant assumptions used to determine fair values of financial instruments</i>]. The methods and significant assumptions used result in a measure of fair value appropriate for financial statement measurement and disclosure purposes.</p>
<p>Financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk exist.</p>	<p>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:</p> <ol style="list-style-type: none"> <li>1. The extent, nature, and terms of financial instruments with off-balance-sheet risk</li> <li>2. The amount of credit risk of financial instruments with off-balance-sheet risk and information about the collateral supporting such financial instruments</li> <li>3. Significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments</li> </ol>

*Assets*

<i>Condition</i>	<i>Illustrative Examples</i>
<p><i>Receivables</i> Receivables have been recorded in the financial statements.</p>	<p>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.</p>
<p><i>Inventories</i> Excess or obsolete inventories exist.</p>	<p>Provision has been made to reduce excess or obsolete inventories to their estimated net realizable value.</p>
<p><i>Investments</i> Unusual considerations are involved in determining the application of equity accounting.</p>	<p>[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:]</p> <ul style="list-style-type: none"> <li>• 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.</li> <li>• 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.</li> </ul>
<p><i>Deferred Charges</i> Material expenditures have been deferred.</p>	<p>We believe that all material expenditures that have been deferred to future periods will be recoverable.</p>
<p><i>Deferred Tax Assets</i> A deferred tax asset exists at the balance sheet date.</p>	<p>The valuation allowance has been determined pursuant to the provisions of FASB ASC 740, <i>Income Taxes</i>, 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.]</p> <p>or</p> <p>A valuation allowance against deferred tax assets at the balance-sheet date is not considered necessary because it is more likely than not that the deferred tax asset will be fully realized.</p>

*(continued)*

*Liabilities*

<i>Condition</i>	<i>Illustrative Examples</i>
<p><i>Debt</i></p> <p>Short term debt could be refinanced on a long term basis and management intends to do so.</p>	<p>The company has excluded short-term obligations totaling \$[<i>amount</i>] from current liabilities because it intends to refinance the obligations on a long-term basis. [<i>Complete with appropriate wording detailing how amounts will be refinanced as follows:</i>]</p> <ul style="list-style-type: none"> <li>• The company has issued a long term obligation [<i>debt security</i>] 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.</li> <li>• The company has the ability to consummate the refinancing, by using the financing agreement referred to in note [X] to the financial statements.</li> </ul>
<p>Tax-exempt bonds have been issued.</p>	<p>Tax-exempt bonds issued have retained their tax-exempt status.</p>
<p><i>Taxes</i></p> <p>Management intends to reinvest undistributed earnings of a foreign subsidiary.</p>	<p>We intend to reinvest the undistributed earnings of [<i>name of foreign subsidiary</i>].</p>
<p><i>Contingencies</i></p> <p>Estimates and disclosures have been made of environmental remediation liabilities and related loss contingencies.</p>	<p>Provision has been made for any material loss that is probable from environmental remediation liabilities associated with [<i>name of site</i>]. 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.</p>
<p>Agreements may exist to repurchase assets previously sold.</p>	<p>Agreements to repurchase assets previously sold have been properly disclosed.</p>
<p><i>Pension and Postretirement Benefits</i></p> <p>An actuary has been used to measure pension liabilities and costs.</p>	<p>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>

*Liabilities*

<i>Condition</i>	<i>Illustrative Examples</i>
Involvement with a multiemployer plan exists.	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].
Postretirement benefits have been eliminated.	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].
Employee layoffs that would otherwise lead to a curtailment of a benefit plan are intended to be temporary.	Current employee layoffs are intended to be temporary.
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.	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.

*Equity*

<i>Condition</i>	<i>Illustrative Example</i>
Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements exist.	Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements have been properly disclosed.

*(continued)*

*Income Statement*

<i>Condition</i>	<i>Illustrative Examples</i>
There may be a loss from sales commitments.	Provisions have been made for losses to be sustained in the fulfillment of or from inability to fulfill any sales commitments.
There may be losses from purchase commitments.	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.
Nature of the product or industry indicates the possibility of undisclosed sales terms.	We have fully disclosed to you all sales terms, including all rights of return or price adjustments and all warranty provisions.

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## Review Exhibit C—Illustrative Updating Management Representation Letter

The following letter is presented for illustrative purposes only. It may be used in the circumstances described in paragraph .23. 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 may 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]<sup>1</sup>

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 obtaining limited assurance that 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 (for example, accounting principles generally accepted in the United States of America)*], 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.

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[*Name of Owner or Chief Executive Officer and Title*]

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[*Name of Chief Financial Officer and Title, when applicable*]

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<sup>1</sup> 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.

## Review Exhibit D—Illustrative Review Reports

*Standard accountant's review report on financial statements prepared in accordance with accounting principles generally accepted in the United States of America*

### Independent Accountant's Review Report

[Appropriate Salutation]

I (We) have reviewed 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. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

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.

[Signature of accounting firm or accountant, as appropriate]

[Date]

*Standard accountant's review report on financial statements prepared in accordance with the income tax basis of accounting*

### Independent Accountant's Review Report

[Appropriate Salutation]

I (We) have reviewed the accompanying statement of assets, liabilities, and equity—income tax basis of XYZ Company as of December 31, 20XX, and the related statement of revenue and expenses—income tax basis for the year then ended. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the income tax basis for accounting and for designing, implementing, and maintaining

internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provides a reasonable basis for our report.

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 X.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

*Accountant's review report disclosing a departure from accounting principles generally accepted in the United States of America*

### **Independent Accountant's Review Report**

*[Appropriate Salutation]*

I (We) have reviewed 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. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Based on my (our) review, with the exception of the matter(s) described in the following paragraph(s), 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.

As disclosed in note X to the financial statements, accounting principles generally accepted in the United States of America require that inventory cost consist of material, labor, and overhead. Management has informed (me) us that the inventory of finished goods and work in process is stated in the accompanying financial statements at material and labor cost only, and that the effects of this departure from accounting principles generally

accepted in the United States of America on financial position, results of operations, and cash flows have not been determined.

*or*

As disclosed in note X to the financial statements, the company has adopted [*description of newly adopted method*], whereas it previously used [*description of previous method*]. Although the [*description of newly adopted method*] is in conformity with accounting principles generally accepted in the United States of America, the company does not appear to have reasonable justification for making a change as required by Financial Accounting Standards Board *Accounting Standards Codification 250, Accounting Changes and Error Corrections*.

[*Signature of accounting firm or accountant, as appropriate*]

[*Date*]

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## AR Section 9090

# ***Review of Financial Statements: Accounting and Review Services Interpretations of Section 90***

### **1. Reporting When There Are Significant Departures From the Applicable Financial Reporting Framework**

**.01 Question**—When the financial statements include significant departures from the applicable financial reporting framework, may the accountant modify his or her standard report in accordance with paragraphs .34–.36 of section 90, *Review of Financial Statements*, to include a statement that the financial statements are not in conformity with the applicable financial reporting framework?

**.02 Interpretation**—No. Including such a statement in the accountant's review report would be tantamount to expressing an adverse opinion on the financial statements as a whole. Such an opinion can be expressed only in the context of an audit engagement. Furthermore, such a statement in a review report would confuse users because it would contradict the results of engagement as required by paragraph .28(f) of section 90.

**.03** However, paragraph .33 of section 90 states that an accountant may emphasize, in any report on financial statements, a matter disclosed in the financial statements. The accountant may wish, therefore, to emphasize the limitations of the financial statements in a separate paragraph of his or her review report, depending on his or her assessment of the possible dollar magnitude of the effects of the departures, the significance of the affected items to the entity, the pervasiveness and overall impact of the misstatements, and whether disclosure has been made of the effects of the departures. Such separate paragraph, which would follow the other modifications of his or her report (see illustrations in Review Exhibit D, "Illustrative Review Reports"), might read as follows (the illustration assumes that the accountant is reporting on financial statements in which there are significant departures from accounting principles generally accepted in the United States of America):

Because the significance and pervasiveness of the matters previously discussed makes it difficult to assess their impact on the financial statements 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 accounting principles generally accepted in the United States of America.

**.04** Inclusion of such a separate paragraph in the accountant's review report is not a substitute for disclosure of the specific departures or the effects of such departures when they have been determined by management or are known as a result of the accountant's procedures.

[Issue Date: August 1981; Revised: November 2002; Revised: May 2004; Revised: July 2005; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 7 to section 100).]

## 2. Reporting on Tax Returns

**.05 Question**—May an accountant comply with a request from a nonissuer to issue a review report on financial information contained in a tax return, as in Form 1040, *U.S. Individual Income Tax Return*, or Form 1120, *U.S. Corporation Income Tax Return*, or in an information return, as in Form 990, *Return of Organization Exempt from Income Tax*; Form 1065, *U.S. Partnership Return of Income*; or Form 5500, *Return of Employee Benefit Plan*?

**.06 Interpretation**—Yes. Although paragraph .01 of section 90 states that the section establishes standards and provides guidance on reviews of financial statements and financial information contained in a tax return is not included in the definition of financial statements, an accountant may decide to accept an engagement to issue a review report on such a return. In that case, the performance and reporting requirements of section 90 would apply.

[Issue Date: November 1982; Revised: February 2008;  
Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 10 to section 100).]

## 3. Additional Procedures Performed in a Review Engagement

**.07 Question**—If an accountant performs procedures customarily performed in an audit but not in a review, is the accountant required to change the engagement to an audit?

**.08 Interpretation**—No. Paragraph .07 of section 90 states that review evidence obtained through the performance of analytical procedures and inquiry will ordinarily provide the accountant with a reasonable basis for obtaining limited assurance. However, paragraph .07 further states that the accountant should perform additional procedures if the accountant determines such procedures to be necessary to obtain limited assurance that the financial statements are not materially misstated.

**.09** The wording of confirmation requests or other communications related to additional procedures performed in the course of a review engagement should not use phrases such as "as part of an *audit* of the financial statements" (emphasis supplied).

[Issue Date: March 1983; Revised: October 2000; Revised: November 2002;  
Revised: May 2004; Revised: December 2010 to conform to SSARS No. 19  
(formerly Interpretation No. 13 to section 100).]

## 4. Submitting Draft Financial Statements

**.10 Question**—Accountants frequently submit draft financial statements (a) because information needed to complete a review of the financial statements will not be available until a later date or (b) to provide the client with the opportunity to read and analyze the financial statements prior to their final issuance. Is it permissible for the accountant to submit draft financial statements to management without intending to comply with the reporting provisions of section 90?

**.11 Interpretation**—No. An accountant is precluded from submitting draft financial statements unless he or she intends to submit those financial statements in final form accompanied by an appropriate review report prescribed by section 90. However, as long as the accountant intends to issue a review report on the financial statements in final form and labels each page of draft financial statements with words such as "Draft," "Preliminary Draft," "Draft—Subject to Changes," or "Working Draft," the accountant is not required to comply with

the reporting provisions of section 90 with respect to those draft financial statements. In the rare circumstance in which the accountant intended to but never submitted final financial statements, the accountant may want to document the reasons why he or she was unable to submit financial statements in final form accompanied by an appropriate review report.

[Issue Date: September 1990; Revised: October 2000; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 17 to section 100).]

## **5. Reporting When Financial Statements Contain a Departure From Promulgated Accounting Principles That Prevents the Financial Statements From Being Misleading**

**.12 Question**—The "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct states

A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

Paragraphs .34–.36 of section 90 do not address the "Accounting Principles Rule" circumstances. When the circumstances contemplated by the "Accounting Principles Rule" are present, how should the accountant report on the information described in the "Accounting Principles Rule?"

**.13 Interpretation**—When the circumstances contemplated by the "Accounting Principles Rule" are present in a review engagement, the accountant's review report should include, in a separate paragraph or paragraphs, the information required by the "Accounting Principles Rule." In such a case, the accountant would not modify the standard review report, except for the addition of the separate paragraph(s) that contains the information required by the "Accounting Principles Rule," unless there are other reasons to do so that are not associated with the departure from a promulgated principle.

[Issue Date: February 1991; Revised: October 2000; Revised: November 2002; Revised: May 2004; Revised: July 2005; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 19 to section 100); Revised: January 2015.]

## **6. Special-Purpose Financial Statements to Comply With Contractual Agreements or Regulatory Provisions**

**.14 Question**—An accountant may be asked to review special purpose financial statements prepared to comply with a contractual agreement or regulatory provision that specifies a special basis of presentation. In most circumstances, these financial statements are intended solely for the use of the parties to the agreement, regulatory bodies, or other specified parties. How should the accountant modify the standard review report when reporting on these special-purpose financial statements?

**.15 Interpretation**—An accountant who is asked to review special-purpose financial statements prepared to comply with a contractual agreement or a regulatory provision that specifies a special basis of presentation may issue a review report on those financial statements in accordance with section 90 as described in this interpretation. This interpretation describes reporting on

- a. special-purpose financial statements prepared in compliance with a contractual agreement or regulatory provision that does not constitute a complete presentation of the entity's assets, liabilities, revenues, and expenses, but is otherwise prepared in conformity with generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA), or
- b. a special-purpose financial presentation (may be a complete set of financial statements or a single financial statement) prepared on a basis of accounting prescribed in an agreement that does not result in a presentation in conformity with GAAP or an OCBOA.

***Financial Statements Prepared on a Basis of Accounting Prescribed in a Contractual Agreement or Regulatory Provision That Results in an Incomplete Presentation but One That Is Otherwise in Conformity With GAAP or an OCBOA***

**.16** An entity may engage an accountant to review a special-purpose financial statement prepared in compliance with a contractual agreement or regulatory provision that does not constitute a complete presentation of the entity's assets, liabilities, revenues, or expenses, but is otherwise prepared in conformity with GAAP or an OCBOA. For example, a governmental agency may require a statement of gross income and certain expenses of an entity's real estate operation in which income and expenses are measured in conformity with accounting principles generally accepted in the United States of America, but expenses are defined to exclude certain items such as interest, depreciation, and income taxes. Such a statement may also present the excess of gross income over defined expenses. Also, a buy-sell agreement may specify a statement of gross assets and liabilities of the entity measured in conformity with GAAP, but limited to the assets to be sold and liabilities to be transferred pursuant to the agreement.

**.17** The accountant's report on reviewed special-purpose financial statements prepared in accordance with a basis of accounting prescribed in a contractual agreement or regulatory provision but that is otherwise prepared in conformity with GAAP or an OCBOA should be modified to include a separate paragraph with the following information:

- An explanation of what the financial statement is intended to present and a reference to the note to the special-purpose financial statement that describes the basis of presentation.
- If the basis of presentation is in conformity with GAAP or an OCBOA, a statement that the presentation is not intended to be a complete presentation of the entity's assets, liabilities, revenues, and expenses.
- A separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity, the parties to the contract or agreement, the regulatory agency with which the report is being filed, or those with whom the entity is negotiating directly, and is not intended to be and should not be used by anyone other than these specified parties.

**.18** The following is an illustrative example of a review report on special purpose financial statements:

I (we) have reviewed the accompanying statement of gross income and direct operating expenses of XYZ Company for the year ended December 31, 20X1. A review includes primarily applying analytical procedures to management (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the statement of gross income and direct operating expenses as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the statement of gross income and direct operating expenses in accordance with the regulatory provision described in Note A and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the statement of gross income and direct operating expenses.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the statement of gross income and direct operating expenses. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

The accompanying statement was prepared for the purpose of presenting gross income and direct operating expenses of XYZ Company pursuant to the regulatory provision described in Note A, and is not intended to be a complete presentation of XYZ Company's income and expenses.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying statement of gross income and direct operating expenses in order for it to be 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 specified parties*] and is not intended to be and should not be used by anyone other than these specified parties.

***Financial Statements Prepared on a Basis of Accounting Prescribed in an Agreement That Results in a Presentation That Is Not in Conformity With GAAP or an OCBOA***

**.19** An entity may engage an accountant to review a special-purpose financial statement prepared in conformity with a basis of accounting that departs from GAAP or an OCBOA. A loan agreement, for example, may require the borrower to prepare consolidated financial statements in which assets, such as inventory, are presented on a basis that is not in conformity with GAAP or an OCBOA. Also, an acquisition agreement may require the financial statements of the entity being acquired (or a segment of it) to be prepared in conformity with GAAP except for certain assets, such as receivables, inventories, and properties for which a valuation basis is specified in the agreement.

**.20** Financial statements prepared under a basis of accounting as discussed in the preceding are not considered to be prepared in conformity with an OCBOA because the criteria used to prepare such financial statements do not meet the requirement of "having substantial support," even though the criteria are definite.

**.21** The accountant's report on reviewed special-purpose financial statements prepared on a basis of accounting prescribed in an agreement that results in a presentation that is not in conformity with GAAP or an OCBOA should be modified to include a separate paragraph with the following information:

- An explanation of what the presentation is intended to present and a reference to the note to the special-purpose financial statements that describes the basis of presentation.
- A statement that the financial statement is not intended to be a presentation in conformity with GAAP or an OCBOA.
- A description and the source of significant interpretations, if any, made by the Company's management relating to the provisions of a relevant agreement.
- A separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity, the parties to the contract or agreement, the regulatory agency with which the report is being filed, or those with whom the entity is negotiating directly, and is not intended to be and should not be used by anyone other than these specified parties. For example, if the financial statements have been prepared for the specified purpose of obtaining bank financing, the report's use should be restricted to the various banks with whom the entity is negotiating the proposed financing.

**.22** The following is an illustrative example of a review report on special-purpose financial statements:

I (we) have reviewed the accompanying special-purpose statement of assets and liabilities of XYZ Company as of December 31, 20X1. A review includes primarily applying analytical procedures to management (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the statement of assets and liabilities as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the statement of assets and liabilities in accordance with Section 4 of a loan agreement between DEF Bank and the Company as discussed in Note A and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the statement of assets and liabilities.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the statement of assets and liabilities. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

The accompanying special-purpose statement of assets and liabilities was prepared for the purpose of complying with Section 4 of a loan agreement between DEF Bank and the Company as discussed in Note A and is not intended to be a presentation in conformity with accounting principles generally accepted in the United States of America.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying special-purpose statement of assets and liabilities in order for it to be in conformity with the basis of accounting described in Note A.

This report is intended solely for the information and use of the [specified parties]

[Issue Date: December 2006; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 28 to section 100).]

## **7. Reporting on an Uncertainty, Including an Uncertainty About an Entity's Ability to Continue as a Going Concern**

**.23 Question**—How should an accountant modify the standard review report when, during the performance of 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?

**.24 Interpretation**—Continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. The accountant should follow the guidance in paragraphs .47–.50 of section 90 with respect to his or her consideration of the entity's ability to continue as a going concern during the performance of review procedures.

**.25** 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-matter paragraph with respect to the uncertainty in the accountant's 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.

**.26 Question**—If the accountant, while performing a review, becomes aware of a material uncertainty other than a going concern uncertainty (for example, an uncertainty regarding pending or threatened litigation), what should the accountant consider in deciding whether a report modification is necessary?

**.27 Interpretation**—If the accountant determines that the disclosure of the uncertainty is not in accordance with the applicable financial reporting framework, he or she should follow the guidance in paragraphs .34–.36 of section 90.

**.28** If the accountant concludes that management's disclosure of the uncertainty is in accordance with the applicable financial reporting framework but further decides to include an emphasis-of-matter paragraph with respect to the uncertainty in the accountant's review report, he or she may use the following language (the following is assuming that the financial statements were prepared in accordance with accounting principles generally accepted in the United States of America):

As discussed in Note X, the Company is currently named in a legal action. The Company has determined that it is not possible to predict the eventual outcome of the legal action but has determined that the resolution of the action will not result in an adverse judgment that would materially affect the financial statements. Accordingly, the accompanying financial statements do not include any adjustments related to the legal action under FASB ASC 450.

[Issue date: February 2007; Revised: February 2008; Amended: December 2008; Revised: June 2009; Revised: December 2010 to conform to SSARS No. 19 (formerly Interpretation No. 29 to section 100)]

## 8. Reviews of Financial Statements Prepared in Accordance With International Financial Reporting Standards

**.29 Question**—The International Accounting Standards Board (IASB) has been designated by the Council of the AICPA as the body to establish international financial reporting standards for both private and public entities pursuant to the "Compliance With Standards Rule" (ET sec. 1.310.001) and the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct as of May 18, 2008. As a result, how would an accountant apply the reporting guidance in section 90 when engaged to review financial statements presented in accordance with International Financial Reporting Standards (IFRSs) as issued by the IASB?

**.30 Interpretation**—A report illustration of how an accountant would apply the reporting guidance in section 90 when reporting on financial statements presented in accordance with IFRSs is as follows:

### Independent Accountant's Review Report

*[Appropriate Salutation]*

I (We) have reviewed the accompanying statements of financial position of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of comprehensive income, changes in equity, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the reviews in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

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 International Financial Reporting Standards as issued by the International Accounting Standards Board.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

**.31 Question**—Unlike accounting principles generally accepted in the United States of America as issued by the Financial Accounting Standards Board (FASB), IFRSs require an entity to disclose comparative information in respect of the previous comparative period for all amounts presented in the current year's financial statements. When the accountant reviews financial statements that omit prior year information, should such omission be disclosed in the accountant's review report as a departure from IFRSs as issued by the IASB in accordance with paragraphs .34–.36 of section 90?

**.32 Interpretation**—Yes. Because IFRSs require an entity to disclose comparative information in respect of the previous comparative period for all amounts presented in the current year's financial statements, the failure to include such information in financial statements would be a departure from

generally accepted accounting principles. An example of a paragraph that may be added to the accountant's review report is as follows:

Comparative information with respect to the year ended December 31, 20XX-1 has not been presented. International Financial Reporting Standards [or *IFRSs for SMEs*] as issued by the International Accounting Standards Board require an entity to disclose comparative information in respect of the previous comparative period for all amounts presented in the current year's financial statements.

[Issue Date: May 2008; Revised: June 2010; Revised: August 2010; Revised: December 2010 (formerly Interpretation No. 30 to section 100); Revised: January 2015.]

## 9. Reviews of Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country

**.33 Question**—An accountant may be engaged to review financial statements that have been prepared in conformity with a financial reporting framework generally accepted in another country (including financial statements prepared in accordance with a jurisdictional variation of IFRSs such that the entity's financial statements do not contain an explicit and unreserved statement of compliance with IFRSs as issued by the IASB). How should an accountant apply the reporting requirements in section 90 when reporting on those financial statements?

**.34 Interpretation**— If the financial statements are intended for use only outside of the United States of America, the accountant may report using the standard form of U.S. review report modified as appropriate to identify the applicable financial reporting framework; or alternatively, the accountant may report using the standard review report form and content of the other country. (See Interpretation No. 10 with respect to Considerations Related to Reviews Performed in Accordance with International Standard on Review Engagements [ISRE] 2400 (Revised), *Engagements to Review Historical Financial Statements*).

**.35** The standard review report used in another country, even when it appears similar to that used in the United States of America, may convey a different meaning and entail a different responsibility on the part of the accountant due to custom or culture. Issuing a standard review report of another country may require an understanding of local laws. When issuing the accountant's standard review report of another country, the accountant is required to obtain an understanding of applicable legal responsibilities, in addition to the review standards and accounting principles generally accepted in the other country, as indicated in paragraph .13 of section 90. Therefore, depending on the nature and extent of the accountant's knowledge and experience, the accountant may wish to consult with persons having expertise in the reporting practices of the other country and associated legal responsibilities to obtain the understanding needed to issue that country's standard review report.

**.36** If the accountant's report is intended for use in the United States of America, the reporting requirements described in paragraphs .27–.32 of section 90 would apply. Additionally, paragraph .38 of section 90 states that a need for restriction on the use of the report may result from a number of circumstances, including, but not limited to, the purpose of the report and the potential for the report to be misunderstood when taken out of context in which it was intended to be used. Because of the nature of the basis of presentation of the financial

statements, there is a presumption that the report would be misunderstood or taken out of context in which it was intended to be used. In such instances, the accountant may use the following form of report:

Independent Accountant's Review Report

*[Appropriate Salutation]*

I (We) have reviewed the accompanying balance sheets of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with *[the financial reporting framework generally accepted in another country, including identification of the nationality of the framework]* and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the reviews in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

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 *[the financial reporting framework generally accepted in another country, including identification of the nationality of the framework]*.

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

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

**.37** When the financial statements will be used both outside of the United States of America as well as in the United States of America, nothing precludes the accountant from issuing two reports—a report to be used only outside of the United States of America and another report to be used in the United States of America.

[Issue Date: May 2008; Revised: June 2010; Revised: August 2010; Revised: December 2010 (formerly Interpretation No. 30 to section 100); Revised: December 2012; Revised: January 2015.]

**10. Considerations Related to Reviews Performed in Accordance with International Standard on Review Engagements 2400 (Revised), Engagements to Review Historical Financial Statements, Issued by the International Auditing and Assurance Standards Board**

**.38 Question**—May a U.S. accountant perform a review of historical financial statements of a U.S. entity<sup>1</sup> in accordance with ISRE 2400, *Engagements to*

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<sup>1</sup> A U.S. entity is an entity that is either organized or domiciled in the United States of America.

*Review Financial Statements*, issued by the International Auditing and Assurance Standards Board? The financial statements may have been prepared in accordance with IFRS or accounting principles generally accepted in the United States of America.

**.39 Interpretation**—An accountant performing a review of historical financial statements of a U.S. entity is required to follow the review standards as promulgated by the AICPA's Accounting and Review Services Committee. However, those standards do not prohibit an accountant from indicating that the review also was conducted in accordance with another set of review standards. In an engagement to review the historical financial statements in accordance with ISRE 2400, the accountant may perform the review in accordance with Statements on Standards for Accounting and Review Services (SSARs) as well as ISRE 2400. Such a review report may read as follows:

I (We) have reviewed the accompanying balance sheets of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. A review includes primarily applying analytical procedures to management (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the reviews in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants and in accordance with International Standard on Review Engagements (ISRE 2400) issued by the International Auditing and Assurance Standards Board. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

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 or International Financial Reporting Standards as issued by the International Accounting Standards Board.

**.40** If the report is for use only outside of the United States of America, the accountant is still required to apply SSARs, except for requirements related to report form and content.

[Issue Date: May 2008; Revised: June 2010; Revised: August 2010; Revised: December 2010 (formerly Interpretation No. 30 to section 100); Revised: December 2012; Revised: January 2015.]

## 11. Required Supplementary Information That Accompanies Reviewed Financial Statements

**.41 Question**—Paragraph .60 of section 90 addresses situations when the basic financial statements are accompanied by information presented for supplementary analysis purposes. Certain information presented for supplementary analysis purposes may be required by a body designated by the AICPA

Council to establish GAAP pursuant to the "Compliance With Standards Rule" and the "Accounting Principles Rule"<sup>2</sup> (hereinafter referred to as "required supplementary information"). Examples of required supplementary information that may accompany reviewed financial statements include the following:

- With respect to common interest realty associations, estimates of current or future costs of major repairs and replacements of common property that will be required in the future as required by FASB *Accounting Standards Codification* 972-235-50-3
- Management's discussion and analysis and budgetary comparison statements as required by Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*

Is the accountant required to apply procedures to required supplementary information that accompanies reviewed financial statements?

**.42 Interpretation**—No. SSARSs do not require the accountant to apply procedures to any information presented for supplementary analysis purposes, including required supplementary information.

**.43 Question**—Paragraph .60 of section 90 states that when the basic financial statements are accompanied by information presented for supplementary analysis purposes, the accountant should indicate the degree of responsibility, if any, he or she is taking with respect to such information. How may an accountant modify the accountant's review report to refer to the required supplementary information and explain the circumstances regarding its presentation?

**.44 Interpretation**—The accountant may modify the accountant's review report by including a separate paragraph that refers to the required supplementary information and explains the circumstances regarding its presentation. That separate paragraph would be presented after the paragraph that reports the results of the engagement and may read as follows:

***The Required Supplementary Information Is Included***

*[Identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)] require that [identify the required supplementary information] on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by [identify the designated accounting standard setter] who considers it to be an essential part of financial reporting and for placing the basic financial statements in an appropriate operational, economic, or historical context. Such information was not audited, reviewed, or compiled by me (us) and, accordingly, I (we) do not express an opinion or provide any assurance on it.*

***All Required Supplementary Information Omitted***

Management has omitted *[describe the missing required supplementary information]* that *[identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]* require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by *[identify the designated accounting standard setter]* who considers

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<sup>2</sup> The bodies designated by the AICPA Council to establish professional standards with respect to financial accounting and reporting principles pursuant to these rules are the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the Federal Accounting Standards Advisory Board, and the International Accounting Standards Board.

it to be an essential part of financial reporting and for placing the basic financial statements in an appropriate operational, economic, or historical context. The results of our review of the basic financial statements are not affected by this missing information.

***Some Required Supplementary Information Is Omitted and Some Is Presented in Accordance With the Prescribed Guidelines Regarding the Required Supplementary Information***

*[Identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]* require that *[identify the included supplementary information]* be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by *[identify designated accounting standard setter]* who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Such information was not audited, reviewed, or compiled by me (us) and, accordingly, I (we) do not express an opinion or provide any assurance on it.

Management has omitted *[describe the missing required supplementary information]* that *[identify the applicable financial reporting framework]* require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by *[identify designated accounting standard setter]* who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. The results of our review of the basic financial statements are not affected by this missing information.

[Issue Date: October 2011; Revised: January 2015.]

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## AR Section 100

# ***Compilation and Review of Financial Statements***

Superseded, December 2010, by the issuance of SSARS No. 19.

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## AR Section 110

# ***Compilation of Specified Elements, Accounts, or Items of a Financial Statement***

**Issue date, unless otherwise indicated: July 2005**

**Source: SSARS No. 13; SSARS No. 17**

**.01** Statements on Standards for Accounting and Review Services (SSARSs) provide guidance concerning the standards and procedures applicable when an accountant is engaged to report on compiled financial statements or submits financial statements to his or her client or to third parties. By definition, presentations of specified elements, accounts, or items of a financial statement are not financial statements. This statement expands SSARSs to apply when an accountant is engaged to report or issues a report on one or more compiled specified elements, accounts, or items of a financial statement. If, however, the specified element, account, or item of a financial statement is included as supplementary information, the accountant should refer to paragraph .53 of section 80, *Compilation of Financial Statements*. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.02** A compilation of one or more specified elements, accounts, or items of a financial statement is limited to assisting management (owners) in presenting financial information without undertaking to obtain or provide any assurance that there are no material modifications that should be made to that information. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.03** 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.

## **Conditions for Compiling Specified Elements, Accounts, or Items of a Financial Statement**

**.04** Nothing in this statement is intended to preclude an accountant from assisting management (owners) in presenting one or more specified elements, accounts, or items of a financial statement and submitting such specified elements, accounts, or items of a financial statement to the client or to third parties without the issuance of a compilation report, unless the accountant has been engaged to report on such compiled specified elements, accounts, or items of a financial statement. If an accountant assists management (owners) in presenting a schedule of one or more specified elements, accounts, or items of a financial statement,<sup>[1]</sup> the accountant should consider how such a presentation of specified elements, accounts, or items will be used. The accountant should consider the potential of being associated with the schedule and the likelihood that the user may inappropriately infer, through that association, an unintended level

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<sup>[1]</sup> [Footnote deleted, December 2010, to reflect conforming changes necessary due to the issuance of Statement on Standards for Accounting and Review Services (SSARS) No. 19.]

of reliance on the information. 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 an unintended level of reliance on the information. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.05** An engagement to report on one or more compiled specified elements, accounts, or items of a financial statement may be undertaken as a separate engagement or in conjunction with a compilation, review, or audit of financial statements. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

## **Understanding With the Entity**

**.06** When an accountant is engaged to report on one or more compiled specified elements, accounts, or items of a financial statement, the accountant should establish an understanding with management regarding the services to be performed and should document the understanding through a written communication with management. Such an understanding reduces the risks that either the accountant or management may misinterpret the needs or expectations of the other party. For example, it reduces the risk that management may inappropriately rely on the accountant to protect the entity against certain risks or perform certain functions that are management's responsibility. The accountant should ensure that the understanding includes the objectives of the engagement, management's responsibilities, the accountant's responsibilities, and the limitations of the engagement. In some cases, the accountant may establish such understanding with those charged with governance. An understanding with management and, if applicable, those charged with governance, regarding a compilation of specified elements, accounts, or items of a financial statement should include the following matters:

- The objective of a compilation of specified elements, accounts, or items of a financial statement is to assist management in presenting such financial information.
- The accountant utilizes information that is the representation of management (owners) without undertaking to obtain any assurance that there are no material modifications that should be made to the specified element, account, or item of a financial statement in order for the specified element, account, or item to be in conformity with the applicable financial reporting framework.
- Management is responsible for the preparation and fair presentation of the specified element, account, or item of a financial statement in accordance with the applicable financial reporting framework.
- Management is responsible for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the specified element, account, or item of a financial statement.
- Management is responsible for the prevention and detection of fraud.
- Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

- Management is responsible for making all financial records and related information available to the accountant.
- The accountant is responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.
- A compilation differs significantly from a review or an audit of specified elements, accounts, or items of a financial statement. 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; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, the accountant will not express an opinion or provide any assurance regarding the specified element, account, or item of a financial statement.
- The engagement cannot be relied upon to disclose errors, fraud,<sup>2</sup> or illegal acts.<sup>3</sup>
- 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 procedures<sup>4</sup> that fraud or an illegal act may have occurred.<sup>5</sup> The accountant need not report any matters regarding illegal acts that may have occurred that are clearly inconsequential and may reach agreement in advance with the entity on the nature of any such matters to be communicated.
- The effect of any independence impairments on the expected form of the accountant's compilation report, if applicable.

[Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.07** When the accountant is engaged to report on one or more compiled specified elements, accounts, or items of a financial statement and evidence or information comes to his or her attention during the engagement that fraud or an illegal act may have occurred, the accountant should adhere to the communication requirements contained in paragraphs .54–.55 of section 80. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

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<sup>2</sup> For purposes of this statement, *fraud* is an intentional act that results in a misstatement in compiled specified elements, accounts, or items of a financial statement.

<sup>3</sup> For purposes of this statement, illegal acts are violations of laws or government regulations, excluding fraud.

<sup>4</sup> Performance requirements with respect to an engagement to compile one or more specified elements, accounts, or items of a financial statement are contained in paragraphs .08 and .09.

<sup>5</sup> Whether the act is, in fact, fraudulent or illegal is a determination that is normally beyond the accountant's professional competence. An accountant, in reporting on one or more specified elements, accounts, or items of a financial statement, presents himself or herself as one who is proficient in accounting and compilation 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 about 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.

## Performance Requirements

**.08** When the accountant is engaged to report on one or more compiled specified elements, accounts, or items of a financial statement, he or she should adhere to the compilation performance requirements contained in paragraphs .06–.13 of section 80. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.09** 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 inadequate disclosures. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

## Documentation Requirements

**.10** When the accountant is engaged to report on one or more compiled specified elements, accounts, or items of a financial statement, he or she should adhere to the documentation requirements contained in paragraphs .14–.15 of section 80. [Paragraph added, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

## Reporting Requirements

**.11** The accountant's objective in reporting on one or more compiled specified elements, accounts, or items of a financial statement is to prevent misunderstanding of the degree of responsibility the accountant is assuming when his or her name is associated with the elements, accounts, or items of a financial statement. When the accountant issues a compilation report on one or more specified elements, accounts, or items of a financial statement, the basic elements of the report are as follows:

- a. *Title.* The accountant's compilation report should have a title that clearly indicates that it is the accountant's compilation report. The accountant may indicate that he or she is independent in the title, if applicable. Appropriate titles would be "Accountant's Compilation Report" or "Independent Accountant's Compilation Report."
- b. *Addressee.* The accountant's report should be addressed as appropriate in the circumstances of the engagement.
- c. *Introductory paragraph.* The introductory paragraph in the accountant's report should
  - i. identify the entity whose elements, accounts, or items of a financial statement have been compiled;
  - ii. state that the specified element(s), account(s), or item(s) have been compiled;
  - iii. identify the specified element(s), account(s), or item(s) that have been compiled;
  - iv. specify the date or period covered by the specified element(s), account(s), or items;

- v. include a statement that the accountant has not audited or reviewed the specified element(s), account(s), or item(s) and, accordingly, does not express an opinion or provide any assurance about whether the specified element(s), account(s), or item(s) are in accordance with the applicable financial reporting framework; and
  - vi. if the compilation was performed in conjunction with a compilation of the entity'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).
- d. *Management's responsibility for the specified element(s), account(s), or item(s) and for internal control over financial reporting.* A statement that management (owners) is (are) responsible for the preparation and fair presentation of the specified element(s), account(s), or item(s) in accordance with the applicable financial reporting framework and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the specified element(s), account(s), or item(s).
  - e. *Accountant's responsibility.* A statement that the accountant's responsibility is to conduct the compilation in accordance with SSARSs issued by the AICPA.
  - f. A statement that the objective of a compilation is to assist management in presenting financial information in the form of specified element(s), account(s), or item(s) of a financial statement without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the specified element(s), account(s), or item(s) of a financial statement.
  - g. *Signature of the accountant.* The manual or printed signature of the accounting firm or the accountant, as appropriate.
  - h. *Date of the accountant's report.* The date of the compilation report (the date of completion of the compilation should be used as the date of the accountant's report).

Procedures that the accountant might have performed as part of the compilation engagement should not be described in the report.

See exhibit B, "Illustrative Accountant's Compilation Reports on Specified Elements, Accounts, or Items of a Financial Statement," for illustrative compilation reports.

[Paragraph renumbered and revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.12** Each page of the specified elements, accounts, or items of a financial statement compiled by the accountant should include a reference, such as "See accountant's compilation report" or "See independent accountant's compilation report." [Paragraph renumbered and revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**[.13]** [Paragraph renumbered and deleted, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

## Reporting When the Accountant Is Not Independent

**.14** When the accountant is issuing a report with respect to a compilation of specified element(s), account(s), or item(s) of a financial statement for an entity, with respect to which the accountant is not independent, the accountant's report should be modified. In making a judgment about whether he or she is independent, the accountant should be guided by the AICPA Code of Professional Conduct. The accountant should indicate his or her lack of independence in a final paragraph of the accountant's compilation report. An example of such a disclosure would be<sup>[6]</sup>

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

The accountant is not precluded from disclosing a description about the reason(s) that his or her independence is impaired. The following are examples of descriptions the accountant may use:

- a. I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (a member of the engagement team) had a direct financial interest in XYZ Company.
- b. I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because an individual of my immediate family (an immediate family member of one of the members of the engagement team) was employed by XYZ Company.
- c. I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (we) performed certain accounting services (the accountant may include a specific description of those services) that impaired my (our) independence.

If the accountant elects to disclose a description about the reasons his or her independence is impaired, the accountant should ensure that all reasons are included in the description.

[Paragraph renumbered and revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.15** This section is effective for engagements entered into after December 15, 2005. Early application is permitted. [Paragraph renumbered and revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

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<sup>[6]</sup> [Footnote deleted, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

.16

## Exhibit A

### Illustrative Engagement Letter for a Compilation of Specified Elements, Accounts, or Items of a Financial Statement

*[Appropriate Salutation]*

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will compile, from information you provide, *[identify specified element, account, or item of the financial statement, schedule of accounts receivable or schedule of depreciation – income tax basis]* of XYZ Company as of December 31, 20XX, 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.

The objective of a compilation is to assist you in presenting financial information in the form of *[identify specified element, account, or item of the financial statement]*. We will utilize information that is your representation without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the *[identify specified element, account, or item of the financial statement]* in order for *[identify specified element, account, or item of the financial statement]* to be in conformity with *[the applicable financial accounting framework (for example, accounting principles generally accepted in the United States of America)]*.

You are responsible for

- a. the preparation and fair presentation of *[identify specified element, account, or item of the financial statement]* in accordance with *[the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]*.
- b. designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of *[identify specified element, account, or item of the financial statement]*.
- c. preventing and detecting fraud.
- d. identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
- e. making all financial records and related information available to us.

We are responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.

A compilation differs significantly from a review or an audit of financial information. 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; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, the

## 2114 Statements on Standards for Accounting and Review Services

examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion or provide any assurance regarding the [*identify specified element, account, or item of the financial statement*] being compiled.

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

If, during the period covered by the engagement letter, the accountant's independence is or will be impaired, insert the following:

We are not independent with respect to XYZ Company. We will disclose that we are not independent in our compilation report.

If, for any reason, we are unable to complete the compilation of your [*identify specified element, account, or item of the financial statement*], we will not issue a report on such schedule as a result of this engagement.

Our fees for these services . . . .

We will 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.<sup>[\*]</sup>

Sincerely yours,

\_\_\_\_\_  
[Signature of accountant]

Acknowledged:  
XYZ Company

\_\_\_\_\_  
President

\_\_\_\_\_  
Date

[As amended, effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, by SSARS No. 17. Paragraph renumbered and revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

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<sup>[\*]</sup> [Footnote deleted, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

.17

## Exhibit B

### Illustrative Compilation Reports on Specified Elements, Accounts, or Items of a Financial Statement

#### Standard Compilation Report on a Schedule of Accounts Receivable Prepared in Accordance With Accounting Principles Generally Ac- cepted in the United States of America

##### Accountant's Compilation Report

*[Appropriate Salutation]*

I (we) have compiled the accompanying schedule of accounts receivable of XYZ Company as of December 31, 20XX. I (we) have not audited or reviewed the accompanying schedule of accounts receivable and, accordingly, do not express an opinion or provide any assurance about whether the schedule of accounts receivable is in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the schedule of accounts receivable in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the schedule of accounts receivable.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of a schedule of accounts receivable without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the schedule of accounts receivable.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

#### Standard Compilation Report on a Schedule of Depreciation Prepared in Accordance With the Basis of Accounting the Entity Uses for Federal Income Tax Purposes

##### Accountant's Compilation Report

*[Appropriate Salutation]*

I (we) have compiled the accompanying schedule of depreciation of XYZ Company as of December 31, 20XX. I (we) have not audited or reviewed the accompanying schedule of depreciation and, accordingly, do not express an opinion or provide any assurance about whether the schedule of depreciation is in accordance with the basis of accounting the Company uses for federal income tax purposes.

Management (owners) is (are) responsible for the preparation and fair presentation of the schedule of depreciation in accordance with the basis of accounting the Company uses for federal income tax purposes and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the schedule of depreciation.

## 2116 Statements on Standards for Accounting and Review Services

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of a schedule of depreciation without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the schedule of depreciation.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

[Paragraph added, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

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## AR Section 120

# Compilation of Pro Forma Financial Information

Issue date, unless otherwise indicated: July 2005

Source: SSARS No. 14; SSARS No. 17

**.01** Statements on Standards for Accounting and Review Services (SSARSs) provide guidance concerning the standards and procedures applicable when an accountant is engaged to report on compiled financial statements or submits financial statements to his or her client or third parties. By definition, presentations of pro forma financial information are not financial statements. This statement expands SSARSs to apply when an accountant is engaged to report or issues a report on compiled pro forma financial information. If, however, the pro forma financial information is included as supplementary information, the accountant should refer to paragraph .53 of section 80, *Compilation of Financial Statements*. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.02** A compilation of pro forma financial information is limited to assisting management (owners) in presenting financial information without undertaking to obtain or provide any assurance that there are no material modifications that should be made to that information. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

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

- Business combination
- Change in capitalization
- Disposition of a significant portion of the business
- Change in the form of business organization or status as an autonomous entity
- Proposed sale of securities and the application of the proceeds

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

**.05** 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.

## **Conditions for Compiling Pro Forma Financial Information**

**.06** Nothing in this statement is intended to preclude an accountant from assisting management (owners) in presenting pro forma financial information and submitting such pro forma financial information to the client or to third parties without the issuance of a compilation report, unless the accountant has been engaged to report on such compiled pro forma financial information. If an accountant assists management (owners) in presenting pro forma financial information,<sup>[1]</sup> the accountant should consider how such a presentation of pro forma financial information will be used. The accountant should 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 reliance on the information. 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 an unintended level of reliance on the information. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.07** An engagement to report on compiled 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 only if the document that contains the pro forma financial information includes (or incorporates by reference) the historical financial statements of the entity on which the pro forma financial information is based. Historical interim financial information 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. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.08** 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.

## **Understanding With the Entity**

**.09** When an accountant is engaged to report on compiled pro forma financial information, the accountant should establish an understanding with

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<sup>[1]</sup> [Footnote deleted, December 2010, to reflect conforming changes necessary due to the issuance of Statement on Standards for Accounting and Review Services (SSARS) No. 19.]

management regarding the services to be performed and should document the understanding through a written communication with management. Such an understanding reduces the risks that either the accountant or management may misinterpret the needs or expectations of the other party. For example, it reduces the risk that management may inappropriately rely on the accountant to protect the entity against certain risks or perform certain functions that are management's responsibility. The accountant should ensure that the understanding includes the objectives of the engagement, management's responsibilities, the accountant's responsibilities, and the limitations of the engagement. In some cases, the accountant may establish such understanding with those charged with governance. An understanding with management and, if applicable, those charged with governance regarding a compilation of pro forma financial information should include the following matters:

- The objective of a compilation of pro forma information is to assist management in presenting such financial information.
- The accountant utilizes information that is the representation of management (owners) without undertaking to obtain any assurance that there are no material modifications that should be made to the pro forma financial information in order for the pro forma financial information to be in conformity with the applicable financial reporting framework.
- Management is responsible for the preparation and fair presentation of the pro forma financial information in accordance with the applicable financial reporting framework.
- Management is responsible for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the pro forma financial information.
- Management is responsible for the prevention and detection of fraud.
- Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
- Management is responsible for making all financial records and related information available to the accountant.
- The accountant is responsible for conducting the engagement in accordance with SSARs issued by the AICPA.
- A compilation differs significantly from a review or an audit of pro forma financial information. 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; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, the accountant will not express an opinion or provide any assurance regarding the pro forma financial information.

- The engagement cannot be relied upon to disclose errors, fraud,<sup>2</sup> or illegal acts.<sup>3</sup>
- 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 procedures<sup>4</sup> that fraud or an illegal act may have occurred.<sup>5</sup> The accountant need not report any matters regarding illegal acts that may have occurred that are clearly inconsequential and may reach agreement in advance with the entity on the nature of any such matters to be communicated.
- The effect of any independence impairments on the expected form of the accountant's compilation report, if applicable.

[Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.10** When the accountant is engaged to report on compiled pro forma financial information and evidence or information comes to his or her attention during the engagement that fraud or an illegal act may have occurred, the accountant should adhere to the communication requirements contained in paragraphs .54–.55 of section 80. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

## Performance Requirements

**.11** When the accountant is engaged to report on compiled pro forma financial information, he or she should adhere to the compilation performance requirements contained in paragraphs .06–.13 of section 80. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.12** 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,<sup>6</sup> 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 inadequate

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<sup>2</sup> For purposes of this statement, *fraud* is an intentional act that results in a misstatement in compiled pro forma financial information.

<sup>3</sup> For purposes of this statement, *illegal* acts are violations of laws or government regulations, excluding fraud.

<sup>4</sup> Performance requirements with respect to an engagement to compile pro forma financial information are contained in paragraphs .11–.12.

<sup>5</sup> Whether the act is, in fact, fraudulent or illegal is a determination that is normally beyond the accountant's professional competence. An accountant, in reporting on pro forma financial information, presents himself or herself as one who is proficient in accounting and compilation 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 about 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.

<sup>6</sup> 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 paragraph .20 of section 80, *Compilation of Financial Statements*. [Footnote revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

disclosures. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

## Documentation Requirements

.13 When the accountant is engaged to report on compiled pro forma financial information, he or she should adhere to the documentation requirements contained in paragraphs .14–.15 of section 80. [Paragraph added, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

## Reporting Requirements

.14 The accountant's objective in reporting on compiled pro forma financial information is to prevent misunderstanding of the degree of responsibility the accountant is assuming when his or her name is associated with the pro forma financial information. When the accountant issues a compilation report on pro forma financial information, the basic elements of the report are as follows:

- a. *Title.* The accountant's compilation report should have a title that clearly indicates that it is the accountant's compilation report. The accountant may indicate that he or she is independent in the title, if applicable. Appropriate titles would be "Accountant's Compilation Report" or "Independent Accountant's Compilation Report."
- b. *Addressee.* The accountant's report should be addressed as appropriate in the circumstances of the engagement.
- c. *Introductory paragraph.* The introductory paragraph in the accountant's report should
  - i. identify the entity whose pro forma financial information has been compiled.
  - ii. state that the pro forma financial information has been compiled.
  - iii. identify the pro forma financial information that has been compiled.
  - iv. specify the date or period covered by the pro forma financial information.
  - v. reference the financial statements from which the historical financial information is derived and include 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.)
  - vi. include a statement that the accountant has not audited or reviewed the pro forma financial information and, accordingly, does not express an opinion or provide any assurance about whether pro forma financial information is in accordance with the applicable financial reporting framework.
  - vii. if the compilation was performed in conjunction with a compilation of the entity'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.

- d. *Management's responsibility for the pro forma financial information and for internal control over financial reporting.* A statement that management (owners) is (are) responsible for the preparation and fair presentation of the pro forma financial information in accordance with the applicable financial reporting framework and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the pro forma financial information.
- e. *Accountant's responsibility.* A statement that the accountant's responsibility is to conduct the compilation in accordance with SSARSs issued by the AICPA.
- f. A statement that the objective of a compilation is to assist management in presenting financial information in the form of pro forma financial information without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the pro forma financial information.
- g. A separate paragraph explaining the objective of pro forma financial information and its limitations.
- h. *Signature of the accountant.* The manual or printed signature of the accounting firm or the accountant, as appropriate.
- i. *Date of the accountant's report.* The date of the compilation report (the date of completion of the compilation should be used as the date of the accountant's report).

Procedures that the accountant might have performed as part of the compilation engagement should not be described in the report.

See exhibit B, "Illustrative Accountant's Compilation Report on Pro Forma Financial Information," for an illustrative compilation report.

[Paragraph renumbered and revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.15** Each page of the pro forma financial information compiled by the accountant should include a reference, such as "See accountant's compilation report" or "See independent accountant's compilation report." [Paragraph renumbered and revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

[.16] [Paragraph renumbered and deleted, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]<sup>[7-8]</sup>

## Reporting When the Accountant Is Not Independent

**.17** When the accountant is issuing a report with respect to a compilation of pro forma financial information for an entity, with respect to which the accountant is not independent, the accountant's report should be modified. In making a judgment about whether he or she is independent, the accountant should be guided by the AICPA Code of Professional Conduct. The accountant

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<sup>[7-8]</sup> [Footnotes deleted, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

should indicate his or her lack of independence in a final paragraph of the accountant's compilation report. An example of such a disclosure would be<sup>[9]</sup> If the accountant is not independent, he or she should specifically disclose the lack of independence. However, the reason for the lack of independence should not be described. When the accountant is not independent, the following should be included as the last paragraph of the report:

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

The accountant is not precluded from disclosing a description about the reason(s) that his or her independence is impaired. The following are examples of descriptions the accountant may use:

- a. I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (a member of the engagement team) had a direct financial interest in XYZ Company.
- b. I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because an individual of my immediate family (an immediate family member of one of the members of the engagement team) was employed by XYZ Company.
- c. I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (we) performed certain accounting services (the accountant may include a specific description of those services) that impaired my (our) independence.

If the accountant elects to disclose a description about the reasons his or her independence is impaired, the accountant should ensure that all reasons are included in the description.

[Paragraph renumbered and revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.18** This section is effective for engagements entered into after December 15, 2005. Early application is permitted. [Paragraph renumbered, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

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<sup>[9]</sup> [Footnote deleted, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

## Exhibit A

### Illustrative Engagement Letter for a Compilation of Pro Forma Financial Information

*[Appropriate Salutation]*

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will compile, from information you provide, the pro forma financial information of XYZ Company as of December 31, 20XX, 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.

The objective of a compilation is to assist you in presenting financial information in the form of pro forma financial information. We will utilize information that is your representation without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the pro forma financial information in order for the pro forma financial information to be in conformity with *[the applicable financial accounting framework (for example, accounting principles generally accepted in the United States of America)]*.

You are responsible for

- a. the preparation and fair presentation of the pro forma financial information in accordance with *[the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]*.
- b. designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the pro forma financial information.
- c. preventing and detecting fraud.
- d. identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
- e. making all financial records and related information available to us.

We are responsible for conducting the engagement in accordance with SSARs issued by the AICPA.

A compilation differs significantly from a review or an audit of financial information. 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; testing 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. Accordingly, we will not express an opinion or provide any assurance regarding the pro forma financial information being compiled.

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

If, during the period covered by the engagement letter, the accountant's independence is or will be impaired, insert the following:

We are not independent with respect to XYZ Company. We will disclose that we are not independent in our compilation report.

If, for any reason, we are unable to complete the compilation of your pro forma financial information, we will not issue a report on such schedule as a result of this engagement.

Our fees for these services . . . .

We will 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.<sup>[\*]</sup>

Sincerely yours,

\_\_\_\_\_  
[Signature of accountant]

Acknowledged:

XYZ Company

\_\_\_\_\_  
President

\_\_\_\_\_  
Date

[As amended, effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, by SSARS No. 17. Paragraph renumbered and revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

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<sup>[\*]</sup> [Footnote deleted, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

## Exhibit B

# Illustrative Compilation Report on Pro Forma Financial Information

Compilation report on pro forma financial information reflecting a business combination prepared in accordance with accounting principles generally accepted in the United States of America

### Accountant's Compilation Report

*[Appropriate Salutation]*

I (we) have compiled the accompanying pro forma financial information of XYZ Company as of December 31, 20XX, reflecting the business combination of the Company and ABC Company. 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).<sup>1</sup> I (we) have not audited or reviewed the accompanying pro forma financial information and, accordingly, do not express an opinion or provide any assurance about whether the pro forma financial information is in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the pro forma financial information in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the pro forma financial information.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of pro forma financial information without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the pro forma financial information.

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 transaction (or event) actually occurred earlier.

*Paragraph the accountant may add after the previous paragraph when management has elected to omit substantially all disclosures, but the pro forma financial*

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<sup>1</sup> When 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 the report.

*information is otherwise in conformity with accounting principles generally accepted in the United States of America.*

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

[Paragraph added, December 2010, to reflect the presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

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**AR Section 200****Reporting on Comparative Financial Statements**

Issue date, unless  
otherwise indicated:  
October 1979

See section 9200 for interpretations of this section.

Source: SSARS No. 2;  
SSARS No. 3; SSARS No. 4;  
SSARS No. 5; SSARS No. 7;  
SSARS No. 11; SSARS No. 12;  
SSARS No. 15; SSARS No. 17

**.01** This section establishes standards for reporting on comparative financial statements<sup>[1]</sup> of a nonissuer when financial statements of one or more periods presented have been compiled and reported on or reviewed in accordance with section 80, *Compilation of Financial Statements*, or section 90, *Review of Financial Statements*, respectively.<sup>2</sup> [Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Standards for Accounting and Review Services (SSARS) No. 8. As amended, effective for compilations and reviews of financial statements for periods ending after December 15, 2008, by SSARS No. 17. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.02** When comparative financial statements are presented, the accountant should issue an appropriate report(s) covering each period presented in accordance with the provisions of this section. Exhibit A, "Illustrative Compilation Reports on Comparative Financial Statements," and exhibit B, "Illustrative Review Reports on Comparative Financial Statements," provide illustrative reports on comparative financial statements, including how the title of the report may be modified when the level of service between the years is different.<sup>[3]</sup>

**.03** 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 an indication by the client that the accountant has not audited, reviewed, or compiled those financial statements and that the accountant assumes no responsibility for them. Whenever the accountant becomes aware that financial statements of other periods that have not been audited, reviewed, or compiled have been presented in

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<sup>[1]</sup> [Footnote deleted, December 2010, to reflect conforming changes necessary due to the issuance of Statement on Standards for Accounting and Review Services (SSARS) No. 19.]

<sup>2</sup> The terms *nonissuer* and *financial statements* are defined in paragraph .04 of section 60, *Framework for Performing and Reporting on Compilation and Review Engagements*. [As amended, effective for compilations and reviews of financial statements for periods ending after December 15, 2008, by SSARS No. 17. Footnote revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

<sup>[3]</sup> [Footnote deleted to reflect the conforming changes necessary due to the issuance of SSARS No. 8.]

columnar form in a document with financial statements on which he or she has compiled or reviewed and that his or her name has been used or his or her report included in the document, he or she should advise his or her client that the use of his or her name or report is inappropriate and should consider what other actions might be appropriate, including consultation with his or her attorney.

.04 An accountant may modify his or her report with respect to one or more financial statements for one or more periods while issuing an unmodified report on the other financial statements presented.

.05 Compiled financial statements that omit substantially all of the disclosures required by an applicable financial reporting framework<sup>[4]</sup> are not comparable to financial statements that include such disclosures. Accordingly, the accountant should not issue a report on comparative financial statements when statements for one or more, but not all, of the periods presented omit substantially all of the disclosures required by an applicable financial reporting framework. (See paragraphs .30–.31 for guidance on reporting on financial statements that previously did not omit substantially all of the disclosures required by an applicable financial reporting framework.) [As amended by the issuance of SSARS No. 15, July 2007. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

.06 Each page of the comparative financial statements compiled or reviewed by the accountant should include a reference such as "See Accountant's Compilation Report" or "See Independent Accountant's Review Report." [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

## Definitions

.07 The following definitions apply for purposes of this section:

**Comparative financial statements.** Financial statements of two or more periods presented in columnar form.

**Continuing accountant.** An accountant who has been engaged to audit, review, or compile and report on the financial statements of the current period and one or more consecutive periods immediately prior to the current period.

**Updated report.** A report issued by a continuing accountant that takes into consideration information that he or she becomes aware of during his or her current engagement and that re-expresses his or her previous conclusions or, depending on the circumstances, expresses different conclusions on the financial statements of a prior period as of the date of his or her current report.<sup>5</sup>

**Reissued report.** A report issued subsequent to the date of the original report that bears the same date as the original report. A reissued report may need to be revised for the effects of specific events; in these circumstances, the report should be dual-dated with the original date and a separate date that applies to the effects of such events.

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<sup>[4]</sup> [Footnote deleted, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19]

<sup>5</sup> See paragraph .17 of section 80, *Compilation of Financial Statements*, and paragraph .28 of section 90, *Review of Financial Statements*. [Footnote revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Standards for Accounting and Review Services No. 9. Footnote revised, May 2004, to reflect the conforming changes necessary due to the issuance of Statement on Standards for Accounting and Review Services No. 10. Footnote revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

## Continuing Accountant's Standard Report

**.08** A continuing accountant who performs the same or a higher level of service with respect to the financial statements of the current period should update his or her report on the financial statements of a prior period presented with those of the current period.<sup>6</sup> A continuing accountant who performs a lower level of service with respect to the financial statements of the current period should either (a) include as a separate paragraph of his or her report a description of the responsibility assumed for the financial statements of the prior period (see paragraphs .11–.12) or (b) reissue his or her report on the financial statements of the prior period.

**.09** [Paragraph deleted, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

**.10** [Paragraph deleted, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

**.11** A continuing accountant who performs a compilation of the current-period financial statements and has previously reviewed one or more prior-period financial statements should report as indicated in either (a) or (b) that follow:

- a. Issue a compilation report on the current-period financial statements that includes a description of the responsibility assumed for the financial statements of the prior period. The description should include the original date of the accountant's report and should also state that he or she has not performed any procedures in connection with that review engagement after that date.
- b. Combine his or her compilation report on the financial statements of the current period with his or her reissued review report on the financial statements of the prior period or present them separately. The combined report should state that the accountant has not performed any procedures in connection with that review engagement after the date of his or her review report.

**.12** See exhibit A and exhibit B for examples of a continuing accountant's standard report on comparative financial statements when

- the same level of service has been performed for both periods.
- the financial statements of the current period have been reviewed and those of the prior period have been compiled.
- the financial statements of the current period have been compiled and those of the prior period have been reviewed.

[Revised, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

## Continuing Accountant's Changed Reference to a Departure From the Applicable Financial Reporting Framework

**.13** During his or her current engagement, the accountant should be aware that circumstances or events may affect the prior-period financial statements

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<sup>6</sup> For purposes of this section, a *review* is a higher level of service and a *compilation* is a lower level of service. When one of the periods is audited, see paragraphs .28–.29.

presented, including the adequacy of informative disclosures. The accountant should consider the effects on his or her report on the prior-period financial statements of circumstances or events coming to his or her attention.

**.14** When the accountant's report on the financial statements of the prior period contains a changed reference to a departure from the applicable financial reporting framework,<sup>7</sup> his or her report should include a separate explanatory paragraph indicating

- a. the date of the accountant's previous report.
- b. the circumstances or events that caused the reference to be changed.
- c. when applicable, that the financial statements of the prior period have been changed.

[Revised, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

**.15** See exhibit A and exhibit B for examples of reports which include an explanatory paragraph when an accountant's report contains a changed reference to a departure from accounting principles generally accepted in the United States of America. [Revised, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

## **Predecessor's Compilation or Review Report**

**.16** A predecessor may reissue his or her report at the client's request if he or she is able to make satisfactory arrangements with his or her former client and if he or she complies with the provisions of paragraphs .20–.24. However, a predecessor is not required to reissue his or her compilation or review report on the financial statements of a prior period. If he or she does not reissue his or her compilation or review report on the financial statements of a prior period, a successor should either (a) make reference to the report of the predecessor in accordance with the provisions of paragraphs .17–.19 or (b) perform a compilation or review of the financial statements of the prior period and report on them accordingly.<sup>[8]</sup>

## **Predecessor's Compilation or Review Report Not Presented**

**.17** 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 or her 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).<sup>9</sup>
- b. The date of his or her (their) report.

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<sup>7</sup> A changed reference includes the removal of a prior reference or the inclusion of a new reference.

<sup>[8]</sup> [Footnote deleted by the issuance of SSARS No. 4, December 1981.]

<sup>9</sup> The successor accountant should not name the predecessor accountant in his or her report unless the predecessor accountant if the predecessor accountant's practice was acquired by, or merged with, that of the successor accountant. [Footnote amended, effective May 2004, by SSARS No. 11. Footnote revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

- c. If the financial statements of the prior period were compiled, a statement that the other accountant(s) did not audit or review the financial statements and, accordingly, did not express an opinion or provide any assurance about whether the financial statements are in accordance with the applicable financial reporting framework.
- d. If the financial statements of the prior period were reviewed, a statement that, based on his or her review, the other accountant(s) are 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, other than those modifications, if any, indicated in the report.
- e. A description or a quotation of any modifications of the standard report and of any paragraphs emphasizing a matter regarding the financial statements.

[Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.18** See exhibit A and exhibit B for examples of reports when the predecessor compiled or reviewed the financial statements of the prior period, respectively. [Revised, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

**[.19]** [Paragraph deleted, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

## Predecessor's Compilation or Review Report Reissued

**.20** Before reissuing a compilation or review report on the financial statements of a prior period, a predecessor should consider whether his or her report is still appropriate. In making this determination, the predecessor should consider (a) the current form and manner of presentation of the prior-period financial statements, (b) subsequent events not previously known, and (c) changes in the financial statements that require the addition or deletion of modifications to the standard report.

**.21** A predecessor should perform the following procedures before reissuing his or her compilation or review report on the financial statements of a prior period:

- a. Read the financial statements of the current period and the successor's report.
- b. Compare the prior-period financial statements with those previously issued and with those of the current period.
- c. Obtain a letter from the successor that indicates whether he or she is aware of any matter that, in his or her opinion, might have a material effect on the financial statements, including disclosures, reported on by the predecessor. The predecessor should not refer in his or her reissued report to this letter or to the report of the successor.

**.22** If a predecessor becomes aware of information, including information about events or transactions occurring subsequent to the date of his or her previous report, that he or she believes may affect the prior-period financial statements or his or her report on them, he or she should (a) make inquiries or perform analytical procedures similar to those he or she would have performed if he or she had been aware of such information at the date of his or her report on the prior-period financial statements and (b) perform any other procedures he or

she considers necessary in the circumstances. For example, the predecessor may wish to discuss this information with the successor or to review the engagement documentation of the successor as it relates to the matters affecting the prior-period financial statements. If the predecessor decides, based on the information obtained, that his or her report on the prior-period financial statements should be revised, he or she should follow the guidance in paragraphs .14-.15 and .23-.24. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.23** A predecessor's knowledge of the current affairs of his or her former client is obviously limited in the absence of a continuing relationship. Consequently, when reissuing his or her report on the prior-period financial statements, a predecessor should use the date of his or her previous report to avoid any implication that he or she has performed procedures after that date other than those described in paragraphs .20-.22. If the predecessor revises his or her report or if the financial statements are restated, he or she should dual-date his or her report (for example, "March 1, 20X1, except for note X, as to which the date is March 15, 20X2"). The predecessor's responsibility for events occurring subsequent to the completion of his or her engagement is limited to the specific event referred to in the note or otherwise disclosed. He or she should also obtain a written statement from the former client setting forth the information currently acquired and its effect on the prior-period financial statements and, if applicable, expressing an understanding of its effect on the predecessor's reissued report.

**.24** If a predecessor is unable to complete the procedures described in paragraphs .20-.23, he or she should not reissue his or her report and may wish to consult with his or her attorney regarding the appropriate course of action.

## Restated Prior-Period Financial Statements

**.25** When prior-period financial statements have been restated,<sup>10</sup> the predecessor accountant would normally reissue his or her report following the guidance in paragraph .22. 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. [As amended, effective for compilations and reviews of financial statements for periods ending after December 15, 2005, by SSARS No. 12.]

**.26** See exhibit A and exhibit B for examples of reports when the predecessor accountant's report is not presented and the successor accountant is

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<sup>10</sup> See paragraphs .10-.11 of section 400, *Communications Between Predecessor and Successor Accountants*, for 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. [Footnote added, effective for compilations and reviews of financial statements for periods ending after December 15, 2005, by SSARS No. 12.]

engaged to compile or review the restatement adjustment(s), respectively.<sup>[11]</sup> [As amended, effective for compilations and reviews of financial statements for periods ending after December 15, 2005, by SSARS No. 12. Revised, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

[.27] [Paragraph deleted, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]<sup>[12]</sup>

## Reporting When One Period Is Audited

[.28] [Paragraph deleted, December 2010, to remove reference to auditing literature.]

**.29** When the current-period financial statements of a nonissuer have been compiled or reviewed and those of the prior period have been audited, the accountant should issue an appropriate compilation or review report on the current-period financial statements and, if the auditor's report on the prior period financial statements is not reissued, the report on the current period should include as a separate paragraph an appropriate description of the responsibility assumed for the financial statements of the prior period. The separate paragraph should indicate (a) that the financial statements of the prior period were audited previously, (b) the date of the previous report, (c) the type of opinion expressed previously, (d) if the opinion was other than unmodified, the substantive reasons therefor, and (e) that no auditing procedures were performed after the date of the previous report. See exhibit A and exhibit B for examples of compilation and review reports, respectively, when the prior year financial statements were audited. [Paragraph renumbered by the issuance of SSARS No. 12, July 2005. As amended, effective for compilations and reviews of financial statements for periods ending after December 15, 2008, by SSARS No. 17. Revised, December 2010, to reflect the presentation style and conforming changes necessary due to the issuance of SSARS No. 19. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

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

**.30** An accountant who has compiled, reviewed, or audited financial statements that did not omit substantially all of the disclosures required by an applicable financial reporting framework may subsequently be requested to compile statements for the same period that do omit substantially all of those disclosures when they are to be presented in comparative financial statements. In these circumstances the accountant may report on comparative compiled financial statements that omit such disclosures if he or she includes in his or her report an additional paragraph indicating the nature of the previous service rendered with respect to those financial statements and the date of his or her previous report. [Paragraph renumbered by the issuance of SSARS No. 12, July 2005. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

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<sup>[11]</sup> [Footnote deleted, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

<sup>[12]</sup> [Footnote deleted, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.31** See exhibit A for an example of a report appropriate when prior-period financial statements that omit substantially all disclosures have been compiled from previously reviewed financial statements for the same period. [As amended, effective for periods ending after December 15, 1993, by SSARS No. 7. Paragraph renumbered by the issuance of SSARS No. 12, July 2005. Revised, December 2010, to reflect the presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

**[.32–.33]** [Paragraphs deleted, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]<sup>[13–14]</sup>

## **Transition**

**[.34–.36]** [Paragraphs deleted to reflect conforming changes necessary due to the issuance of SSARS No. 8. Paragraphs renumbered by the issuance of SSARS No. 12, July 2005.]

## **Effective Date**

**.37** This section will be effective for reports on comparative financial statements for periods ending on or after November 30, 1979. However, earlier application is encouraged for periods ending on or after July 1, 1979. [Paragraph renumbered by the issuance of SSARS No. 12, July 2005.]

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<sup>[13–14]</sup> [Footnotes deleted, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

## Exhibit A

### Illustrative Compilation Reports on Comparative Financial Statements

#### Compilation Report on Comparative Financial Statements When a Compilation Has Been Performed for Both Periods

##### Accountant's Compilation Report

*[Appropriate Salutation]*

I (we) have compiled the accompanying balance sheets of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilations in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

#### Compilation Report When the Financial Statements of the Current Year Have Been Compiled and Those of The Prior Year Have Been Reviewed

##### Accountant's Compilation Report<sup>1</sup>

*[Appropriate Salutation]*

I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the 20X2 financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles

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<sup>1</sup> Alternatively, an accountant may use a title that does not describe the level of service such as "Accountant's Report" or "Report of Certified Public Accountants" because the report refers to different levels of service.

generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilations in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

The accompanying 20X1 financial statements were previously reviewed by me (us) and I (we) stated that I was (we were) not aware of any material modifications that should be made to those financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America in my (our) report dated March 31, 20X2, but I (we) have not performed any procedures in connection with that review engagement since that date.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

**Compilation Report on Comparative Financial Statements When the Accountant's Report Includes a Changed Reference to a Departure From Accounting Principles Generally Accepted in the United States of America**

**Accountant's Compilation Report**

*[Appropriate Salutation]*

I (we) have compiled the accompanying balance sheets of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilations in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

In my (our) report dated March 1, 20X2 with respect to the 20X1 financial statements, we referred to a departure from accounting principles generally accepted in the United States of America because the company carried its land at appraised values. As described in Note X, the Company has changed its method of accounting for land and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

**Compilation Report on Comparative Financial Statements When the Prior Period Financial Statements Were Compiled By a Predecessor Accountant and the Predecessor's Report Is Not Presented****Accountant's Compilation Report**

*[Appropriate Salutation]*

I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America. The financial statements of XYZ Company as of December 31, 20X1, were compiled by other accountants whose report dated February 1, 20X2 stated that they have not audited or reviewed the 20X1 financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the 20X2 compilations in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

**Compilation Report on Comparative Financial Statements When the Predecessor Accountant's Report Is Not Presented, and the Successor Accountant Is Engaged to Compile the Restatement Adjustment(s)****Accountant's Compilation Report**

*[Appropriate Salutation]*

I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America. The financial statements prior to adjustment of XYZ Company as of and for the year ended December 31, 20X1, were compiled by other accountants whose report dated February 1, 20X2, stated that they have not audited or reviewed the 20X1 financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles

generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilations in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

I (We) also compiled the adjustments described in Note X that were applied to restate the 20X1 financial statements. I (we) have not audited or reviewed the adjustments described in Note X that were applied to restate the 20X1 financial statements and, accordingly, do not express an opinion or provide any assurance about whether the adjustments described in Note X that were applied to restate the 20X1 financial statements are in accordance with accounting principles generally accepted in the United States of America.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

**Compilation Report on Comparative Financial Statements When the Prior Period Financial Statements Were Audited**

**Accountant's Compilation Report<sup>2</sup>**

*[Appropriate Salutation]*

I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilations in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

The 20X1 financial statements were audited by me (us) (other accountants) and I (we) (they) expressed an unmodified opinion on them in my (our) (their) report dated March 1, 20X2, but I (we) (they) have not performed any auditing procedures since that date.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

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<sup>2</sup> Alternatively, an accountant may use a title that does not describe the level of service such as "Accountant's Report" or "Report of Certified Public Accountants" because the report refers to different levels of service.

**Compilation Report on Comparative Financial Statements When Prior Period Financial Statements That Omit Substantially All Disclosures Have Been Compiled From Previously Reviewed Financial Statements of the Same Period**

**Accountant's Compilation Report**

*[Appropriate Salutation]*

I (we) have compiled the accompanying balance sheets of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilations in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

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

The 20X1 financial statements were compiled by me (us) from financial statements that did not omit substantially all of the disclosures required by accounting principles generally accepted in the United States of America and that I (we) previously reviewed as indicated in my (our) report dated March 1, 20X2.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

[Paragraph added, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

## Exhibit B

### Illustrative Review Reports on Comparative Financial Statements

#### Review Report on Comparative Financial Statements When a Review Has Been Performed for Both Periods

##### Independent Accountant's Review Report

*[Appropriate Salutation]*

I (We) have reviewed the accompanying balance sheets of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the reviews in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

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 accounting principles generally accepted in the United States of America.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

#### Review Report on Comparative Financial Statements When the Financial Statements of the Current Period Have Been Reviewed and Those of The Prior Period Have Been Compiled

##### Independent Accountant's Review Report<sup>1</sup>

*[Appropriate Salutation]*

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management's (owners') financial data and making

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<sup>1</sup> Alternatively, an accountant may use a title that does not describe the level of service such as "Accountant's Report" or "Report of Certified Public Accountants" because the report refers to different levels of service.

inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the reviews in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the 20X2 financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

The accompanying 20X1 financial statements of XYZ Company were compiled by me (us). The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements. Accordingly, I (we) do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

### **Review Report on Comparative Financial Statements When the Accountant's Report Includes a Changed Reference to a Departure From Accounting Principles Generally Accepted in the United States Of America**

#### **Independent Accountant's Review Report**

*[Appropriate Salutation]*

I (We) have reviewed the accompanying balance sheets of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the reviews in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform

procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

In my (our) report dated March 1, 20X2, with respect to the 20X1 financial statements, we referred to a departure from accounting principles generally accepted in the United States of America because the company carried its land at appraised values. As described in Note X, the Company has changed its method of accounting for land and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, my (our) present statement on the 20X1 financial statements, as presented herein, that I am (we are) not aware of any material modifications that should be made to the accompanying financial statements is different from that expressed in our previous report.

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 accounting principles generally accepted in the United States of America.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

**Review Report on Comparative Financial Statements When the Prior Period Financial Statements Were Reviewed by a Predecessor Accountant, and the Predecessor's Report Is Not Presented**

**Independent Accountant's Review Report**

*[Appropriate Salutation]*

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion. The financial statements of XYZ Company as of December 31, 20X1, were reviewed by other accountants whose report dated February 1, 20X2, stated that based on their procedures, they are not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the 20X2 financial statements in order for them to be in

conformity with accounting principles generally accepted in the United States of America.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

**Review Report on Comparative Financial Statements When the Predecessor Accountant's Report Is Not Presented, and the Successor Accountant Is Engaged to Review the Restatement Adjustments**

**Independent Accountant's Review Report**

*[Appropriate Salutation]*

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion. The financial statements of XYZ Company as of December 31, 20X1 prior to adjustment were reviewed by other accountants whose report dated February 1, 20X2, stated that based on their procedures, they are not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the 20X2 financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

I (We) also reviewed the adjustments described in Note X that were applied to restate the 20X1 financial statements. Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the adjustments described in Note X that were applied to restate the 20X1 financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

**Review Report on Comparative Financial Statements When the Prior Period Financial Statements Were Audited**

**Independent Accountant's Review Report<sup>2</sup>**

*[Appropriate Salutation]*

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the 20X2 financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were audited by me (us) (other accountants) and I (we) (they) expressed an unmodified opinion on them in my (our) (their) report dated March 1, 20X2, but I (we) (they) have not performed any auditing procedures since that date.

[Paragraph added, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

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<sup>2</sup> Alternatively, an accountant may use a title that does not describe the level of service such as "Accountant's Report" or "Report of Certified Public Accountants" because the report refers to different levels of service.

## AR Section 9200

# Reporting on Comparative Financial Statements: Accounting and Review Services Interpretations of Section 200

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

**.01 Question**—Paragraph .30 of section 200, *Reporting on Comparative Financial Statements*, states that an accountant who has compiled, reviewed, or audited financial statements that do not omit substantially all of the disclosures required by an applicable financial reporting framework may subsequently compile financial statements for the same period that do omit substantially all of those disclosures when they are to be presented in comparative financial statements. In these circumstances, section 200 requires the accountant's compilation report to include an additional paragraph indicating (a) the nature of the service rendered with respect to the financial statements that previously did not omit substantially all disclosures and (b) the date of the accountant's previous report.

**.02** When the accountant has previously audited such financial statements, the accountant may have issued a modified opinion on the financial statements (a qualified opinion, an adverse opinion, or a disclaimer of opinion; see AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*). What effect, if any, should this have on the accountant's compilation report on the comparative financial statements? Also, when the accountant has previously compiled or reviewed such financial statements, what effect should a modification to the accountant's compilation or review report have on the accountant's compilation report on the comparative financial statements?

**.03 Interpretation**—If financial statements that omit substantially all disclosures are compiled from financial statements that the accountant has previously audited, the accountant's compilation report on the comparative financial statements should indicate whether the accountant modified the opinion on the audited financial statements, and the substantive reasons therefor. Similarly, if the accountant issued a modified compilation or review report or a report containing any paragraphs emphasizing a matter regarding the financial statements on financial statements that previously did not omit substantially all disclosures, the accountant's reference to that report in the accountant's compilation report on the comparative financial statements should include a description or a quotation of any modifications of the standard report and of any paragraphs emphasizing a matter regarding the financial statements.

**.04** Statements on Standards for Accounting and Review Services do not require an accountant to modify the standard compilation report for an uncertainty or an inconsistency in the application of an applicable financial reporting framework. When the accountant's compilation report on comparative financial statements that omit substantially all of the disclosures required by the applicable financial reporting framework includes a reference to a previous audit report that includes an emphasis-of-matter paragraph describing an uncertainty, users may assume, in the absence of an indication to the contrary,

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that the uncertainty has been resolved. Thus, in such circumstances, in accordance with paragraph .25 of section 80, *Compilation of Financial Statements*, the accountant may emphasize the uncertainty in a separate paragraph of that portion of the accountant's report that relates to the financial statements for the current period.

[Issue Date: November, 1980; Revised: November, 2002;  
Revised: May, 2004; Revised: July, 2005; Revised: December, 2012.]

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**AR Section 300****Compilation Reports on Financial Statements  
Included in Certain Prescribed Forms**

Issue date, unless  
otherwise indicated:  
December 1981

See section 9300 for interpretations of this section.

Source: SSARS No. 3; SSARS No. 5;  
SSARS No. 7; SSARS No. 15; SSARS No. 17

**.01** The requirements of section 80, *Compilation of Financial Statements*, and section 200, *Reporting on Comparative Financial Statements*, are applicable when the unaudited financial statements of a nonissuer are included in a prescribed form. This section provides reporting guidance when the accountant is engaged to compile financial statements included in a prescribed form and the prescribed form or related instructions call for departure from the applicable financial reporting framework by specifying a measurement principle not in conformity with the applicable financial reporting framework or by failing to request the disclosures or presentation required by applicable financial reporting framework.<sup>1</sup> This section also provides additional guidance applicable to reports on financial statements included in a prescribed form.<sup>[2]</sup> [As amended, effective for compilations and reviews of financial statements for periods ending after December 15, 2008, by Statement on Standards for Accounting and Review Services (SSARS) No. 17. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.02** For purposes of this section, a *prescribed form* is any standard preprinted form designed or adopted by the body to which it is to be submitted, for example, 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. A form designed or adopted by the entity whose financial statements are to be compiled is not considered to be a prescribed form. The terms *applicable financial reporting framework*, *financial statements*, and *nonissuer* are defined in paragraph .04 of section 60, *Framework for Performing and Reporting on Compilation and Review Engagements*. [As amended, effective for compilations and reviews of financial statements for periods ending after December 15, 2008, by SSARS No. 17. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.03** There is a presumption that the information required by a prescribed form is sufficient to meet the needs of the body that designed or adopted the

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<sup>1</sup> See paragraphs .04 and .37–.39 of section 60, *Framework for Performing and Reporting on Compilation and Review Engagements*, for guidance with respect to applicable financial reporting frameworks. [Footnote amended, effective for compilations and reviews of financial statements for periods ending on or after December 15, 2007, by the issuance of Statements on Standards for Accounting and Review Services (SSARS) No. 15. Footnote revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

<sup>[2]</sup> [Footnote deleted to reflect the incorporation of material into relevant sections of the Statements on Standards for Accounting and Review Services.]

form and that there is no need for that body to be advised of departures from the applicable financial reporting framework required by the prescribed form or related instructions. See the exhibit, "Illustrative Compilation Reports When the Financial Statements Are Included in a Prescribed Form That Calls for a Departure From Accounting Principles Generally Accepted in the United States of America," for an illustrative example of a standard compilation report that may be used when the compiled financial statements are included in a prescribed form that calls for a departure from accounting principles generally accepted in the United States of America. [As amended, effective for periods ending after December 15, 1993, by SSARS No. 7. As amended, effective for compilations and reviews of financial statements for periods ending after December 15, 2008, by SSARS No. 17. Revised, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

**.04** If the accountant becomes aware of a departure from an applicable financial reporting framework other than departures that may be called for by the prescribed form or related instructions (see paragraph .01), he or she should follow the guidance in paragraphs .27–.29 of section 80 regarding such departures. If the accountant becomes aware of a departure from the requirements of the prescribed form or related instructions, he or she should consider that departure as the equivalent of a departure from an applicable financial reporting framework in determining its effect on his or her report. See the exhibit for an illustration of a report containing a departure from the prescribed form or related instructions. [Revised, November 2002, to reflect conforming changes necessary due to the issuance of SSARS No. 9. Revised, May 2004, to reflect conforming changes necessary due to the issuance of SSARS No. 10. Revised, July 2005, to reflect conforming changes necessary due to the issuance of SSARS No. 12. Revised, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

**.05** The accountant should not sign a preprinted report form that does not conform to the guidance in this section or section 80, whichever is applicable. In such circumstances, the accountant should append an appropriate report to the prescribed form. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

.06

## Exhibit

### Illustrative Compilation Reports on Financial Statements Included in Certain Prescribed Forms

#### Standard Compilation Report When the Compiled Financial Statements Are Included in a Prescribed Form That Calls for a Presentation Departure From Accounting Principles Generally Accepted in the United States of America

##### Accountant's Compilation Report

*[Appropriate Salutation]*

I (we) have compiled the (identification of financial statements, including period covered and the name of entity) included in the accompanying prescribed form. I (we) have not audited or reviewed the financial statements included in the accompanying prescribed form and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements included in the form prescribed by (name of body) in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

The financial statements included in the accompanying prescribed form are presented in accordance with the requirements of *[name of body]*, and are not intended to be a presentation in accordance with accounting principles generally accepted in the United States of America.

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

*[Signature of accounting firm or accountant, as appropriate]*

*[Date]*

**Compilation Report When the Compiled Financial Statements Are Prepared in Accordance With a Special Purpose Framework Prescribed by Contract or Regulation and That Framework Prescribes a Format for the Financial Information<sup>3</sup>**

Accountant's Compilation Report

[Appropriate Salutation]

I (we) have compiled the [identification of financial statements, including period covered and the name of entity] included in the accompanying prescribed form. I (we) have not audited or reviewed the financial statements included in the accompanying prescribed form and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the basis of accounting prescribed by [describe contract or regulation].

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements included in the form in accordance with the basis of accounting prescribed by [describe contract or regulation] and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

The financial statements included in the accompanying prescribed form are presented in accordance with the requirements of [describe contract or regulation], and are not intended to be a complete presentation of [name of entity's] assets and liabilities.

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

[Signature of accounting firm or accountant, as appropriate]

[Date]

[Paragraph added, December 2010, to reflect presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

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<sup>3</sup> See Interpretation No. 11, "Special-Purpose Financial Statements to Comply With Contractual Agreements or Regulatory Provisions," of section 80, *Compilation of Financial Statements* (sec. 9080 par. .32-.40).

## AR Section 9300

# ***Compilation Reports on Financial Statements Included in Certain Prescribed Forms: Accounting and Review Services Interpretations of Section 300***

### **1. Omission of Disclosures in Financial Statements Included in Certain Prescribed Forms**

**.01 Question**—The accountant may have reviewed financial statements including disclosures required by accounting principles generally accepted in the United States of America and be asked to compile financial statements included in a prescribed form which does not request such disclosures. If the measurement principles to be used do not cause the compiled financial statements in the prescribed form to be materially different from the reviewed statements, can the accountant's compilation report on the prescribed form refer to the accountant's report on the reviewed financial statements?

**.02 Interpretation**—Yes. An accountant who has reviewed the financial statements of a nonissuer may issue a compilation report on financial statements for the same period that are included in a prescribed form that calls for a departure from accounting principles generally accepted in the United States of America. When the difference between the previously reviewed financial statements and the financial statements included in the prescribed form is limited to the omission of disclosures not requested by the form, the accountant may wish to refer to his review report in his report on the compiled financial statements included in the prescribed form. This might be accomplished by adding a sentence such as the following to the introductory paragraph of the report or as a separate paragraph: "These financial statements were compiled by me (us) from financial statements for the same period which I (we) previously reviewed, as indicated in my (our) report dated \_\_\_\_."<sup>[\*]</sup> The reference to a previous review report should include a description or a quotation of any modifications of the standard review report previously issued and of any paragraphs emphasizing a matter regarding the financial statements.

**.03** If the measurement principles used in the compiled financial statements in the prescribed form cause such financial statements to be materially different from the previously reviewed financial statements, no reference should be made to the review engagement.

[Issue Date: May, 1982. Revised: February, 2008; Revised: December, 2012.]

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<sup>[\*]</sup> [Footnote deleted, December 2012, to reflect conforming changes necessary due to the issuance of Statement on Standards for Accounting and Review Services No. 19.]



## AR Section 400

# Communications Between Predecessor and Successor Accountants

Issue date, unless  
otherwise indicated:  
December 1981

See section 9400 for interpretations of this section.

Source: SSARS No. 4; SSARS No. 7;  
SSARS No. 9; SSARS No. 15; SSARS No. 17

**.01** This section provides guidance on communications between a predecessor and successor accountant when the successor accountant decides to communicate with the predecessor accountant regarding acceptance of an engagement to compile or review the financial statements of a nonissuer.<sup>[1]</sup> This section also provides guidance on inquiries a successor accountant may wish to make of a predecessor, and the predecessor's responses, to facilitate the conduct of the successor's compilation or review engagement. 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. [As amended, effective for periods ending after December 15, 1993, by Statement on Standards for Accounting and Review Services (SSARS) No. 7. As amended, effective November 2002, by SSARS No. 9.]

**.02** The following definitions apply for purposes of this section:

**Successor accountant.** An accountant who has been invited to make a proposal for an engagement to compile or review financial statements and is considering accepting the engagement or an accountant who has accepted such an engagement.

**Predecessor accountant.** An accountant who (a) has reported on the most recent compiled or reviewed financial statements or was engaged to perform, but did not complete, a compilation or review of the financial statements, and (b) has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated.

[As amended, effective November 2002, by SSARS No. 9.]

## Inquiries Regarding Acceptance of an Engagement

**.03** A successor accountant is not required 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

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<sup>[1]</sup> [Footnote deleted, November 2002, by the issuance of Statement on Standards for Accounting and Review Services (SSARS) No. 9.]

accountant may consider making inquiries of the predecessor accountant when circumstances such as the following exist:<sup>[2]</sup>

- a. The information obtained about the prospective client and its management and principals is limited or appears to require special attention.
- b. The change in accountants takes place substantially after the end of the accounting period for which statements are to be compiled or reviewed.
- c. There have been frequent changes in accountants.

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. [As amended, effective November 2002, by SSARS No. 9.]

**.04** 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.<sup>3</sup> 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. [As amended, effective November 2002, by SSARS No. 9.]

**.05** When the successor accountant decides to communicate with the predecessor accountant, the inquiries may be oral or written. 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 would include (a) information that might bear on the integrity of management (owners), (b) disagreements with management (owners) about accounting principles or the necessity for the performance of certain procedures or similarly significant matters, (c) the cooperation of management (owners) in providing additional or revised information, if necessary, (d) the predecessor's knowledge of any fraud or illegal acts perpetrated within the client, and (e) the predecessor's understanding of the reason for the change of accountants. [As amended, effective November 2002, by SSARS No. 9.]

**.06** The predecessor accountant should respond promptly and fully to the inquiries, on the basis of known facts. However, if the predecessor accountant decides, due to unusual circumstances<sup>4</sup> 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. The successor accountant should consider the implications of a limited response in connection with acceptance of the engagement. [As amended, effective November 2002, by SSARS No. 9.]

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<sup>[2]</sup> [Footnote deleted, November 1992, by the issuance of SSARS No. 7.]

<sup>3</sup> The successor accountant is not precluded from making these inquiries before making a proposal for the engagement.

<sup>4</sup> Unpaid fees, as discussed in paragraph .08, are not considered to be an unusual circumstance for purposes of this paragraph; however, see paragraph .08.

## Other Inquiries

[.07] [Paragraph deleted, November 2002, by the issuance of SSARS No. 9.]

.08 The successor accountant also may wish to review the predecessor's engagement documentation (terms such as *working papers* or *workpapers* are also sometimes used).<sup>[5]</sup> In these circumstances, the successor accountant should request the client to authorize the predecessor accountant to allow access. It is customary in such circumstances for the predecessor accountant to make himself or herself available to the successor accountant for consultation and to make available for review certain engagement documentation. The predecessor accountant should determine which documentation is to be made available for review and which may be copied. Ordinarily, the predecessor accountant should provide the successor accountant access to documentation relating to matters of continuing accounting significance and those relating to contingencies. Valid business reasons (including but not limited to unpaid fees), however, may lead the predecessor to decide not to allow access to the documentation.<sup>6</sup> The predecessor accountant may decide to reach an understanding with the successor accountant about the use of the documentation.<sup>7</sup> Further, when more than one accountant is considering acceptance of an engagement, the predecessor accountant should not be expected to make himself or herself or his or her documentation available until the client has designated one of those accountants as the successor accountant. [As amended, effective November 2002, by SSARS No. 9. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

## Successor Accountant's Use of Communications

.09 The successor accountant should not make reference to the report or work of a predecessor accountant in his or her own report, except as specifically permitted by section 200, *Reporting on Comparative Financial Statements*, with respect to the financial statements of a prior period. [As amended, effective November 2002, by SSARS No. 9. As amended, effective for compilations and reviews of financial statements for periods ending on or after December 15, 2007, by SSARS No. 15.]

## Financial Statements Reported on by Predecessor Accountant

.10 If, during the engagement, the successor accountant becomes aware of information that leads him or her to believe that financial statements reported on by the predecessor accountant may require revision, the successor accountant should request the client to communicate this information to the

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<sup>[5]</sup> [Footnote deleted, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

<sup>6</sup> See the "Records Request" interpretation (ET sec. 1.400.200) under the "Acts Discreditable Rule" (ET sec. 1.400.001), for guidance on what constitutes an accountant's working papers. [Footnote added, April 30, 1982, by the Accounting and Review Services Committee. Footnote revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

<sup>7</sup> Before permitting access to the documentation, the predecessor accountant may wish to obtain a written communication from the successor accountant regarding the use of the documentation. The exhibit contains an illustrative successor accountant acknowledgment letter. [Footnote added, effective November 2002, by SSARS No. 9. Footnote revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

predecessor accountant. Paragraphs .47–.52 of section 80, *Compilation of Financial Statements*, and paragraphs .54–.59 of section 90, *Review of Financial Statements*, provide guidance to the predecessor accountant in determining an appropriate course of action with respect to compilation and review engagements, respectively. [As amended, effective November 2002, by SSARS No. 9. Revised, May 2004, to reflect conforming changes necessary due to the issuance of SSARS No. 10. Revised, July 2005, to reflect conforming changes necessary due to the issuance of SSARS No. 12. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.11** If the client refuses to communicate with the predecessor accountant or if the successor accountant is not satisfied with the predecessor accountant's course of action, 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. [Paragraph added, effective November 2002, by SSARS No. 9.]

.12

## Exhibit

### Illustrative Successor Accountant Acknowledgment Letter

Paragraph .08 footnote 7 states, "Before permitting access to the documentation, the predecessor accountant may wish to obtain a written communication from the successor accountant regarding the use of the documentation." The following letter is presented for illustrative purposes only and is not required by professional standards.

[Date]

[Successor Accountant]

[Address]

We have previously [reviewed or compiled], in accordance with Statements on Standards for Accounting and Review Services the December 31, 20X1, financial statements of ABC Enterprises (ABC). In connection with your [review or compilation] of ABC's 20X2 financial statements, you have requested access to our documentation prepared in connection with that engagement. ABC has authorized our firm to allow you to review that documentation.

Our [review or compilation], and the documentation prepared in connection therewith, of ABC's financial statements was not planned or conducted in contemplation of your [review or compilation]. Therefore, items of possible interest to you may not have been specifically addressed. Our use of professional judgment for the purpose of this engagement means that matters may have existed that would have been assessed differently by you. We make no representation about the sufficiency or appropriateness of the information in our documentation for your purposes.

We understand that the purpose of your review of our documentation is to obtain information about ABC and our 20X1 [compilation or review] procedures to assist you in planning your 20X2 [compilation or review] of the financial statements of ABC. For that purpose only, we will provide you access to our documentation that relate to that objective.

Upon request, we will provide copies of the documentation that provide factual information about ABC. You agree to subject any such copies, or information otherwise derived from our documentation, to your normal policy for retention of documentation and protection of confidential client information. Furthermore, in the event of a third-party request for access to your documentation prepared in connection with your (reviews or compilations) of ABC, you agree to obtain our permission before voluntarily allowing any such access to our documentation or information otherwise derived from our documentation, and to obtain on our behalf any releases that you obtain from such third party. You agree to advise us promptly and provide us a copy of any subpoena, summons, or other court order for access to your documentation that include copies of our documentation or information otherwise derived therefrom.

Please confirm your agreement with the foregoing by signing and dating a copy of this letter and returning it to us.

Very truly yours,

[Predecessor Accountant]

By: \_\_\_\_\_

Accepted:

[Successor Accountant]

By: \_\_\_\_\_ Date: \_\_\_\_\_

## 2160 Statements on Standards for Accounting and Review Services

Even with the client's consent, access to the predecessor accountant's documentation may still be limited. Experience has shown that the predecessor accountant may be willing to grant broader access if given additional assurance concerning the use of the documentation. Accordingly, the successor accountant might consider agreeing to the following limitations on the review of the predecessor accountant's documentation in order to obtain broader access:

- The successor accountant will not comment, orally or in writing, to anyone as a result of the review about whether the predecessor accountant's engagement was performed in accordance with Statements on Standards for Accounting and Review Services.
- The successor accountant will not provide expert testimony or litigation services or otherwise accept an engagement to comment on issues relating to the quality of the predecessor accountant's engagement.

The following paragraph illustrates the above:

Because your review of our documentation is undertaken solely for the purpose described above and may not entail a review of all our documentation, you agree that (1) the information obtained from the review will not be used by you for any other purpose, (2) you will not comment, orally or in writing, to anyone as a result of that review about whether our engagement was performed in accordance with Statements on Standards for Accounting and Review Services, (3) you will not provide expert testimony or litigation services or otherwise accept an engagement to comment on issues relating to the quality of our engagement.

[Paragraph added, effective November 2002, by SSARS No. 9. Revised, September 2005, to reflect conforming changes necessary due to the Accounting and Review Services Committee. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

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## AR Section 9400

# ***Communications Between Predecessor and Successor Accountants: Accounting and Review Services Interpretations of Section 400***

### **1. Reports on the Application of Accounting Principles**

**.01 Question**—Section 400, *Communications Between Predecessor and Successor Accountants*, provides guidance on communication between a successor accountant and a predecessor accountant. The guidance provided concerns only the situation in which one accountant succeeds another in a compilation or review engagement.

**.02** In other situations, an accountant in public practice may be requested by an entity that has not engaged that accountant to report on its financial statements to provide advice about the application of accounting principles or about the type of report to be issued on its financial statements (compilation, review, or audit report). Such requests are often made to obtain a second opinion about these matters from another accountant. What guidance should be followed by the accountant who is requested to provide advice on these matters?

**.03 Interpretation**—AU-C section 915, *Reports on Application of Requirements of an Applicable Financial Reporting Framework*, addresses the reporting accountant's responsibilities when requested to issue a written report on the application of the requirements of an applicable financial reporting framework to a specific transaction or the type of report that may be issued on a specific entity's financial statements.

**.04** AU-C section 915 also applies to oral advice provided by the reporting accountant that the reporting accountant concludes is intended to be used by a principal to the transaction as an important factor considered in reaching a decision on the application of the requirements of an applicable financial reporting framework to a specific transaction or on the type of report that may be issued on a specific entity's financial statements.

**.05** Paragraph .13 of AU-C section 915 states that the reporting accountant should consult with the continuing accountant to determine whether the reporting accountant has obtained the available facts relevant to form a conclusion. The reporting accountant should follow AU-C section 915 for such engagements.

[Issue Date: August, 1987; Revised: November, 2002; Revised: December, 2012.]

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## AR Section 500

# *Reporting on Compiled Financial Statements*

Deleted, November 1992, by the issuance of SSARS No. 7.

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**AR Section 600****Reporting on Personal Financial Statements  
Included in Written Personal Financial Plans**

Issue date, unless  
otherwise indicated:  
September 1986

See section 9600 for interpretations of this section.

Source: SSARS No. 6

**.01** This section provides an exemption from section 80, *Compilation of Financial Statements*, 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.<sup>1</sup> However, this statement does not preclude an accountant from complying with section 80 in such engagements. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.02** Because the purpose of such financial statements is solely to assist in developing the client's personal financial plan, they frequently omit disclosures required by an applicable financial reporting framework. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.03** An accountant may submit a written personal financial plan containing unaudited personal financial statements to a client without complying with the requirements of section 80 when all of the following conditions exist:

- a. The accountant establishes an understanding with the client and documents the understanding through a written communication with the client that the financial statements
  - i. will be used solely to assist the client and the client's advisers to develop the client's personal financial goals and objectives.
  - ii. will not be used to obtain credit or for any purposes other than developing these goals and objectives.
- b. Nothing comes to the accountant's attention during the engagement that would cause the accountant to believe that the financial statements will be used to obtain credit or for any purposes other than developing the client's financial goals and objectives.

[Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.04** An accountant using the exemption provided by this section should issue a written report stating that the unaudited financial statements

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<sup>1</sup> For purposes of this statement, personal financial statements are those financial statements of an individual that meet the definition of *financial statements* in paragraph .04 of section 60, *Framework for Performing and Reporting on Compilation and Review Engagements*. [Footnote revised, December 2010, to reflect conforming changes necessary due to the issuance of Statement on Standards for Accounting and Review Services (SSARS) No. 19]

## 2166 Statements on Standards for Accounting and Review Services

- a. are designed solely to help develop the financial plan.
- b. may be incomplete or contain other departures from the applicable financial reporting framework and should not be used to obtain credit or for any purposes other than developing the personal financial plan.
- c. have not been audited, reviewed, or compiled.

**.05** See the exhibit, "Illustrative Report When the Accountant Submits a Written Financial Plan Containing Unaudited Personal Financial Statements That the Accountant Did Not Compile," for an illustration. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

**.06** Each of the personal financial statements should include a reference to the accountant's report.

### Effective Date

**.07** This section is effective on September 30, 1986.

.08

**Exhibit****Illustrative Report When the Accountant Submits a Written Financial Plan Containing Unaudited Personal Financial Statements That the Accountant Did Not Compile****Accountant's Report**

The accompanying Statement of Financial Condition of X, as of December 31, 20XX, was prepared solely to help you develop your personal financial plan. Accordingly, it may be incomplete or contain other departures from accounting principles generally accepted in the United States of America and should not be used to obtain credit or for any purposes other than developing your financial plan. We have not audited, reviewed, or compiled the statement.

[Paragraph added, December 2010, to reflect the presentation style and conforming changes necessary due to the issuance of SSARS No. 19.]

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## AR Section 9600

# ***Reporting on Personal Financial Statements Included in Written Personal Financial Plans: Accounting and Review Services Interpretation of Section 600***

### **1. Submitting a Personal Financial Plan to a Client's Advisers**

**.01 Question**—Paragraph .03 of section 600, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans*, states that an accountant may submit a written personal financial plan containing unaudited personal financial statements to a client without complying with the requirements of section 80, *Compilation of Financial Statements*, when, among other conditions, the accountant establishes an understanding with the client that the financial statements will be used solely to assist the client and the client's advisers to develop the client's personal financial goals and objectives. Does developing the client's personal financial goals and objectives encompass implementing the personal financial plan by the client or the client's advisers?

**.02 Interpretation**—Yes. Developing a client's personal financial goals and objectives includes implementing the personal financial plan by the client or the client's advisers because implementing the plan may be considered the culmination of the process of developing personal financial goals and objectives. Therefore, an accountant may submit a written personal financial plan containing unaudited personal financial statements to a client, to be used by the client or the client's advisers to implement the personal financial plan, without complying with the requirements of section 80, provided the conditions in paragraph .03 of section 600 exist.

**.03 Examples of implementation of a personal financial plan by the client's advisers include use of the plan by**

- an insurance broker who will identify specific insurance products.
- an investment adviser who will provide specific recommendations about the investment portfolio.
- an attorney who will draft a will or trust documents.

[Issue Date: May 1991; Revised: December 2012.]

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**AR****EXHIBITS**

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## AR Exhibit A

# ***Analytical Procedures in a Review Engagement***

### **Notice to Readers**

The purpose of the documentation guidance contained in this exhibit is to illustrate how an accountant might document expectations in a review engagement. The examples are presented for illustrative purposes only and should not be considered to represent either minimum or maximum documentation requirements.

This exhibit is an other compilation and review publication as defined in AR section 50, *Standards for Accounting and Review Services*. Other compilation and review publications have no authoritative status; however, they may help the accountant understand and apply Statements on Standards for Accounting and Review Services (SSARSs). If an accountant applies the guidance included in an other compilation and review publication, the accountant should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of the subject engagement. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate.

### **Expectations**

Forming an expectation is an integral phase of the analytical procedure process. Expectations are the accountant's predictions of recorded amounts or ratios developed from recorded amounts. In performing analytical procedures, the accountant develops the expectation in such a way that a material difference between the expectation and the recorded amount or ratio is indicative of a possible misstatement and, therefore, the accountant should obtain explanations for the difference (for example, an unusual event occurred). Expectations are developed by identifying plausible relationships (for example, store square footage and retail sales) that are reasonably expected to exist based on the accountant's understanding of the client and the industry in which the client operates. The accountant selects from a variety of data sources to form expectations. For example, the accountant may use prior-period information (adjusted for expected changes), management's budgets or forecasts, industry data, or nonfinancial data. Additionally, information that is developed when an accountant compiles interim financial statements can be utilized by the accountant in developing expectations associated with the review of financial statements.

An accountant cannot, under any circumstances, perform effective analytical procedures without first developing expectations related to the results of those analytical procedures. 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.

Pursuant to paragraph .26 of AR section 90, *Review of Financial Statements*, the accountant should document expectations and factors considered in the development of those expectations when the expectations are not otherwise readily determinable from the documentation of the work performed. [Revised, September 2012, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

The following are examples of how an accountant can document expectations. These examples are not intended to be all inclusive.

## Example 1—Expected Increase in Revenue

An accountant is engaged to review the financial statements of a company that manufactures components that are utilized by other companies in customizing vehicles for use by the United States military. Because of various conflicts occurring in the world and the United States' role in those conflicts, the accountant reasonably expects sales to increase. Using his or her knowledge of the client, the client's business, and the industry in which the client operates, the accountant expects a 10 percent to 15 percent increase in sales. Further, the accountant concludes that receivables should increase and that loans payable and interest expense would also increase because the client would need to borrow money to fund the additional production.

### *Sample documentation*

Teemickmag Military Supply Company  
Analytical Procedures  
For the year ended December 31, 20XX

### *Expectations*

The following are factors that should affect the relationship between current and prior year amounts:

- Increase in military spending by the government due to world events should result in an increase in sales. Expected increase is between 10 percent and 15 percent. The accountant expects a similar increase in accounts receivable.
- Because of an increase in production of military vehicles, the company had to borrow additional funds. Therefore, expected increase in loans payable and interest expense is between 10 percent and 15 percent.
- No significant change in either days sales in inventory or inventory turnover is expected. Although a build-up in inventory is expected, that build-up is not expected to correspond with the increase in sales because the vehicles are expected to be sold near the date of completion. Any change greater than 5 percent will be subjected to additional inquiries.

Balance sheets and income statements are available for the current year and the two years prior to the current year.

### *Trend analysis*

	<u>Current Year</u>	<u>Prior Year</u>	<u>Change</u>	<u>% Change</u>
Sales	\$2,500,000	\$2,175,000	\$325,000	14.94%
Cost of goods sold	1,780,000	1,566,000	214,000	13.67%
Gross margin	720,000	609,000		
Gross margin as a % of sales	28.80%	28.00%		
Selling expenses	230,000	184,000	46,000	25.00%
Interest expense	48,000	42,000	6,000	14.29%

*Balance sheet ratio analysis*

	<u>Current Year</u>	<u>Prior Year</u>	<u>Two Years Prior</u>
Accounts receivable, net	\$1,100,000	\$843,000	\$703,000
Inventory	1,000,000	832,000	694,000
Loans payable	498,000	437,000	418,000

*Days sales in receivables*

Days sales in receivables = Accounts receivable, net at end of period / (Net sales/365)

Current year days sales in receivables = \$1,100,000 / (\$2,500,000 / 365) = 161 days

Prior year days sales in receivables = \$843,000 / (\$2,175,000 / 365) = 141 days

The increase of 20 days sales in receivables (161 days – 141 days) represents a 14 percent increase. Because this increase is within the expected range, no further inquiry is necessary.

*Days sales in inventory*

Days sales in inventory = Inventory at the end of period / (Total cost of goods sold / 365)

Current year days sales in inventory = \$1,000,000 / (\$1,780,000 / 365) = 205 days

Prior year days sales in inventory = \$832,000 / (\$1,566,000 / 365) = 194 days

The increase of 11 days sales in inventory (205 days – 194 days) represents a 6 percent increase. Because this increase is greater than expected, the accountant should inquire of the client and document the reason for the unexpected increase.

*Inventory turnover*

Inventory turnover = Cost of goods sold / Average inventory

Current year inventory turnover = \$1,780,000 / ((\$1,100,000 + 832,000) / 2) = 1.84 times

Prior year inventory turnover = \$1,566,000 / ((\$832,000 + 694,000) / 2) = 2.05 times

The inventory turnover decreased 10 percent; therefore, because this decrease is greater than expected, the accountant should inquire of the client and document the reason for the unexpected decrease.

The preceding documentation would be adequate. Further, after performing the trend analysis, the accountant concludes that sales, costs of goods sold, and interest expense are all "reasonable" given the expectations associated with these amounts. In addition, with respect to balance sheet accounts, the increase in loans payable is also reasonable (14 percent increase) when considered with the corresponding increase in interest expense and the expectation associated with the loan payable account; however, because selling expenses increased by 25 percent, the accountant should inquire of the client and document the reason for that unexpected increase (actual increase does not correspond to expected increase).

## Example 2—Expected Decrease in Revenue

An accountant is engaged to review the financial statements of a client that either owns or manages, or both owns and manages, a shopping mall. Due to a poor economy, the mall lost tenants during the year; as such, the accountant reasonably expects revenue to decrease. Using his or her knowledge of the client, the client's business, and the industry in which the client operates, the accountant expects a 5 percent to 10 percent decrease in revenue during the year. Further, the accountant expects that general and administrative expenses should increase due to an increase in leasing and sales expenses and that management fees should decrease due to a decrease in tenants in the building.

### *Sample documentation*

Pearl River Mall

Analytical Procedures

For the year ended December 31, 20XX

### *Expectations*

The following are factors that should affect the relationship between current and prior year amounts:

- Loss of tenants due to poor economy should result in a decrease in revenue. Expected decrease is between 5 percent and 10 percent.
- Because of the increased number of vacancies, general and administrative expenses are expected to increase because of an increase in leasing and sales expenses. Expected increase is between 5 percent and 10 percent (corresponds with the decrease in revenue).
- Because of the decrease in the number of tenants in the building, management fees are expected to decrease between 5 percent and 10 percent (corresponds with decrease in revenue).

Balance sheets and income statements are available for the current year and the two years prior to the current year.

### *Trend analysis*

	<u>Current</u> <u>Year</u>	<u>Prior Year</u>	<u>Change</u>	<u>% Change</u>
Tenant revenue	\$7,223,000	\$8,603,000	\$(1,380,000)	(16.04)%
Costs and expenses:				
Management fees	339,000	387,000	(48,000)	(12.40)%
General and administrative	583,000	511,000	72,000	14.09 %

Similar balance sheet analytics should be performed as those performed in Example 1 above.

The preceding documentation would be adequate; however, the results of the analytical procedures do not agree with the documented expectations associated with those procedures. Therefore, the accountant should inquire and document why the decrease in tenant revenue, the decrease in management fees, and the increase in general and administrative expenses exceeded expectations.

### Example 3—No significant change in revenue or expenses expected

An accountant is engaged to review the financial statements of a small, privately held client in the candy store business. The accountant has performed a review of the financial statements of the candy store for each of the past five years with no significant change in revenue or expenses in any of those years. The accountant expects that trend to continue.

#### *Sample documentation*

Mom and Pop Candy Store  
Analytical Procedures  
For the year ended December 31, 20XX

#### *Expectations*

- Based on discussions with the owner and manager, no significant changes from prior year amounts are expected.
- All increases and decreases greater than 5 percent will be subjected to additional inquiries.

#### *Trend analysis*

	<u>Current Year</u>	<u>Prior Year</u>	<u>Change</u>	<u>% Change</u>
Sales	\$44,000	\$39,000	\$5,000	12.82%
Cost of goods sold	32,500	31,000	1,500	4.84%
Gross margin	11,500	8,000		
Gross margin as a % of sales	26.14%	20.51%		
Operating expenses	5,200	4,500	700	15.56%
Net income	6,300	3,500		

Similar balance sheet analytics should be performed as those performed in Example 1 above.

The preceding documentation would be adequate; however, the results of the analytical procedures do not agree with the documented expectations associated with those procedures. Therefore, the accountant may deem it appropriate to inquire and document why sales increased by an amount greater than expected. In addition, the accountant should inquire as to why there was not a comparable increase in cost of goods sold. Also, the accountant should discuss with the owner and manager why there is a greater than expected increase in operating expenses and document the results of the discussion.

### Example 4—Expected Changes in Construction Contracts

An accountant is engaged to review the financial statements of a general construction contractor primarily engaged in the construction of commercial office buildings. The accountant has performed the review of this company's financial statements for several years and expects that the current project in process should yield a 5 percent gross profit margin consistent with similar projects in the past and in accordance with the initial project estimate.

*Sample documentation*

ABC Construction Contractors  
 Analytical Procedures  
 For the year ended December 31, 20XX

*Expectations*

- Based upon discussions with the project manager, it is believed that the gross margin will be consistent with the 5 percent margin achieved in the past and in accordance with the initial project estimate.
- Any deviation in the margin greater than 1 percent will be subjected to additional inquiries.

*Trend analysis*

<u>Building Contract</u>	<u>Current Year</u>	<u>Prior Year</u>	<u>\$ Change</u>	<u>% Change</u>
Contract value	\$5.0 million	\$5.0 million		
Estimated costs at completion	4.9 million	4.75 million	\$150,000	3.15%
Planned profit	100,000	250,000	150,000	60.00%
Costs incurred	2.5 Million	1.0 million		
Profit recognized contract to date	50,000	50,000		

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## AR Exhibit B

# Going Concern Considerations

### Notice to Readers

The purpose of this nonauthoritative exhibit is to help practitioners better understand the accounting concepts of going concern in performing a compilation or review engagement. This exhibit has been prepared and reviewed by AICPA staff; however, it has not been approved, disapproved, or otherwise acted upon by the Accounting and Review Service Committee or any senior committee of the AICPA.

### Going Concern Consideration

Continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Ordinarily, information that indicates an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time, typically not to exceed one year beyond the date of the financial statements, relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions.

Certain conditions or events, when considered in the aggregate, may indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. The following are examples of such conditions and events:

- *Negative trends.* For example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, adverse key financial ratios.
- *Other indications of possible financial difficulties.* For example, default on loan or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, restructuring of debt, noncompliance with statutory capital requirements, need to seek new sources or methods of financing or to dispose of substantial assets.
- *Internal matters.* For example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, need to significantly revise operations.
- *External matters that have occurred.* For example, legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; uninsured or underinsured catastrophe such as a drought, earthquake, or flood.

After identifying adverse conditions and events, management's plans for dealing with the conditions or events may include the following:

- Plans to dispose of assets
  - Restrictions on disposal of assets, such as covenants limiting such transactions in loan or similar agreements or encumbrances against assets
  - Apparent marketability of assets that management plans to sell
  - Possible direct or indirect effects of disposal of assets
- Plans to borrow money or restructure debt
  - Availability of debt financing, including existing or committed credit arrangements, such as lines of credit or arrangements for factoring receivables or sale-leaseback of assets
  - Existing or committed arrangements to restructure or subordinate debt or to guarantee loans to the entity
  - Possible effects on management's borrowing plans of existing restrictions on additional borrowing or the sufficiency of available collateral
- Plans to reduce or delay expenditures
  - Apparent feasibility of plans to reduce overhead or administrative expenditures, to postpone maintenance or research and development projects, or to lease rather than purchase assets
  - Possible direct or indirect effects of reduced or delayed expenditures
- Plans to increase ownership equity
  - Apparent feasibility of plans to increase ownership equity, including existing or committed arrangements to raise additional capital
  - Existing or committed arrangements to reduce current dividend requirements or to accelerate cash distributions from affiliates or other investors

## Financial Statement Effects

When management concludes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, management should consider disclosing the following:

- Pertinent conditions and events giving rise to the assessment of the uncertainty about the entity's ability to continue as a going concern for a reasonable period of time
- The possible effects of such conditions and events
- Management's evaluation of the significance of those conditions and events and any mitigating factors
- Possible discontinuance of operations
- Management's plans (including relevant prospective financial information)
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities

When management concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time is alleviated, management should consider the need for disclosure of the principal conditions and events that initially caused it to believe there was an uncertainty. The consideration of disclosure may include the possible effects of such conditions and events, and any mitigating factors, including management's plans.

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## AR Exhibit C

[Exhibit deleted, October 2009, to reflect conforming changes necessary due to the issuance of FASB ASC 855, which provides authoritative accounting guidance for subsequent events.]

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**AR****APPENDIXES**

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## AR Appendix A

*[Reserved.]*

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## AR Appendix B

*[Reserved.]*

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## AR Appendix C

## ***Schedule of Changes in Statements on Standards for Accounting and Review Services***

<i>Section</i>	<i>Paragraph</i>	<i>Changes</i>	<i>Date of Change</i>
20		SSARS No. 16 added	December 2007
20		Superseded by SSARS No. 19	December 2009
50		Added by SSARS No. 11	May 2004
50		Superseded by SSARS No. 19	December 2009
50	.01	Amended by SSARS No. 17	December 2008
60		Added by SSARS No. 19	December 2009
80		Added by SSARS No. 19	December 2009
90		Added by SSARS No. 19	December 2009
90	.01	Amended by SSARS No. 20	February 2011
100		Superseded by SSARS No. 19	December 2009
100	.01	Amended by SSARS No. 8	October 2000
100	.01	Amended by SSARS No. 15	July 2007
100	.01	Amended by SSARS No. 17	February 2008
100	.01	Amended by SSARS No. 18	February 2009
100	.02	Amended by SSARS No. 3	December 1981
100	.02	Amended by SSARS No. 8	October 2000
100	.02	Amended by SSARS No. 17	December 2008
100	.03	Amended by SSARS No. 8	October 2000
100	.03	Amended by SSARS No. 9	November 2002
100	.03	Amended by SSARS No. 17	February 2008
100	.04	Amended by SSARS No. 2	October 1979
100	.04	Amended by SSARS No. 8	October 2000
100	.04	Amended by SSARS No. 9	November 2002
100	.04	Amended by SSARS No. 15	July 2007
100	.04	Amended by SSARS No. 17	February 2008
100	.05	Amended by SSARS No. 8	October 2000
100	.05	Amended by SSARS No. 12	July 2005
100	.06	New paragraph added by issuance of SSARS No. 17; subsequent paragraphs renumbered	February 2008
100	.07	Amended by SSARS No. 8	October 2000
100	.08	Amended by SSARS No. 8	October 2000
100	.09	Amended by SSARS No. 8	October 2000
100	.10	Amended by SSARS No. 8	October 2000
100	.10	Amended by SSARS No. 9	November 2002
100	.10	Amended by SSARS No. 12	July 2005

(continued)

<i>Section</i>	<i>Paragraph</i>	<i>Changes</i>	<i>Date of Change</i>
100	.11	Amended by SSARS No. 8	October 2000
100	.12	New paragraph added by issuance of SSARS No. 17; subsequent paragraphs renumbered	February 2008
100	.13	Amended by SSARS No. 8	October 2000
100	.13	Amended by SSARS No. 9	November 2002
100	.14	Amended by SSARS No. 8	October 2000
100	.14	Deleted by SSARS No. 9	November 2002
100	.15–.16	Amended by SSARS No. 8	October 2000
100	.16	Amended by SSARS No. 15	July 2007
100	.17	New paragraph added by issuance of SSARS No. 15; subsequent paragraphs renumbered	July 2007
100	.18–.19	Amended by SSARS No. 3	December 1981
100	.20–.21	Amended by SSARS No. 8	October 2000
100	.21	Amended by SSARS No. 15	July 2007
100	.22	New paragraph added by issuance of SSARS No. 15; subsequent paragraphs renumbered	July 2007
100	.23–.27	Amended by SSARS No. 8	October 2000
100	.28	New paragraph added by issuance of SSARS No. 17; subsequent paragraphs renumbered	February 2008
100	.29	Amended by SSARS No. 9	November 2002
100	.29	Amended by SSARS No. 10	May 2004
100	.29	Amended by SSARS No. 17	February 2008
100	.30	New paragraph added by issuance of SSARS No. 17; subsequent paragraphs renumbered	February 2008
100	.31	Amended by SSARS No. 9	November 2002
100	.31	Amended and transferred, from former 100.32, by SSARS No. 10; subsequent paragraphs renumbered	May 2004
100	.31	Amended by SSARS No. 12	July 2005
100	.31	Amended by SSARS No. 17	February 2008
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120		SSARS No. 14 added	July 2005
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### Part I—Statements on Standards for Accounting and Review Services and Sources of Sections in Current Text

#### Statements on Standards for Accounting and Review Services \*

No.	Date Issued	Title	AR-C Section
21	Oct. 2014	<i>Statements on Standards for Accounting and Review Services: Clarification and Recodification</i> <sup>1</sup>	

#### Sources of Sections in Current Text

AR-C Section	Contents	Source
60	<i>General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services</i>	SSARS No. 21
70	<i>Preparation of Financial Statements</i>	SSARS No. 21
80	<i>Compilation Engagements</i>	SSARS No. 21
90	<i>Review of Financial Statements</i>	SSARS No. 21

\* This table lists Statements on Standards for Accounting and Review Services (SSARSs) issued subsequent to SSARS No. 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*, which was issued in October 2014. Refer to part II, "List of Statements on Standards for Accounting and Review Services Nos. 1–20," of this section for SSARSs issued prior to SSARS No. 21.

<sup>1</sup> SSARS No. 21 created various sections throughout *Accounting and Review Services (Clarified)*. See the following section, "Sources of Sections in Current Text," for a full list.

## Part II—List of Statements on Standards for Accounting and Review Services Nos. 1–20

<i>No.</i>	<i>Date Issued</i>	<i>Title</i>
1	Dec. 1978	<i>Compilation and Review of Financial Statements</i>
2	Oct. 1979	<i>Reporting on Comparative Financial Statements</i>
3	Dec. 1981	<i>Compilation Reports on Financial Statements Included in Certain Prescribed Forms</i>
4	Dec. 1981	<i>Communications Between Predecessor and Successor Accountants</i>
5	July 1982	<i>Reporting on Compiled Financial Statements</i>
6	Sept. 1986	<i>Reporting on Personal Financial Statements Included in Written Personal Financial Plans</i>
7	Nov. 1992	<i>Omnibus Statement on Standards for Accounting and Review Services—1992</i>
8	Oct. 2000	<i>Amendment to Statement on Standards for Accounting and Review Services No. 1, Compilation and Review of Financial Statements</i>
9	Nov. 2002	<i>Omnibus Statement on Standards for Accounting and Review Services—2002</i>
10	May 2004	<i>Performance of Review Engagements</i>
11	May 2004	<i>Standards for Accounting and Review Services</i>
12	July 2005	<i>Omnibus Statement on Standards for Accounting and Review Services—2005</i>
13	July 2005	<i>Compilation of Specified Elements, Accounts, or Items of a Financial Statement</i>
14	July 2005	<i>Compilation of Pro Forma Financial Information</i>
15	July 2007	<i>Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services</i>
16	Dec. 2007	<i>Defining Professional Requirements in Statements on Standards for Accounting and Review Services</i>
17	Feb. 2008	<i>Omnibus Statement on Standards for Accounting and Review Services—2008</i>
18	Feb. 2009	<i>Applicability of Statements on Standards for Accounting and Review Services</i>
19	Dec. 2009	<i>Compilation and Review Engagements</i>
20	Feb. 2011	<i>Revised Applicability of Statements on Standards for Accounting and Review Services</i>

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## AR-C Introduction

### Foreword

## Clarified Statements on Standards for Accounting and Review Services

In October 2011, the Auditing Standards Board (ASB) reached a major milestone in its project to redraft all the auditing sections in the Codification of Statements on Auditing Standards (contained in AICPA *Professional Standards*), with the release of Statement on Auditing Standards (SAS) Nos. 122–124. The clarified auditing standards are designed to make the standards easier to read, understand, and apply.

The Accounting and Review Services Committee (ARSC) concluded that by undertaking a similar clarity project, it would serve the public interest and have all professional literature for audits, reviews, and compilations drafted using the same conventions. In addition, the resulting clarified compilation and review standards would be easier to read, understand, and apply.

In May 2010, ARSC approved a project to revise all existing compilation and review standards in the Codification of Statements on Standards for Accounting and Review Services (AR sections of AICPA *Professional Standards*) substantially using the drafting conventions adopted by the ASB in clarifying the auditing literature.

ARSC determined, however, that there would be certain differences between its clarity drafting conventions and those adopted by the ASB. Specifically, ARSC determined to not include specific application guidance with respect to governmental entities and smaller, less complex entities. Accordingly, the clarified SSARs have been drafted in accordance with ARSC's clarity drafting conventions, which include the following:

- Establish objectives for each clarified AR-C section
- Include a Definitions section, where relevant, in each clarified AR-C section
- Separate requirements from application and other explanatory material
- Number application and other explanatory material paragraphs using an A- prefix and present them in a separate section that follows the Requirements section
- Use formatting techniques, such as bullet lists, to enhance readability

### Convergence

Whereas the ASB used, where applicable, the corresponding International Standards on Auditing (ISA) as a base when drafting each clarified auditing standard, ARSC has used AU-C section 930, *Interim Financial Information*, as a base for the clarified review literature. AU-C section 930 was clarified using the corresponding international standard for reviews of interim financial statements as a base (International Standard on Review Engagements [ISRE] 2410, *Review of Interim Financial Information Performed by the Independent*

*Auditor of the Entity*), and there are no substantive differences between AU-C section 930 and ISRE 2410. ARSC determined that it was more appropriate to converge with the corresponding limited assurance engagement guidance in the American auditing literature than with ISRE 2400 (Revised), *Engagements to Review Historical Financial Statements*.

Although ARSC has considered International Standard on Related Services (ISRS) 4410, *Engagements to Compile Financial Statements*, and has adopted certain of the requirements, section 80, *Compilation Engagements*, has not been fully harmonized with ISRS 4410 because some of the underlying premises (for example, the requirement to determine independence) are different in the United States of America.

## SSARS No. 21

Statement on Standards for Accounting and Review Services (SSARS) No. 21 supersedes all outstanding SSARSs through No. 20, except SSARS No. 14, *Compilation of Pro Forma Financial Information*, as amended (AR sec. 120). SSARS No. 14 is currently being redrafted and will be issued as a separate SSARS when finalized.

All compilation and review interpretations of the SSARS have been considered in the development of the clarified SSARS and either been incorporated accordingly or will be considered for inclusion in the 2015 edition of the AICPA Guide *Review, Compilation, and Financial Statement Preparation Engagements*.

SSARS No. 21 is a standalone standard and does not represent the Codification of Statements on Standards for Accounting and Review Services.

## Effective Date

Section 60 is effective for engagements performed in accordance with SSARSs for periods ending on or after December 15, 2015.

Section 70 is effective for engagements to prepare financial statements for periods ending on or after December 15, 2015.

Section 80 is effective for compilations of financial statements for periods ending on or after December 15, 2015.

Section 90 is effective for reviews of financial statements for periods ending on or after December 15, 2015.

Early implementation is permitted for all sections.

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## AR-C Glossary

### *Glossary of Terms*

**Analytical procedures.** Evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass such investigation, as is necessary, of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

**Applicable financial reporting framework.** The financial reporting framework adopted by management and, when appropriate, those charged with governance, in the preparation and fair presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements or that is required by law or regulation.

**Basic financial statements.** Financial statements excluding supplementary information and required supplementary information.

**Comparative financial statements.** A complete set of financial statements for one or more prior periods included for comparison with the financial statements of the current period.

**Designated accounting standard-setter.** A body designated by the Council of the AICPA to promulgate accounting principles generally accepted in the United States of America pursuant to the "Compliance With Standards Rule" (ET sec. 1.310.001) and the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct.

**Emphasis-of-matter paragraph.** A paragraph included in the accountant's compilation or review report that is required by Statements on Standards for Accounting and Review Services (SSARSs), or is included at the accountant's discretion, and that refers to a matter appropriately presented or disclosed in the financial statements that, in the accountant's professional judgment, is of such importance that it is fundamental to the users' understanding of the financial statements.

**Engagement partner.**<sup>1</sup> The partner or other person in the firm who is responsible for the engagement and its performance and for the report that is issued on behalf of the firm and who, when required, has the appropriate authority from a professional, legal, or regulatory body.

**Engagement team.** All accountants and staff performing the engagement and any individuals engaged by the firm who perform procedures on the engagement.

**Error.** Mistakes in the financial statements, including arithmetical or clerical mistakes, and mistakes in the application of accounting principles, including inadequate disclosures.

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<sup>1</sup> This term is also defined in paragraph .13 of QC section 10, *A Firm's System of Quality Control*, for purposes of the Statements on Quality Control Standards. Refer to QC section 10 for specific language.

**Experienced accountant.** An individual (whether internal or external to the firm) who has practical review experience and a reasonable understanding of

- a. review processes;
- b. SSARs and applicable legal and regulatory requirements;
- c. the business environment in which the entity operates; and
- d. review and financial reporting issues relevant to the entity's industry.

**Financial reporting framework.** A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements (for example, accounting principles generally accepted in the United States of America [U.S. GAAP], International Financial Reporting Standards promulgated by the International Accounting Standards Board, or a special purpose framework).

**Financial statements.** A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources and obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term *financial statements* ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework but can also refer to a single financial statement.

**Firm.** A form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the AICPA and that is engaged in the practice of public accounting.

**Fraud.** An intentional act that results in a misstatement in financial statements.

**Generally accepted accounting principles (GAAP).** References to *generally accepted accounting principles* in SSARs means generally accepted accounting principles promulgated by bodies designated by the Council of the AICPA pursuant to the "Compliance With Standards Rule" (ET sec. 1.310.001) and the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct.

**Historical financial information.** Information expressed in financial terms regarding a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

**Interpretive publications.** Interpretations of SSARs; the AICPA Guide *Preparation, Compilation, and Review Engagements*, guidance on reviews, compilations, and engagements to prepare financial statements included in AICPA Audit and Accounting Guides; and AICPA Statements of Position, to the extent that those statements are applicable to such engagements.

**Management.** The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance (for example, executive members of a governance board or an owner-manager).

**Misstatement.** A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be presented fairly in accordance with the applicable financial reporting framework. Misstatements can arise from fraud or error.

Misstatements also include those adjustments of amounts, classifications, presentations, or disclosures that, in the accountant's professional judgment, are necessary for the financial statements to be presented fairly, in all material respects.

**Noncompliance.** Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into, by, or in the name of, the entity or on its behalf by those charged with governance, management, or employees. *Noncompliance* does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management, or employees of the entity.

**Other-matter paragraph.** A paragraph included in the accountant's compilation or review report that is required by SSARs, or is included at the accountant's discretion, and that refers to a matter other than those presented or disclosed in the financial statements that, in the accountant's professional judgment, is relevant to users' understanding of the compilation or review, the accountant's responsibilities, or the accountant's compilation or review report.

**Other preparation, compilation and review publications.** Publications other than interpretive publications. These include AICPA accounting and review publications not defined as interpretive publications; the AICPA's annual *Alert Developments in Review, Compilation, and Financial Statement Preparation Engagements*; articles addressing reviews, compilations, and engagements to prepare financial statements in the *Journal of Accountancy* and other professional journals; continuing professional education programs and other instruction materials, textbooks, guide books, programs for reviews, compilations, and engagements to prepare financial statements, and checklists; and other publications addressing reviews, compilations, and engagements to prepare financial statements from state CPA societies, other organizations, and individuals.

**Professional judgment.** The application of relevant training, knowledge, and experience, within the context provided by SSARs and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the review, compilation, or engagement to prepare financial statements.

**Report release date.** The date the accountant grants the entity permission to use the accountant's review report in connection with the financial statements.

**Required supplementary information.** Information that a designated accounting standards-setter requires to accompany an entity's basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standards-setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the

methods of measurement and presentation of the information have been established.

**Review documentation.** The record of review procedures performed, relevant review evidence obtained, and conclusions the accountant reached (terms such as *working papers* or *workpapers* are also sometimes used).

**Review evidence.** Information used by the accountant to provide a reasonable basis for obtaining limited assurance.

**Special purpose framework.** A financial reporting framework other than GAAP that is one of the following bases of accounting:

- a. **Cash basis.** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).
- b. **Tax basis.** A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.
- c. **Regulatory basis.** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission).
- d. **Contractual basis.** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the accountant.
- e. **Other basis.** A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

The cash-basis, tax-basis, regulatory-basis, and other-basis of accounting are commonly referred to as *other comprehensive bases of accounting* (OCBOA).

**Specified parties.** The intended users of the accountant's compilation or review report.

**Subsequent events.** Events occurring between the date of the financial statements and the date of the accountant's compilation or review report.

**Subsequently discovered facts.** Facts that become known to the accountant after the date of the accountant's review report that, had they been known to the accountant at that date, may have caused the accountant to revise the accountant's compilation or review report.

**Supplementary information.** Information presented outside the basic financial statements, excluding required supplementary information, that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework.

**Those charged with governance.** The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of an entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel (for example, executive members of a governance board or an owner-manager).

**Updated report.** A report issued by a continuing accountant that takes into consideration information that the accountant becomes aware of during the accountant's current engagement and that re-expresses the accountant's previous conclusions or, depending on the circumstances, expresses different conclusions on the financial statements of a prior period reviewed by the accountant as of the date of the accountant's current report.

**Written representation.** A written statement by management provided to the accountant to confirm certain matters or to support other review evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

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## AR-C Section

# STATEMENTS ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES (CLARIFIED)

The following is a Codification of Statements on Standards for Accounting and Review Standards (SSARs) resulting from the Accounting and Review Services Committee's (ARSC's) project to clarify and revise the standards for reviews, compilations, and engagements to prepare financial statements. SSARs are issued by the ARSC, the senior committee of the AICPA designated to issue pronouncements in connection with the unaudited financial statements or other unaudited financial information of a nonpublic entity. Council has designated ARSC as a body to establish technical standards under the "Compliance With Standards Rule" (ET sec. 1.310.001) of the AICPA Code of Professional Conduct.

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## AR-C Section 60

# ***General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services***

Source: SSARS No. 21

Effective for engagements performed in accordance with SSARSs for periods ending on or after December 15, 2015.

## **Introduction**

### **Scope of This Section**

.01 This section provides general principles for engagements performed in accordance with Statements on Standards for Accounting and Review Services (SSARSs) issued by the Accounting and Review Services Committee (ARSC) and codified into AR-C sections. This section also sets forth the meaning of certain terms used in SSARSs when describing the professional requirements imposed on accountants performing a review, compilation, or an engagement to prepare financial statements.

.02 This section is intended to help accountants better understand their professional responsibilities when performing an engagement in accordance with SSARSs. Additional sections have been established to set forth specific performance and reporting requirements. Such additional requirements are based on the general principles provided by this section, and any requirements created by this section also have been incorporated into the additional sections.

.03 SSARSs are written in the context of a review, compilation, or an engagement to prepare financial statements by an accountant. They are to be adapted as necessary in the circumstances when applied to reviews, compilations, and engagements to prepare other historical or prospective financial information. SSARSs do not address the responsibilities of the accountant that may exist in legislation, regulation, or otherwise. Such responsibilities may differ from those established in SSARSs. Accordingly, although the accountant may find aspects of SSARSs helpful in such circumstances, it is the responsibility of the accountant to ensure compliance with all relevant legal, regulatory, or professional obligations.

### **Effective Date**

.04 This section is effective for engagements performed in accordance with SSARSs for periods ending on or after December 15, 2015. Early implementation is permitted.

### **Objective**

.05 The objective of the accountant is to obtain an understanding of the general principles for engagements performed in accordance with SSARSs.

## Definitions

.06 For purposes of SSARSs, the following terms have the meanings attributed as follows:

**Engagement partner.**<sup>1</sup> The partner or other person in the firm who is responsible for the engagement and its performance and for the report that is issued on behalf of the firm and who, when required, has the appropriate authority from a professional, legal, or regulatory body.

**Engagement team.** All accountants and staff performing the engagement and any individuals engaged by the firm who perform procedures on the engagement.

**Firm.** A form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the AICPA and that is engaged in the practice of public accounting.

**Interpretive publications.** Interpretations of SSARSs; the AICPA Guide *Compilation and Review Engagements*,<sup>2</sup> guidance on reviews, compilations, and engagements to prepare financial statements included in AICPA Audit and Accounting Guides; and AICPA Statements of Position, to the extent that those statements are applicable to such engagements.

**Other preparation, compilation and review publications.** Publications other than interpretive publications. These include AICPA accounting and review publications not defined as interpretive publications; the AICPA's annual Alert *Developments in Review, Compilation, and Financial Statement Preparation Engagements*; articles addressing reviews, compilations, and engagements to prepare financial statements in the *Journal of Accountancy* and other professional journals; continuing professional education programs and other instruction materials, textbooks, guide books, programs for reviews, compilations, and engagements to prepare financial statements, and checklists; and other publications addressing reviews, compilations, and engagements to prepare financial statements from state CPA societies, other organizations, and individuals.

**Professional judgment.** The application of relevant training, knowledge, and experience, within the context provided by SSARSs and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the review, compilation, or engagement to prepare financial statements.

## Requirements

### Financial Statements

.07 The financial statements subject to the engagement performed in accordance with SSARSs are those of the entity. SSARSs do not impose

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<sup>1</sup> This term is also defined in paragraph .13 of QC section 10, *A Firm's System of Quality Control*, for purposes of the Statements on Quality Control Standards. Refer to QC section 10 for specific language.

<sup>2</sup> The title of the 2015 guide will be *Review, Compilation, and Financial Statement Preparation Engagements*.

responsibilities on management and do not override laws and regulations that govern their responsibilities. (Ref: par. .A1–.A10)

## Ethical Requirements

.08 The accountant should comply with relevant ethical requirements. (Ref: par. .A11–.A14)

## Professional Judgment

.09 The accountant should exercise professional judgment in the performance of an engagement in accordance with SSARs. (Ref: par. .A15–.A19)

## Conduct of the Engagement in Accordance With SSARs

.10 The accountant must perform a review, compilation, or an engagement to prepare financial statements in accordance with SSARs, except for certain reviews of interim financial information as discussed in section 90, *Review of Financial Statements*.<sup>3</sup>

### *Complying With AR-C Sections Relevant to the Engagement*

.11 The accountant should comply with all AR-C sections relevant to the engagement. An AR-C section is relevant to the engagement when the AR-C section is in effect, and the circumstances addressed by the AR-C section exist. (Ref: par. .A20–.A25)

.12 The accountant should have an understanding of the entire text of an AR-C section, including its application and other explanatory material, to understand its objectives and apply its requirements properly. (Ref: par. .A26–.A30)

.13 An accountant should not represent compliance with SSARs in the accountant's compilation or review report unless the accountant has complied with the requirements of this section and all other AR-C sections relevant to the engagement.

### *Complying With Relevant Requirements*

.14 Subject to paragraph .16, the accountant should comply with each requirement of the relevant AR-C section unless, in the circumstances of the engagement, the requirement is not relevant because it is conditional, and the condition does not exist. (Ref: par. .A31)

### *Defining Professional Responsibilities in SSARs*

.15 SSARs use the following two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on accountants:

- *Unconditional requirements.* The accountant must comply with an unconditional requirement in all cases in which such requirement is relevant. SSARs use the word "must" to indicate an unconditional requirement.
- *Presumptively mandatory requirements.* The accountant must comply with a presumptively mandatory requirement in all cases

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<sup>3</sup> Paragraph .02 of section 90, *Review of Financial Statements*.

in which such a requirement is relevant, except in rare circumstances discussed in paragraph .16. SSARs use the word "should" to indicate a presumptively mandatory requirement. (Ref: par. .A32)

**.16** In rare circumstances, the accountant may judge it necessary to depart from a relevant presumptively mandatory requirement. In such circumstances, the accountant should perform alternative procedures to achieve the intent of the requirement. The need for an accountant to depart from a relevant, presumptively mandatory requirement is expected to arise only when the requirement is for a specific procedure to be performed and, in the specific circumstances of the engagement, that procedure would be ineffective in achieving the intent of the requirement.

### ***Interpretive Publications***

**.17** The accountant should consider applicable interpretive publications in the performance of an engagement in accordance with SSARs. (Ref: par. .A33)

### ***Other Preparation, Compilation and Review Publications***

**.18** In applying the guidance included in an other preparation, compilation and review publication, the accountant should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the engagement. (Ref: par. .A34–.A36)

## **Engagement Level Quality Control**

**.19** In an engagement performed in accordance with SSARs, the engagement partner should possess the competence and capabilities to perform the engagement and competence in financial reporting, appropriate to the engagement circumstances.

**.20** In an engagement performed in accordance with SSARs, the engagement partner should take responsibility for the following: (Ref: par. .A37–.A40)

- a. The overall quality of each engagement to which that partner is assigned
- b. The direction, supervision, planning and performance of the engagement in compliance with professional standards and applicable legal and regulatory requirements (Ref: par. .A41)
- c. The accountant's report being appropriate in the circumstances
- d. The engagement being performed in accordance with the firm's quality control policies and procedures, including the following:
  - i. Being satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and engagements have been followed, and that conclusions reached are appropriate, including considering whether there is information that would lead the engagement partner to conclude that management lacks integrity (Ref: par. .A42–.A43)
  - ii. Being satisfied that the engagement team collectively has the appropriate competence and capabilities to perform the engagement and expertise in financial reporting to
    - (1) perform the engagement in accordance with professional standards and applicable legal and regulatory requirements and

- (2) enable a report that is appropriate in the circumstances to be issued, if applicable
- iii. Taking responsibility for appropriate engagement documentation being maintained.

### ***Relevant Considerations After Engagement Acceptance***

**.21** If the engagement partner obtains information that would have caused the firm to decline the engagement had that information been available earlier, the engagement partner should communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.

### ***Compliance With Relevant Ethical Requirements***

**.22** Throughout the engagement, the engagement partner should remain alert, through observation and making inquiries as necessary, for evidence of noncompliance with relevant ethical requirements by members of the engagement team. If matters come to the engagement partner's attention through the firm's system of quality control or otherwise that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, should determine the appropriate action.

### ***Monitoring***

**.23** An effective system of quality control for a firm includes a monitoring process designed to provide the firm with reasonable assurance that the firm's policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner should consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the engagement.

## **Acceptance and Continuance of Client Relationships and Engagements**

**.24** The accountant should not accept an engagement to be performed in accordance with SSARs if (Ref: par. .A44)

- a. the accountant has reason to believe that relevant ethical requirements will not be satisfied; (Ref: par. .A45)
- b. the accountant's preliminary understanding of the engagement circumstances indicates that information needed to perform the engagement is likely to be unavailable or unreliable; or (Ref: par. .A46)
- c. the accountant has cause to doubt management's integrity such that it is likely to affect the performance of the engagement.

**.25** As a condition for accepting an engagement to be performed in accordance with SSARs, the accountant should

- a. determine whether preliminary knowledge of the engagement circumstances indicate that ethical requirements regarding professional competence will be satisfied.
- b. determine whether the financial reporting framework selected by management to be applied in the preparation of the financial statements is acceptable. (Ref: par. .A47)

- c. obtain the agreement of management that it acknowledges and understands its responsibility (Ref: par. .A48)
  - i. for the selection of the financial reporting framework to be applied in the preparation of financial statements.
  - ii. for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error.
  - iii. for preventing and detecting fraud.
  - iv. for ensuring that the entity complies with laws and regulations applicable to its activities.
  - v. for the accuracy and completeness of the records, documents, explanations, and other information, including significant judgments provided by management for the preparation of financial statements.
  - vi. to provide the accountant with (Ref: par. .A49)
    - (1) access to all information of which management is aware that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters.
    - (2) additional information that the accountant may request from management for the purpose of the engagement.
    - (3) unrestricted access to persons within the entity of whom the accountant determines it necessary to make inquiries.

## Application and Other Explanatory Material

### Financial Statements (Ref: par. .07)

**.A1** The preconditions for the performance of an engagement to prepare financial statements are included in paragraphs .24–.25 of this section.

**.A2** The preconditions for the performance of a compilation engagement are included in paragraphs .24–.25 of this section and paragraph .08 of section 80, *Compilation Engagements*.

**.A3** The preconditions for the performance of a review engagement are included in paragraphs .24–.25 of this section and paragraphs .08–.09 of section 90.

**.A4** The preparation and fair presentation of the financial statements require

- the identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.
- the preparation and fair presentation of the financial statements in accordance with that framework.
- the inclusion of an adequate description of that framework in the financial statements.

The preparation and fair presentation of the financial statements require management to exercise judgment when making accounting estimates that are reasonable in the circumstances as well as when selecting and applying

appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

**.A5** The financial statements may be prepared in accordance with one of the following:

- A general purpose framework (a financial reporting framework designed to meet the common financial information needs of a wide range of users)
- A special purpose framework

**.A6** The applicable financial reporting framework often encompasses financial accounting standards promulgated by an authorized or recognized standards-setting organization or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial accounting standards promulgated by an authorized or recognized standards-setting organization and legislative or regulatory requirements. Other sources may provide direction on the application of the applicable financial reporting framework. In some cases, the applicable financial reporting framework may encompass such other sources or may even consist only of such sources. Such other sources may include the following:

- The legal and ethical environment, including statutes, regulations, court decisions, and professional ethical obligations regarding accounting matters
- Published accounting interpretations of varying authority issued by standards-setting, professional, or regulatory organizations
- Published views of varying authority on emerging accounting issues issued by standards-setting, professional, or regulatory organizations
- General and industry practices widely recognized and prevalent
- Accounting literature

When conflicts exist between the financial reporting framework and the sources from which direction on its application may be obtained or among the sources that encompass the financial reporting framework, the source with the highest authority prevails.

**.A7** The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficiently broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

**.A8** The financial accounting standards promulgated by organizations that are authorized or recognized to promulgate standards to be used by entities for preparing financial statements in accordance with a general purpose framework include the FASB *Accounting Standards Codification*; International Financial Reporting Standards, issued by the International Accounting Standards Board; Statements of Federal Financial Accounting Standards, issued by the Federal Accounting Standards Advisory Board for U.S. federal government entities; and Statements of the Governmental Accounting Standards Board, issued by the Governmental Accounting Standards Board for U.S. state and local governmental entities.

**.A9** The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case

of many frameworks, financial statements are intended to provide information about the financial position, financial performance, and cash flows of an entity. For example, a complete set of financial statements might include a balance sheet, an income statement, a statement of changes in equity, a cash flow statement, and related notes. For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements. Examples of a single financial statement, each of which would include related notes, include the following:

- Balance sheet
- Statement of income or statement of operations
- Statement of retained earnings
- Statement of cash flows
- Statement of assets and liabilities
- Statement of changes in owners' equity
- Statement of revenue and expenses
- Statement of operations by product lines

**.A10** An accountant may be engaged to prepare or perform a compilation or review engagement on a complete set of financial statements or an individual financial statement (for example, balance sheet only). The financial statements may be for an annual period or for a shorter or longer period, depending on management's needs. However, it is likely not appropriate for the entity to present financial statements for a period longer or shorter than an annual period in a comparative presentation with financial statements for an annual period.

### **Ethical Requirements (Ref: par. .08)**

**.A11** The accountant is subject to relevant ethical requirements relating to engagements performed in accordance with SSARs. Ethical requirements consist of those contained in the AICPA Code of Professional Conduct, together with rules of state boards of accountancy and applicable regulatory agencies that are more restrictive.

**.A12** The AICPA Code of Professional Conduct establishes the fundamental principles of professional ethics, which include the following:

- Responsibilities
- The public interest
- Integrity
- Objectivity and independence
- Due care
- Scope and nature of services

**.A13** Due care requires the accountant to discharge professional responsibilities with competence and have the appropriate capabilities to perform the engagement and enable an appropriate accountant's report to be issued, if applicable.

**.A14** QC section 10, *A Firm's System of Quality Control*, sets out the firm's responsibilities to establish and maintain its system of quality control for engagements performed in accordance with SSARs and establish policies and procedures designed to provide it with reasonable assurance that the firm and

its personnel comply with relevant ethical requirements, including those pertaining to independence.<sup>4</sup>

### **Professional Judgment (Ref: par. .09)**

**.A15** Professional judgment is essential to the proper conduct of an engagement in accordance with SSARs because interpretation of relevant ethical requirements and SSARs and the informed decisions required throughout the engagement cannot be made without the application of relevant knowledge and experience to the facts and circumstances.

**.A16** The distinguishing feature of the professional judgment expected of the accountant is that it is exercised by an accountant whose training, knowledge, and experience have assisted in developing the necessary competencies to achieve reasonable judgments and make informed decisions about appropriate courses of action when undertaking an engagement in accordance with SSARs. Consultation on difficult or contentious matters during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, assists the accountant in making informed and reasonable judgments.

**.A17** The exercise of professional judgment in individual engagements is based on the facts and circumstances that are known by the accountant throughout the engagement, including

- knowledge acquired from engagements carried out for the entity's financial statements in prior periods, where applicable.
- the accountant's understanding of the entity and its environment, including its accounting system, and the application of the applicable financial reporting framework in the entity's industry.
- the extent to which the preparation and presentation of the financial statements requires the exercise of judgment by management or the accountant, if applicable.

**.A18** Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of SSARs and accounting principles and is appropriate in light of, and consistent with, the facts and circumstances that were known to the accountant up to the date of the issuance of financial statements prepared by the accountant or the date of the accountant's compilation or review report.

**.A19** Professional judgment needs to be exercised throughout the engagement performed in accordance with SSARs. It also needs to be appropriately documented in accordance with the requirements of section 70, *Preparation of Financial Statements*; section 80, *Compilation Engagements*; or section 90, as applicable. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or, in a review engagement, the evidence obtained.

## **Conduct of an Engagement in Accordance With SSARs**

### **Complying With AR-C Sections Relevant to the Engagement (Ref: par. .11-.12)**

**.A20** ARSC is designated to promulgate standards under the "General Standards Rule" (ET sec. 1.300.001) and the "Compliance With Standards Rule"

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<sup>4</sup> Paragraphs .21--25 of QC section 10.

(ET sec. 1.310.001) of the AICPA Code of Professional Conduct<sup>5</sup> with respect to unaudited financial statements or other unaudited financial information of an entity that is not required to file financial statements with a regulatory agency in connection with the sale or trading of its securities in a public market. ARSC develops and issues standards in the form of SSARSs through a process that includes deliberation in meetings open to the public, public exposure of proposed SSARSs, and a formal vote. SSARSs are codified in AR-C sections in AICPA *Professional Standards*.

**.A21** SSARSs provide the standards used for fulfilling the overall objectives of the accountant's work. SSARSs address the general responsibilities of the accountant as well as the accountant's further considerations relevant to the application of those responsibilities to specific topics.

**.A22** The scope, effective date, and any specific limitation of the applicability of a specific AR-C section are made clear in the AR-C section. Unless otherwise stated in the AR-C section, the accountant is permitted to apply an AR-C section before the effective date specified therein.

**.A23** In certain engagements, the accountant also may be required to comply with other requirements in addition to SSARSs. SSARSs do not override law or regulation that governs a review, compilation, or an engagement to prepare financial statements. In the event that such law or regulation differs from SSARSs, an engagement conducted only in accordance with law or regulation will not necessarily comply with SSARSs.

**.A24** The accountant may also conduct the compilation or review in accordance with both SSARSs and

- International Standard on Related Services 4410 (Revised), *Compilation Engagements*,
- International Standard on Review Engagements 2400 (Revised), *Engagements to Review Historical Financial Statements*, or
- compilation or review standards of a specific jurisdiction or country.

In such cases, in addition to complying with each of the AR-C sections relevant to the engagement, it may be necessary for the accountant to perform additional compilation or review procedures in order to comply with the other compilation or review standards.

**.A25** SSARSs are relevant to engagements to prepare financial statements and compilations and reviews of financial statements of governmental entities. The accountant's responsibilities, however, may be affected by law, regulation, or other authority (such as government policy requirements or resolutions of the legislature), which may encompass a broader scope than an engagement in accordance with SSARSs. These additional responsibilities are not dealt with in SSARSs.

**.A26** In addition to objectives and requirements, an AR-C section contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the AR-C section and definitions. The entire text of an AR-C section, therefore, is relevant to an understanding of the objectives stated

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<sup>5</sup> AICPA's Professional Ethics Executive Committee has restructured the Code of Professional Conduct. References in this standard are to the revised code, which is effective December 15, 2014. It is available at <http://pub.aicpa.org/codeofconduct>.

in an AR-C section and the proper application of the requirements of an AR-C section.

**.A27** When necessary, the application and other explanatory material provides further explanation of the requirements of an AR-C section and guidance for carrying them out. In particular, it may

- explain more precisely what a requirement means or is intended to cover.
- include examples of procedures that may be appropriate in the circumstances.

Although such guidance does not, in itself, impose a requirement, it is relevant to the proper application of the requirements of an AR-C section. The accountant is required by paragraph .12 to understand the application and other explanatory material; how the accountant applies the guidance in the engagement depends on the exercise of professional judgment in the circumstances consistent with the objective of the AR-C section. The words "may," "might," and "could" are used to describe these actions and procedures. The application and other explanatory material may also provide background information on matters addressed in an AR-C section.

**.A28** Appendixes form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related AR-C section or within the title and introduction of the appendix itself.

**.A29** Introductory material may include, as needed, such matters as explanation of the following:

- The purpose and scope of the AR-C section, including how the AR-C section relates to other AR-C sections
- The subject matter of the AR-C section
- The respective responsibilities of the accountant and others in relation to the subject matter of the AR-C section
- The context in which the AR-C section is set

**.A30** An AR-C section may include, in a separate section under the heading "Definitions," a description of the meanings attributed to certain terms for purposes of SSARs. These are provided to assist in the consistent application and interpretation of SSARs and are not intended to override definitions that may be established for other purposes, whether in law, regulation, or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout SSARs.

### ***Complying With Relevant Requirements (Ref: par. .14)***

**.A31** Within a relevant AR-C section, there may be conditional requirements. Such a requirement is relevant when the circumstances envisioned in the requirement apply, and the condition exists. In some cases, a requirement may be expressed as being conditional on applicable law or regulation. For example, the accountant may be required to withdraw from the review, compilation, or engagement to prepare financial statements when withdrawal is possible under applicable law or regulation, or the accountant may be required to perform a certain action, unless prohibited by law or regulation.

### ***Defining Professional Responsibilities in SSARs (Ref: par. .15)***

**.A32** If an AR-C section provides that a procedure or action is one that the accountant "should consider," consideration of the procedure or action is

presumptively required. Whether the accountant performs the procedure or action is based upon the outcome of the accountant's consideration and the accountant's professional judgment.

### ***Interpretive Publications (Ref: par. .17)***

**.A33** Interpretive publications are not SSARs. *Interpretive publications* are recommendations on the application of SSARs in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of ARSC only after all ARSC members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with SSARs. Compilation and review interpretations of SSARs and exhibits to SSARs are included in the AR-C sections.

### ***Other Preparation, Compilation and Review Publications (Ref: par. .18)***

**.A34** Other preparation, compilation and review publications have no authoritative status; however, they may help the accountant understand and apply SSARs. The accountant is not expected to be aware of the full body of other preparation, compilation and review publications.

**.A35** Although the accountant determines the relevance of these publications in accordance with paragraph .18, the accountant may presume that other preparation, compilation and review publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are appropriate. These other preparation, compilation and review publications are listed in the exhibit, "Other Preparation, Compilation and Review Publications."

**.A36** When determining whether an other preparation, compilation and review publication that has not been reviewed by the AICPA Audit and Attest Standards staff is appropriate to the circumstances of the engagement, the accountant may wish to consider the degree to which the publication is recognized as being helpful in understanding and applying SSARs and the degree to which the issuer or author is recognized as an authority in matters addressing reviews, compilations, and engagements to prepare financial statements. Other preparation, compilation and review publications that have not been reviewed by the AICPA Audit and Attest Standards staff that contradict an other preparation, compilation and review publication that has been reviewed by the AICPA Audit and Attest Standards staff is inappropriate.

### ***Engagement Level Quality Control (Ref: par. .20)***

**.A37** Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures applicable to the engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.

**.A38** The actions of the engagement partner and appropriate messages to the other members of the engagement team, in the context of the engagement partner taking responsibility for the overall quality of each engagement, emphasize the fact that quality is essential when performing an engagement in accordance with SSARs and the importance to the quality of the engagement of

- a. performing work that complies with professional standards and regulatory and legal requirements.

- b. complying with the firm's quality control policies and procedures, as applicable.
- c. issuing a report, if applicable, for the engagement that is appropriate in the circumstances.
- d. the engagement team's ability to raise concerns without fear of reprisals.

**.A39** Unless information provided by the firm or other parties suggests otherwise, the engagement team is entitled to rely on the firm's system of quality control. For example, the engagement team may rely on the firm's system of quality control in relation to

- competence of personnel through their recruitment and formal training.
- independence through the accumulation and communication of relevant independence information.
- maintenance of client relationships through acceptance and continuance systems.
- adherence to regulatory and legal requirements through the monitoring process.

When considering the deficiencies identified in the firm's system of quality control that may affect the engagement, the engagement partner may consider measures taken by the firm to rectify those deficiencies.

**.A40** A deficiency in the firm's system of quality control does not necessarily indicate that an engagement was not performed in accordance with professional standards and applicable legal and regulatory requirements or that the accountant's report, if applicable, was not appropriate.

### ***Assignment of Engagement Teams (Ref: par. .20b)***

**.A41** When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the 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 applicable legal and regulatory requirements.
- technical expertise, including expertise with relevant information technology and specialized areas of accounting or attest services.
- knowledge of relevant industries in which the client operates.
- ability to apply professional judgment.
- understanding of the firm's quality control policies and procedures.

### ***Acceptance and Continuance of Client Relationships and Engagements Performed in Accordance With SSARSs (Ref: par. .20d(i))***

**.A42** QC section 10 requires the firm to obtain information considered 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. Information such as the following assists the engagement partner in determining whether

the conclusions reached regarding the acceptance and continuance of client relationships and engagements in accordance with SSARs are appropriate:

- The integrity of the principal owners, key management, and those charged with governance of the entity
- Whether the engagement team is competent to perform the engagement and has the necessary capabilities, including time and resources
- Whether the firm and the engagement team can comply with relevant ethical requirements
- Significant findings or issues that have arisen during the current or previous engagement and their implications for continuing the relationship

**.A43** If the engagement partner has cause to doubt management's integrity to a degree that is likely to affect proper performance of the engagement, it is not appropriate to accept the engagement, unless required by law or regulation, because doing so may lead to the accountant being associated with the entity's financial statements in an inappropriate manner.

## Acceptance and Continuance of Client Relationships and Engagements (Ref: par. .24–.25)

**.A44** The accountant's consideration of engagement continuance and relevant ethical requirements occurs throughout the engagement as conditions and changes in circumstances occur. Performing initial procedures on engagement continuance and evaluation of relevant ethical requirements at the beginning of an engagement informs the accountant's decisions and actions prior to the performance of other significant activities for the engagement.

**.A45** Relevant ethical requirements with respect to a review engagement include independence.

**.A46** This consideration is not directed at the need that sometimes arises in the course of an engagement to assist management by recommending adjusting entries required to finalize the financial statements prepared by management. An example of where the accountant may have cause to doubt whether the information needed to perform the review will be available or reliable is when the accounting records necessary for performing analytical procedures are suspected to be substantially inaccurate or incomplete.

**.A47** Factors that are relevant to the accountant's determination of the acceptability of the financial reporting framework selected by management to be applied in the preparation of the financial statements include the following:

- The purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users)
- Whether law or regulation prescribes the applicable financial reporting framework

**.A48** In accordance with this section, the accountant is required to obtain the agreement of management on management's responsibilities in relation to the financial statements as a condition precedent to accepting the engagement. In smaller entities, management may not be well-informed about what those responsibilities are, including those arising in applicable law or regulation. In order to obtain management's agreement on an informed basis, the accountant

may find it necessary to discuss those responsibilities with management in advance of seeking management's agreement on its responsibilities.

**.A49** The accountant is entitled to rely on management to provide all relevant information for the engagement. The form of the information provided by management for the purpose of the engagement will vary in different engagement circumstances. In broad terms, it will comprise records, documents, explanations, and other information relevant to the preparation of the financial statements in accordance with the financial reporting framework adopted by management. The information provided may include, for example, information about management's assumptions, intentions, or plans underlying development of accounting estimates needed to prepare the financial statements in accordance with the applicable financial reporting framework.

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## Exhibit—Other Preparation, Compilation and Review Publications

This listing identifies *other preparation, compilation and review publications* published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff and are, therefore, presumed to be appropriate, as defined in section 60. Products may be obtained through [www.cpa2biz.com](http://www.cpa2biz.com).

### Current AICPA Alerts

*Developments in Review, Compilation, and Financial Statement Preparation Engagements*

*Understanding the Financial Reporting Framework for Small- and Medium-Sized Entities*

*Independence and Ethics Developments*

**AICPA Technical Questions and Answers Accounting and Compilation and Review Technical Questions and Answers (Q&A) Sections** (available in hard copy)

### Special Purpose Frameworks

- Q&A Section 1500.07, "Disclosure Concerning Subsequent Events in Special Purpose Financial Statements"
- Q&A Section 1800.06, "Applicability of Fair Value Disclosure Requirements in FASB ASC 820 to Financial Statements Prepared in Accordance With a Special Purpose Framework"

### Compilation and Review Engagements

- Q&A Section 9150.04, "Financial Statements Marked As Unaudited"
- Q&A Section 9150.08, "Supplementary Information"
- Q&A Section 9150.09, "Applicability of AR Section 300 to Certain Companies Required to File With Regulatory Bodies"
- Q&A Section 9150.10, "Review of Financial Statements Included in a Prescribed Form"
- Q&A Section 9150.16, "Reference to Accountant's Report in Notes to Financial Statements"
- Q&A Section 9150.18, "Bank Engaged an Accountant to Compile a Financial Statement of Another Entity"
- Q&A Section 9150.20, "Reissuance When Not Independent"
- Q&A Section 9150.24, "Issuing a Compilation Report on Financial Statements That Omit Substantially All Disclosures After Issuing a Report on the Same Financial Statements That Include Substantially All Disclosures"
- Q&A Section 9150.25, "Determining Whether Financial Statements Have Been Prepared by the Accountant"

- Q&A Section 9150.26, "The Accountant's Responsibilities for Subsequent Events in Compilation and Review Engagements"
- Q&A Section 9150.27, "The Accountant's Reporting Responsibility With Respect to Subsequent Discovery of Facts Existing at the Date of the Report"
- Q&A Section 9150.29, "Effects on Compilation and Review Engagements When Management Does Not Assess Whether the Reporting Entity Is the Primary Beneficiary of a Variable Interest Entity and Instructs the Accountant to Not Perform the Assessment"
- Q&A Section 9150.30, "Disclosure of Independence Impairment in the Accountant's Compilation Report on Comparative Financial Statements When the Accountant's Independence Is Impaired in Only One Period"
- Q&A Section 9150.31, "Break-Even Financial Statements"

### ***Compilation of Financial Statements***

- Q&A Section 1300.17, "Omission of Reconciliation of Net Income to Cash Flow From Operations"
- Q&A Section 9160.26, "Compilation and Review—Comparative Financial Statements"
- Q&A Section 8900.10, "Successor Accountant Becomes Aware of Information During the Performance of a Compilation or Review That Leads the Successor Accountant to Believe That Financial Statements Reported On by a Predecessor Accountant Who Has Ceased Operations May Require Revision"

### ***Compilation Reports***

- Q&A Section 1300.17, "Omission of Reconciliation of Net Income to Cash Flow From Operations"
- Q&A Section 9110.07, "Statement of Cash Receipts and Disbursements"

### ***Review of Financial Statements***

- Q&A Section 8900.10, "Successor Accountant Becomes Aware of Information During the Performance of a Compilation or Review That Leads the Successor Accountant to Believe That Financial Statements Reported On by a Predecessor Accountant Who Has Ceased Operations May Require Revision"

### ***Review Reports***

- Q&A Section 8800.30, "Making Reference to Review Report"
- Q&A Section 9110.07, "Statement of Cash Receipts and Disbursements"

### ***Other Publications***

*Corporations: Checklists and Illustrative Financial Statements*

*The Engagement Letter: Best Practices and Examples*

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## AR-C Section 70

# *Preparation of Financial Statements*

Source: SSARS No. 21

Effective for the preparation of financial statements for periods ending on or after December 15, 2015.

## Introduction

### Scope of This Section

.01 This section applies when an accountant in public practice is engaged to prepare financial statements. This section does not apply when an accountant prepares financial statements

- and is engaged to perform an audit, review, or compilation of those financial statements,
- solely for submission to taxing authorities,
- for inclusion in written personal financial plans prepared by the accountant,
- in conjunction with litigation services that involve pending or potential legal or regulatory proceedings, or
- in conjunction with business valuation services.

This section may also be applied, adapted as necessary in the circumstances, to the preparation of other historical or prospective financial information.<sup>1</sup> (Ref: par. .A1)

.02 The determination about whether the accountant has been engaged to prepare financial statements or merely assist in preparing financial statements (which is a bookkeeping service that is not subject to this section) is determined based on services the client requests the accountant to perform and requires the accountant to apply professional judgment. (Ref: par. .A2)

### The Preparation Engagement

.03 An engagement to prepare financial statements is a nonattest service and does not require a determination about whether the accountant is independent of the entity. (Ref: par. .A3)

.04 In addition, an engagement to prepare financial statements does not require the accountant to verify the accuracy or completeness of the information provided by management or otherwise gather evidence to express an opinion or a conclusion on the financial statements or otherwise report on the financial statements.

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<sup>1</sup> The Accounting and Review Services Committee plans to expose for public comment separate proposed Statements on Standards for Accounting and Review Services that would provide requirements and guidance to accountants with respect to compilation engagements on pro forma or prospective financial information.

## Effective Date

.05 This section is effective for the preparation of financial statements for periods ending on or after December 15, 2015. Early implementation is permitted.

## Objective

.06 The objective of the accountant is to prepare financial statements pursuant to a specified financial reporting framework.

## Definitions

.07 For purposes of Statements on Accounting and Review Standards (SSARs), the following terms have the meanings attributed as follows:

**Applicable financial reporting framework.** The financial reporting framework adopted by management and, when appropriate, those charged with governance, in the preparation and fair presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements or that is required by law or regulation.

**Financial reporting framework.** A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements (for example, accounting principles generally accepted in the United States of America [U.S. GAAP], International Financial Reporting Standards promulgated by the International Accounting Standards Board, or a special purpose framework).

**Management.** The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance (for example, executive members of a governance board or an owner-manager).

**Special purpose framework.** A financial reporting framework other than GAAP that is one of the following bases of accounting:

- a. **Cash basis.** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).
- b. **Tax basis.** A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.
- c. **Regulatory basis.** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission). (Ref: par. .A4)
- d. **Contractual basis.** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the accountant.
- e. **Other basis.** A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

The cash-basis, tax-basis, regulatory-basis, and other-basis of accounting are commonly referred to as *other comprehensive bases of accounting* (OCBOA).

**Those charged with governance.** The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of an entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel (for example, executive members of a governance board or an owner-manager).

## Requirements

### General Principles for Performing Engagements to Prepare Financial Statements

.08 In addition to complying with this section, an accountant is required to comply with section 60, *General Principles For Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*.

### Acceptance and Continuance of Client Relationships and Engagements to Prepare Financial Statements

.09 If the accountant is not satisfied with any of the matters set out in paragraph .25 of section 60 as preconditions for accepting an engagement to prepare financial statements, the accountant should discuss the matter with management or those charged with governance. If changes cannot be made to satisfy the accountant about those matters, the accountant should not accept the proposed engagement.

### Agreement on Engagement Terms

.10 The accountant should agree upon the terms of the engagement with management or those charged with governance, as appropriate. The agreed-upon terms of the engagement should be documented in an engagement letter or other suitable form of written agreement and should include the following: (Ref: par. .A5–.A9)

- a. The objective of the engagement
- b. The responsibilities of management set forth in paragraph .25c of section 60
- c. The agreement of management that each page of the financial statements will include a statement indicating that no assurance is provided on the financial statements or the accountant will be required to issue a disclaimer that makes clear that no assurance is provided on the financial statements. (Ref: par. .A11)
- d. The responsibilities of the accountant
- e. The limitations of the engagement to prepare financial statements
- f. Identification of the applicable financial reporting framework for the preparation of financial statements
- g. Whether the financial statements are to contain a known departure or departures from the applicable financial reporting framework (including inadequate disclosure) or omit substantially all

disclosures required by the applicable financial reporting framework.

.11 The engagement letter or other suitable form of written agreement should be signed by

- a. the accountant or the accountant's firm and
- b. management or those charged with governance, as appropriate. (Ref: par. .A8)

## The Accountant's Knowledge and Understanding of the Entity's Financial Reporting Framework

.12 The accountant should obtain an understanding of the financial reporting framework and the significant accounting policies intended to be used in the preparation of the financial statements. (Ref: par. .A10)

## Preparing the Financial Statements

.13 The accountant should prepare the financial statements using the records, documents, explanations, and other information provided by management.

.14 The accountant should ensure that a statement is included on each page of the financial statements indicating, at a minimum, that "no assurance is provided" on the financial statements. If the accountant is unable to include a statement on each page of the financial statements, the accountant should (Ref: par. .A11)

- issue either a disclaimer that makes clear that no assurance is provided on the financial statements or (Ref: par. .A12)
- perform a compilation engagement in accordance with section 80, *Compilation Engagements*

.15 When preparing financial statements in accordance with a special purpose framework, the accountant should include a description of the financial reporting framework on the face of the financial statements or in a note to the financial statements. (Ref: par. .A13)

.16 If, during the preparation of financial statements, the accountant assists management with significant judgments regarding amounts or disclosures to be reflected in the financial statements, the accountant should discuss those judgments with management so management understands the significant judgments reflected in financial statements and accepts responsibility for those judgments. (Ref: par. .A14 and .A18)

.17 If the accountant becomes aware that the records, documents, explanations, or other information, including significant judgments, used in the preparation of the financial statements are incomplete, inaccurate, or otherwise unsatisfactory, the accountant should bring that to the attention of management and request additional or corrected information.

.18 When, after discussions with management, the accountant prepares financial statements that contain a known departure or departures from the applicable financial reporting framework (including inadequate disclosure), the accountant should disclose the material misstatement or misstatements in the financial statements. (Ref: par. .A15)

## Financial Statements That Omit Substantially All the Disclosures Required by the Applicable Financial Reporting Framework

**.19** When, after discussions with management, the accountant prepares financial statements that omit substantially all disclosures required by the applicable financial reporting framework, the accountant should disclose such omission in the financial statements. (Ref: par. .A16)

**.20** The accountant should not prepare financial statements that omit substantially all disclosures required by the financial reporting framework if the accountant becomes aware that the omission of substantially all disclosures was undertaken with the intention of misleading users of such financial statements. (Ref: par. .A17)

## Documentation in a Preparation Engagement

**.21** The accountant should prepare documentation in connection with each preparation engagement in sufficient detail to provide a clear understanding of the work performed which, at a minimum, includes the following: (Ref: par. .A18)

- a. The engagement letter or other suitable form of written documentation with management, as described in paragraphs .10–.11
- b. A copy of the financial statements that the accountant prepared

**.22** If, in rare circumstances, the accountant judges it necessary to depart from a relevant presumptively mandatory requirement, the accountant must document the justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the intent of that requirement.

## Application and Other Explanatory Material

### Scope of This Section (Ref: par. .01–.02)

**.A1** Other historical or prospective financial information to which this section may be applied includes the following:

- Specified elements, accounts, or items of a financial statement, such as schedules of rentals, royalties, profit participation, or provision for income taxes
- Supplementary information
- Required supplementary information
- Pro forma financial information
- Prospective financial information, including budgets, forecasts, or projections

**.A2** The appendix, "Preparation of Financial Statements Versus Assistance in Preparing Financial Statements," provides examples of services that the accountant may be engaged to perform and whether this section would apply.

### The Preparation Engagement (Ref: par. .03)

**.A3** The "Nonattest Services" subtopic of the "Independence Rule" (ET sec. 1.295) addresses the accountant's considerations with respect to independence

when performing nonattest services for attest clients. For example, the accountant may prepare monthly or other interim financial statements and be engaged to perform an audit, review, or compilation engagement with respect to the annual financial statements. The accountant needs to be aware that the performance of the preparation services may impair independence unless the safeguards described in this subtopic are met.

### Definitions (Ref: par. .07)

**.A4** Certain regulators, including state and local government legislators, regulatory agencies, or departments, require financial statements to be prepared in accordance with a financial reporting framework that is based on GAAP but does not comply with all the requirements of GAAP. Such frameworks are regulatory-bases of accounting, as defined in paragraph .07. In some circumstances, however, the cash- or tax-basis of accounting may be permitted by a regulator. For purposes of this section, the cash- and tax-bases of accounting are not regulatory-bases of accounting.

### Agreement on Engagement Terms (Ref: par. .10–.11)

**.A5** Both management and the accountant have an interest in documenting the agreed-upon terms of the engagement to prepare financial statements before the commencement of the engagement to help avoid misunderstandings with respect to the engagement. For example, it reduces the risk that management may inappropriately rely on or may expect the accountant to protect management against certain risks or to perform certain functions, including those that are management's responsibility.

**.A6** When a third party has contracted for an engagement to prepare the entity's financial statements, agreeing the terms of the engagement with management of the entity is necessary in order to establish that the preconditions for an engagement to prepare financial statements are present.

**.A7** A contract is another suitable form of written communication. The understanding with management regarding the services to be performed for engagements to prepare financial statements is required by paragraph .10 to be in a documented form, and, accordingly, a verbal understanding is insufficient. An engagement letter is the most common, and usually the most convenient, method for documenting the understanding with management regarding the services to be performed for engagements to prepare financial statements.

**.A8** The roles of management and those charged with governance in agreeing upon the terms of the engagement to prepare financial statements for the entity depend on the governance structure of the entity and relevant law or regulation. Depending on the entity's structure, the agreement may be with management, those charged with governance, or both. Nonetheless, when the agreement on the terms of engagement is only with those charged with governance in accordance with paragraph .25c of section 60, the accountant is required to obtain management's agreement that it acknowledges and understands its responsibilities.

**.A9** An illustrative example of an engagement letter for an engagement to prepare financial statements is presented in the exhibit, "Illustrative Engagement Letter."

## The Accountant's Knowledge and Understanding of the Entity's Financial Reporting Framework (Ref: par. .12)

**.A10** The requirement that the accountant obtain an understanding of the financial reporting framework adopted by management intended to be used in the preparation of the financial statements and the significant accounting policies adopted by management does not prevent the accountant from accepting an engagement to prepare financial statements for an entity in an industry in which the accountant has no previous experience. The accountant may obtain such understanding, for example, by consulting AICPA guides, industry publications, financial statements of other entities in the industry, textbooks and periodicals, appropriate continuing professional education, or individuals who are knowledgeable about the industry.

## Preparing the Financial Statements (Ref: par. .10, .14–.16, and .18)

**.A11** The statement on each page of the financial statements, including related notes, is intended to avoid misunderstanding on the part of users with respect to the accountant's involvement with the financial statements. The statement is made at management's discretion, and the accountant or the accountant's firm name is not required to be included. The accountant is concerned that the indication is not misleading. Examples of a statement on each page of the financial statements include the following:

- No assurance is provided on these financial statements.
- These financial statements have not been subjected to an audit or review or compilation engagement, and no assurance is provided on them.

Other statements that convey that no assurance is provided on the financial statements would also be acceptable.

**.A12** An example of a disclaimer that the accountant may issue is as follows:

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

*[Signature of accounting firm or accountant, as appropriate]*

*[Accountant's city and state]*

*[Date]*

**.A13** A description of the special purpose framework is usually placed next to or under the title of the financial statements (for example "statement of assets and liabilities—modified cash basis"). However, the description may be placed elsewhere in the financial statements.

**.A14** In the preparation of financial statements, the accountant may provide assistance to management with significant judgments (for example, the accountant may advise management on alternative accounting policies that are significant to the financial statements or help management with significant judgments regarding material accounting estimates).

**.A15** The disclosure of the material misstatement or misstatements may be made on the face of the financial statements or in a note to the financial statements.

**Financial Statements That Omit Substantially All the Disclosures Required by the Applicable Financial Reporting Framework (Ref: par. .19–.20)**

**.A16** The disclosure of the omission of substantially all disclosures required by the applicable financial reporting framework may be made on the face of the financial statements or in a selected note to the financial statements.

**.A17** The accountant may prepare financial statements that include disclosures about only a few matters in the notes to the financial statements. Such disclosures may be labeled "Selected Information—Substantially All Disclosures Required by [*the applicable financial reporting framework*] Are Not Included."

**Documentation in a Preparation Engagement (Ref: par. .16 and .21)**

**.A18** Documentation may include documentation regarding significant consultations or significant professional judgments made throughout the engagement.

.A19

## Appendix—Preparation of Financial Statements Versus Assistance in Preparing Financial Statements (Ref: par. .A2)

The determination about whether the accountant has been engaged to prepare financial statements or merely assist in preparing financial statements (which is a bookkeeping service that is not subject to this section) is determined based on the services the client requests the accountant to perform and requires the accountant to apply professional judgment. The following table provides examples of services that the accountant may be engaged to perform and whether section 70 would apply. The table is not intended to be all inclusive, and professional judgment would still need to be applied.

<i>Examples of Services for Which This Section Applies</i>	<i>Examples of Accountant Services for Which This Section Does Not Apply</i>
Preparation of financial statements prior to audit or review by another accountant	Preparation of financial statements when the accountant is engaged to perform an audit, review, or compilation of such financial statements
Preparation of financial statements for an entity to be presented alongside the entity's tax return	Preparation of financial statements with a tax return solely for submission to taxing authorities
Preparation of personal financial statements for presentation alongside a financial plan	Personal financial statements that are prepared for inclusion in written personal financial plans prepared by the accountant
	Financial statements prepared in conjunction with litigation services that involve pending or potential legal or regulatory proceedings
	Financial statements prepared in conjunction with business valuation services
	Maintaining depreciation schedules
	Preparing or proposing certain adjustments, such as those applicable to deferred income taxes, depreciation, or leases
Preparation of single financial statements, such as a balance sheet or income statement or financial statements with substantially all disclosures omitted	Drafting financial statement notes
Using the information in a general ledger to prepare financial statements outside of an accounting software system	Entering general ledger transactions or processing payments (general bookkeeping) in an accounting software system

.A20

## Exhibit—Illustrative Engagement Letter (Ref: par. .A9)

The following is an example of an engagement letter for an engagement to prepare financial statements prepared in accordance with accounting principles generally accepted in the United States of America. This engagement letter is intended as an illustration that may be used in conjunction with the considerations outlined in Statements on Standards for Accounting and Review Services. The engagement letter will vary according to individual requirements and circumstances and is drafted to refer to the preparation of financial statements for a single reporting period. The accountant may seek legal advice about whether a proposed letter is suitable.

To the appropriate representative of ABC Company:<sup>1</sup>

You<sup>2</sup> have requested that we prepare the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended and the related notes to the financial statements.<sup>3, 4</sup> We are pleased to confirm our acceptance and our understanding of this engagement to prepare the financial statements of ABC Company by means of this letter.

### Our Responsibilities

The objective of our engagement is to prepare financial statements in accordance with accounting principles generally accepted in the United States of America based on information provided by you. We will conduct our engagement in accordance with Statements on Standards for Accounting and Review Services (SSARSs) promulgated by the Accounting and Review Services Committee of the AICPA and comply with the AICPA's Code of Professional Conduct, including the ethical principles of integrity, objectivity, professional competence, and due care.

We are not required to, and will not, verify the accuracy or completeness of the information you will provide to us for the engagement or otherwise gather evidence for the purpose of expressing an opinion or a conclusion. Accordingly, we will not express an opinion or a conclusion or provide any assurance on the financial statements.

Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by fraud or error, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations.

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<sup>1</sup> The addresses and references in the engagement letter would be those that are appropriate in the circumstances of the engagement to prepare financial statements, including the relevant jurisdiction. It is important to refer to the appropriate persons. See paragraph .A8.

<sup>2</sup> Throughout this engagement letter, references to *you*, *we*, *us*, *management*, and *accountant* would be used or amended as appropriate in the circumstances.

<sup>3</sup> If the accountant is to be engaged to prepare financial statements that omit the statement of cash flows and the related notes, the sentence may be revised to read, "You have requested that we prepare the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income and changes in stockholders' equity." The following additional sentence may then be added: "These financial statements will not include a statement of cash flows and related notes to the financial statements."

<sup>4</sup> The accountant may include other nonattest services to be performed as part of the engagement, such as income tax preparation and bookkeeping services.

**Management Responsibilities**

The engagement to be performed is conducted on the basis that management acknowledges and understands that our role is to prepare financial statements in accordance with accounting principles generally accepted in the United States of America. Management has the following overall responsibilities that are fundamental to our undertaking the engagement to prepare your financial statements in accordance with SSARSs:

- a. The selection of accounting principles generally accepted in the United States of America as the financial reporting framework to be applied in the preparation of the financial statements
- b. The prevention and detection of fraud
- c. To ensure that the entity complies with the laws and regulations applicable to its activities
- d. The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement to prepare financial statements
- e. To provide us with:
  - i. Documentation, and other related information that is relevant to the preparation and presentation of the financial statements,
  - ii. Additional information that may be requested for the purpose of the preparation of the financial statements, and
  - iii. Unrestricted access to persons within ABC Company of whom we determine necessary to communicate.

The financial statements will not be accompanied by a report. However, you agree that the financial statements will clearly indicate that no assurance is provided on them.

*[If the accountant expects to issue a disclaimer, instead of the preceding paragraph, the following may be added:*

*As part of our engagement, we will issue a disclaimer that will state that the financial statements were not subjected to an audit, review, or compilation engagement by us and, accordingly, we do not express an opinion, a conclusion, nor provide any assurance on them.]*

**Other Relevant Information**

Our fees for these services. . . .

*[The accountant may include language, such as the following, regarding limitation of, or other arrangements regarding, the liability of the accountant or the entity, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements):*

*You agree to hold us harmless and to release, indemnify, and defend us from any liability or costs, including attorney's fees, resulting from management's knowing misrepresentations to us.]*

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our engagement

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to prepare the financial statements described herein, and our respective responsibilities.

Sincerely yours,

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*[Signature of accountant or accountant's firm]*

Acknowledged and agreed on behalf of ABC Company by:

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*[Signed]*

*[Name and Title]*

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*[Date]*

[Revised, February 2015, to include additional required engagement letter elements.]

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## AR-C Section 80

# *Compilation Engagements*

Source: SSARS No. 21

Effective for compilations of financial statements for periods ending on or after December 15, 2015.

## Introduction

### Scope of This Section

.01 This section applies when the accountant is engaged to perform a compilation engagement. This section may also be applied, adapted as necessary in the circumstances, to other historical or prospective financial information.<sup>1</sup> (Ref: par. .A1)

### The Compilation Engagement

.02 Because a compilation engagement is not an assurance engagement, a compilation engagement does not require the accountant to verify the accuracy or completeness of the information provided by management or otherwise gather evidence to express an opinion or a conclusion on the financial statements.

### Effective Date

.03 This section is effective for compilations of financial statements for periods ending on or after December 15, 2015. Early implementation is permitted.

### Objective

.04 The objective of the accountant in a compilation engagement is to apply accounting and financial reporting expertise to assist management in the presentation of financial statements and report in accordance with this section without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in accordance with the applicable financial reporting framework.

### Definitions

.05 For purposes of Statements on Accounting and Review Standards (SSARs), the following terms have the meanings attributed as follows:

**Applicable financial reporting framework.** The financial reporting framework adopted by management and, when appropriate, those charged with governance, in the preparation and fair presentation of the financial statements that is acceptable in view of the nature of the

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<sup>1</sup> The Accounting and Review Services Committee plans to expose for public comment separate proposed Statements on Standards for Accounting and Review Services that would provide requirements and guidance to accountants with respect to compilation engagements on pro forma or prospective financial information.

entity and the objective of the financial statements or that is required by law or regulation.

**Basic financial statements.** Financial statements excluding supplementary information and required supplementary information.

**Financial reporting framework.** A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements (for example, accounting principles generally accepted in the United States of America [U.S. GAAP], International Financial Reporting Standards promulgated by the International Accounting Standards Board, or a special purpose framework).

**Generally accepted accounting principles (GAAP).** Reference to *generally accepted accounting principles* in SSARSs means generally accepted accounting principles promulgated by bodies designated by the Council of the AICPA pursuant to the "Compliance With Standards Rule" (ET sec. 1.310.001) and the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct.

**Management.** The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance (for example, executive members of a governance board or an owner-manager).

**Misstatement.** A difference between the amount, classification, presentation, or disclosure of a reported financial item and the amount, classification, presentation, or disclosure that is required for the item to be presented fairly in accordance with the applicable financial reporting framework. Misstatements can arise from fraud or error.

Misstatements also include those adjustments of amounts, classifications, presentations, or disclosures that, in the accountant's professional judgment, are necessary for the financial statements to be presented fairly, in all material respects.

**Required supplementary information.** Information that a designated accounting standards-setter requires to accompany an entity's basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standards-setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established.

**Special purpose framework.** A financial reporting framework other than GAAP that is one of the following bases of accounting:

- a. **Cash basis.** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).
- b. **Tax basis.** A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.
- c. **Regulatory basis.** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity

is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission). (Ref: par. .A2)

- d. **Contractual basis.** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the accountant.
- e. **Other basis.** A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

The cash-basis, tax-basis, regulatory-basis, and other-basis of accounting are commonly referred to as *other comprehensive bases of accounting* (OCBOA).

**Supplementary information.** Information presented outside the basic financial statements, excluding required supplementary information, that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework.

**Those charged with governance.** The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel (for example, executive members of a governance board or an owner-manager).

## Requirements

### General Principles for Performing and Reporting on Compilation Engagements

.06 In addition to complying with this section, an accountant is required to comply with section 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*.

### Independence

.07 The accountant must determine whether the accountant is independent of the entity. (Ref: par. .A3)

### Acceptance and Continuance of Client Relationships and Compilation Engagements

.08 As a condition for accepting an engagement to perform a compilation with respect to an entity's financial statements, in addition to the requirements in paragraph .25 of section 60, the accountant should obtain the agreement of management that it acknowledges and understands its responsibility

- a. for the preparation and fair presentation of financial statements in accordance with the applicable financial reporting framework and the inclusion of all informative disclosures that are appropriate for the applicable financial reporting framework used to prepare the entity's financial statements. If the financial statements

are prepared in accordance with a special purpose framework, this includes (Ref: par. .A4)

- i. a description of the special purpose framework, including a summary of significant accounting policies, and how the framework differs from GAAP, the effect of which need not be quantified, and informative disclosures similar to those required by GAAP, in the case of special purpose financial statements that contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, (Ref: par. .A23)
  - ii. a description of any significant interpretations of the contract on which the special purpose financial statements are prepared, in the case of financial statements prepared in accordance with a contractual-basis of accounting, and
  - iii. additional disclosures beyond those specifically required by the framework that may be necessary for the special purpose framework to achieve fair presentation.
- b. to include the accountant's compilation report in any document containing financial statements that indicates that the entity's accountant has performed a compilation engagement on such financial statements unless a different understanding is reached. (Ref: par. .A5)

**.09** If the accountant is not satisfied about any of the matters set out in paragraph .25 of section 60 or paragraph .08 of this section as preconditions for accepting a compilation engagement, the accountant should discuss the matter with management or those charged with governance. If changes cannot be made to satisfy the accountant about those matters, the accountant should not accept the proposed engagement.

## Agreement on Engagement Terms

**.10** The accountant should agree upon the terms of the engagement with management or those charged with governance, as appropriate. The agreed-upon terms of the engagement should be documented in an engagement letter or other suitable form of written agreement and should include the following: (Ref: par. .A6–.A11)

- a. The objectives of the engagement
- b. The responsibilities of management set forth in paragraph .25c of section 60 and paragraph .08 of this section
- c. The responsibilities of the accountant
- d. The limitations of the compilation engagement
- e. Identification of the applicable financial reporting framework for the preparation of the financial statements
- f. The expected form and content of the accountant's compilation report and a statement that there may be circumstances in which the report may differ from its expected form and content

**.11** The engagement letter or other suitable form of written agreement should be signed by

- a. the accountant or the accountant's firm and
- b. management or those charged with governance, as appropriate. (Ref: par. .A7)

## The Accountant's Knowledge and Understanding of the Entity's Financial Reporting Framework

**.12** The accountant should obtain an understanding of the applicable financial reporting framework and the significant accounting policies intended to be used in the preparation of the financial statements. (Ref: par. .A12)

### Compilation Procedures

**.13** The accountant should read the financial statements in light of the accountant's understanding of the applicable financial reporting framework and the significant accounting policies adopted by management and consider whether such financial statements appear to be appropriate in form and free from obvious material misstatements.

**.14** If, in the course of the engagement, the accountant becomes aware that the records, documents, explanations, or other information, including significant judgments, provided by management are incomplete, inaccurate, or otherwise unsatisfactory, the accountant should bring that to the attention of management and request additional or corrected information. (Ref: par. .A13)

**.15** If the accountant becomes aware during the course of the engagement that

- a. the financial statements do not adequately refer to or describe the applicable financial reporting framework (Ref: par. .A14);
- b. revisions to the financial statements are required for the financial statements to be in accordance with the applicable financial reporting framework; or
- c. the financial statements are otherwise misleading (Ref: par. .A15–.A16)

the accountant should propose the appropriate revisions to management.

**.16** The accountant should withdraw from the engagement and inform management of the reasons for withdrawing if (Ref: par. .A17–.A18)

- a. the accountant is unable to complete the engagement because management has failed to provide records, documents, explanations, or other information, including significant judgments, as requested, or
- b. management does not make appropriate revisions that are proposed by the accountant or does not disclose such departures in the financial statements, and the accountant determines to not disclose such departures in the accountant's compilation report.

### The Accountant's Compilation Report

**.17** The accountant's compilation report should be in writing and (Ref: par. .A19 and .A22)

- a. include a statement that management (owners) is (are) responsible for the financial statements.
- b. identify the financial statements that have been subjected to the compilation engagement.
- c. identify the entity whose financial statements have been subjected to the compilation engagement.
- d. specify the date or period covered by the financial statements.

- e. include a statement that the accountant performed the compilation engagement in accordance with SSARs promulgated by the Accounting and Review Services Committee of the AICPA.
- f. include a statement that the accountant did not audit or review the financial statements nor was the accountant required to perform any procedures to verify the accuracy or completeness of the information provided by management and, accordingly, does not express an opinion, a conclusion, nor provide any assurance on the financial statements.
- g. include the signature of the accountant or the accountant's firm. (Ref: par. .A20)
- h. include the city and state where the accountant practices. (Ref: par. .A21)
- i. include the date of the report, which should be the date that the accountant has completed the procedures required by this section.

### The Accountant's Compilation Report on Financial Statements Prepared in Accordance With a Special Purpose Framework

**.18** Unless the entity elects to omit substantially all disclosures, the accountant should modify the compilation report when that accountant becomes aware that the financial statements do not include

- a. a description of the special purpose framework. (Ref: par. .A23)
- b. a summary of significant accounting policies. (Ref: par. .A24)
- c. an adequate description about how the special purpose framework differs from GAAP. The effects of these differences need not be quantified. (Ref: par. .A25)
- d. informative disclosures similar to those required by GAAP when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP. (Ref: par. .A26)

**.19** In the case of financial statements prepared in accordance with a contractual-basis of accounting, the accountant should modify the compilation report if the financial statements do not adequately describe any significant interpretations of the contract on which the financial statements are based.

**.20** The accountant's compilation report on financial statements prepared in accordance with a special purpose framework should

- a. make reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances when management has a choice of financial reporting frameworks in the preparation of such financial statements.
- b. describe the purpose for which the financial statements are prepared or refer to a note in the financial statements that contains that information when the financial statements are prepared in accordance with a regulatory- or contractual-basis of accounting. (Ref: par. .A27)

**.21** The accountant's compilation report on financial statements prepared in accordance with a special purpose framework should include a separate paragraph that

- a. indicates that the financial statements are prepared in accordance with the applicable special purpose framework,
- b. refers to the note to the financial statements that describes the framework, if applicable, and
- c. states that the special purpose framework is a basis of accounting other than GAAP.

## Reporting When the Accountant Is Not Independent

**.22** When the accountant is not independent with respect to the entity, the accountant should indicate the accountant's lack of independence in a final paragraph of the accountant's compilation report. (Ref: par. .A28–.A30)

**.23** If the accountant elects to disclose a description about the reasons the accountant's independence is impaired, the accountant should include all such reasons in the description.

## Reporting on Financial Statements That Omit Substantially All the Disclosures Required by the Applicable Financial Reporting Framework

**.24** The accountant should not issue an accountant's compilation report on financial statements that omit substantially all disclosures required by the applicable financial reporting framework unless the omission of substantially all disclosures is not, to the accountant's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements. (Ref: par. .A16)

**.25** When reporting on financial statements that omit substantially all disclosures required by the applicable financial reporting framework, the accountant should include a separate paragraph in the accountant's compilation report that includes the following elements: (Ref: par. .A31–.A32)

- a. A statement that management has elected to omit substantially all the disclosures (and the statement of cash flows, if applicable) required by the applicable financial reporting framework (or ordinarily included in the financial statements if the financial statements are prepared in accordance with a special purpose framework)
- b. A statement that if the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user's conclusions about the entity's financial position, results of operations, and cash flows (or the equivalent for presentations other than GAAP)
- c. A statement that, accordingly, the financial statements are not designed for those who are not informed about such matters

**.26** The omission of one or more notes, when substantially all other disclosures are presented, should be treated in a compilation report like any other departure from the applicable financial reporting framework, and the nature of the departure and its effects, if known, should be disclosed in accordance with paragraphs .27–.31.

## Reporting Known Departures From the Applicable Financial Reporting Framework

**.27** When the accountant becomes aware of a departure from the applicable financial reporting framework (including inadequate disclosure) that is material to the financial statements and the financial statements are not revised, or the departure is not disclosed in the notes to the financial statements, the accountant should modify the compilation report to disclose the departure. (Ref: par. .A34)

**.28** The effects of the departure on the financial statements should be disclosed if such effects have been determined by management or are readily known to the accountant as the result of the accountant's procedures.

**.29** If the effects of the departure have not been determined by management or are not readily known to the accountant as a result of the accountant's procedures, the accountant is not required to determine the effects of a departure; however, in such circumstances, the accountant should state in the report that such determination has not been made by management.

**.30** If the accountant believes that modification of the compilation report is not adequate to indicate the deficiencies in the financial statements as a whole, the accountant should withdraw from the engagement and provide no further services with respect to those financial statements. (Ref: par. .A18)

**.31** The accountant should not modify the compilation report to include a statement that the financial statements are not in conformity with the applicable financial reporting framework. (Ref: par. .A33)

## Supplementary Information That Accompanies Financial Statements and the Accountant's Compilation Report Thereon

**.32** When supplementary information accompanies financial statements and the accountant's compilation report thereon, the accountant should clearly indicate the degree of responsibility, if any, the accountant is taking with respect to such information in either (Ref: par. .A35)

- a. an other-matter paragraph in the accountant's compilation report on the financial statements or
- b. a separate report on the supplementary information.

**.33** When the accountant has performed a compilation engagement with respect to both the financial statements and the supplementary information, the accountant should include an other-matter paragraph in the accountant's compilation report on the financial statements or issue a separate report on the supplementary information that states (Ref: par. .A36 and .A38)

- a. the information is presented for purposes of additional analysis and is not a required part of the basic financial statements;
- b. the information is the representation of management; and
- c. the information was subject to the compilation engagement, however, the accountant has not audited or reviewed the information and, accordingly, does not express an opinion, a conclusion, nor provide any assurance on such information.

**.34** When the accountant has performed a compilation engagement with respect to the financial statements but the supplementary information was not subject to the compilation engagement, the accountant should include an other-matter paragraph in the accountant's compilation report on the financial

statements or issue a separate report on the supplementary information that states (Ref: par. .A37–.A38)

- a. the information is presented for purposes of additional analysis and is not a required part of the basic financial statements;
- b. the information is the representation of management; and
- c. the information was not subject to the compilation engagement and, accordingly, the accountant does not express an opinion, a conclusion, nor provide any assurance on such information.

## Required Supplementary Information

**.35** With regard to the requirement in paragraph .32, with respect to required supplementary information, the accountant should include an other-matter paragraph in the accountant's compilation report on the financial statements. The other-matter paragraph should include language to explain the following circumstances, as applicable: (Ref: par. .A39)

- a. The required supplementary information is included, and the accountant performed a compilation engagement on the required supplementary information.
- b. The required supplementary information is included, and the accountant did not perform a compilation, review, or audit on the required supplementary information.
- c. The required supplementary information is omitted.
- d. Some required supplementary information is missing, and some is presented in accordance with the prescribed guidelines. (Ref: par. .A40)
- e. The accountant has identified departures from the prescribed guidelines.
- f. The accountant has unresolved doubts about whether the required supplementary information is presented in accordance with prescribed guidelines.

**.36** If the entity has presented all or some of the required supplementary information and the accountant did not perform a compilation engagement on the required supplementary information, the other-matter paragraph in the accountant's compilation report referred to in paragraph .32 should include the following elements: (Ref: par. .A41)

- a. A statement that *[identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]* requires that the *[identify the required supplementary information]* be presented to supplement the basic financial statements
- b. A statement that such information, although not a part of the basic financial statements, is required by *[identify designated accounting standards-setter]*, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context
- c. A statement that the accountant did not perform a compilation, review, or audit on the required supplementary information and, accordingly, does not express an opinion, a conclusion, nor provide any assurance on the information

- d. If some of the required supplementary information is omitted:
- i. A statement that management has omitted [*description of the missing required supplementary information*] that [*identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*] require to be presented to supplement the basic financial statements
  - ii. A statement that such missing information, although not a part of the basic financial statements, is required by [*identify designated accounting standards-setter*], who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context
- e. If the measurement or presentation of the required supplementary information departs materially from the prescribed guidelines, a statement that material departures from prescribed guidelines exist [*describe the material departures from the applicable financial reporting framework*]
- f. If the accountant has unresolved doubts about whether the required supplementary information is measured or presented in accordance with prescribed guidelines, a statement that the accountant has doubts about whether material modifications should be made to the required supplementary information for it to be presented in accordance with guidelines established by [*identify designated accounting standards-setter*]

**.37** If all the required supplementary information is omitted, the separate paragraph in the accountant's compilation report should include the following elements:

- a. A statement that management has omitted [*description of the missing required supplementary information*] that [*identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*] require to be presented to supplement the basic financial statements
- b. A statement that such missing information, although not a part of the basic financial statements, is required by [*identify designated accounting standards-setter*], who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context

## Documentation in a Compilation Engagement

**.38** The accountant should prepare documentation in connection with each compilation engagement in sufficient detail to provide a clear understanding of the work performed which, at a minimum, includes the following:

- a. The engagement letter or other suitable form of written documentation with management, as described in paragraphs .10–.11 (Ref: par. .A9 and .A11)
- b. A copy of the financial statements
- c. A copy of the accountant's report

## Application and Other Explanatory Material

### Scope of This Section (Ref: par. .01)

.A1 Other historical or prospective financial information that may be the subject of a compilation engagement include the following:

- Specified elements, accounts, or items of a financial statement, such as schedules of rentals, royalties, profit participation, or provision for income taxes
- Supplementary information
- Required supplementary information
- Pro forma financial information
- Prospective financial information, including budgets, forecasts, or projections

### Definitions (Ref: par. .05)

.A2 Certain regulators, including state and local government legislators, regulatory agencies, or departments, require financial statements to be prepared in accordance with a financial reporting framework that is based on GAAP but does not comply with all the requirements of GAAP. Such frameworks are regulatory-bases of accounting, as defined in paragraph .05. In some circumstances, however, the cash- or tax-basis of accounting may be permitted by a regulator. For purposes of this section, the cash- and tax-bases of accounting are not regulatory-bases of accounting.

### Independence (Ref: par. .07)

.A3 The interpretations of the "Independence Rule" (ET sec. 1.200.001) of the AICPA Code of Professional Conduct provide authoritative guidance with respect to independence. It is in the public interest and, therefore, required by this section, that the accountant modify the accountant's compilation report when the accountant is not independent of the entity whose financial statements are the subject of the compilation engagement. The AICPA Code of Professional Conduct also defines *independence* as consisting of two elements, independence of mind and independence in appearance. Independence enhances the accountant's ability to act with integrity and be objective. Independence implies an impartiality that recognizes an obligation to be fair not only to management but also to users of the financial statements, who may rely upon the accountant's compilation report. In the absence of an interpretation of the "Independence Rule" that addresses a particular relationship or circumstance, a member should apply the "Conceptual Framework for Independence" interpretation (ET sec. 1.210.010).

### Acceptance and Continuance of Client Relationships and Compilation Engagements (Ref: par. .08)

.A4 A compilation in accordance with SSARs is conducted on the premise that management has acknowledged and understands that it has the responsibility set out in paragraph .25c of section 60. The preparation of financial statements, in whole or in part, is a nonattest service subject to the provisions of the "Nonattest Services" subtopic of the "Independence Rule" (ET sec. 1.295).

To avoid misunderstanding, agreement is reached with management that it acknowledges and understands that it has such responsibilities as part of agreeing and documenting the terms of the compilation engagement as required by paragraphs .10–.11.

**.A5** Documents containing financial statements that may include an indication that such financial statements have been subjected to a compilation engagement by the entity's accountant includes documents submitted to bonding companies.

### **Agreement on Engagement Terms (Ref: par. .10–.11 and .38)**

**.A6** Both management and the accountant have an interest in documenting the terms of the compilation engagement before the commencement of the engagement to help avoid misunderstandings with respect to the engagement. For example, it reduces the risk that management may inappropriately rely on or expect the accountant to protect management against certain risks or perform certain functions, including those that are management's responsibility.

**.A7** The roles of management and those charged with governance in agreeing upon the terms of the compilation engagement for the entity depend on the governance structure of the entity and relevant law or regulation. Depending on the entity's structure, the agreement may be with management, those charged with governance, or both. Nonetheless, when the agreement on the terms of engagement is only with those charged with governance, in accordance with paragraph .25c of section 60, the accountant is required to obtain management's agreement that it acknowledges and understands its responsibilities.

**.A8** When a third party has contracted for a compilation of the entity's financial statements, agreeing the terms of the compilation with management of the entity is necessary in order to establish that the preconditions for a compilation are present.

**.A9** A contract is another suitable form of written communication. The understanding with management regarding the services to be performed for compilation engagements is required by paragraph .10 to be in a documented form, and, accordingly, a verbal understanding is insufficient. An engagement letter is the most common and usually the most convenient method for documenting the understanding with management regarding the services to be performed for compilation engagements.

**.A10** Although the accountant may prepare the financial statements, in whole or in part, the financial statements are representations of management, and the fairness of their presentation in accordance with the applicable financial reporting framework is management's responsibility.

**.A11** Illustrative examples of engagement letters for a compilation engagement are presented in exhibit A, "Illustrative Engagement Letters."

### **The Accountant's Knowledge and Understanding of the Entity's Financial Reporting Framework (Ref: par. .12)**

**.A12** The requirement that the accountant obtain an understanding of the applicable financial reporting framework intended to be used in the preparation of the financial statements, and the significant accounting policies adopted by management, does not prevent the accountant from accepting a compilation engagement for an entity in an industry in which the accountant has no previous experience. The accountant may obtain such understanding, for example, by consulting AICPA guides, industry publications, financial statements of

other entities in the industry, textbooks and periodicals, appropriate continuing professional education, or individuals who are knowledgeable about the framework or the industry.

### **Compilation Procedures (Ref: par. .14–.16, .24, and .30)**

**.A13** The accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. However, the accountant may have performed such inquiries or procedures and the results of those inquiries or procedures, knowledge gained from prior engagements, or the financial statements themselves may cause the accountant to become aware that information provided by management is incorrect, incomplete, or otherwise unsatisfactory.

**.A14** The financial statements may adequately refer to or describe the applicable financial reporting framework via

- the financial statement titles or
- the notes to the financial statements.

**.A15** Financial statements may be misleading, for example, if the applicable financial reporting framework includes the premise that the financial statements are prepared on the going concern basis, and undisclosed uncertainties exist regarding the entity's ability to continue as a going concern. If the accountant becomes aware that uncertainties exist regarding the entity's ability to continue as a going concern, the accountant may suggest additional disclosures concerning the entity's ability to continue as a going concern in order to avoid the financial statements being misleading.

**.A16** Disclosure of items, such as an uncertainty, is not required in financial statements in which substantially all the disclosures required by the applicable financial reporting framework are omitted.

**.A17** In circumstances addressed by the requirements of this section in which withdrawal from the engagement is necessary, the responsibility to inform management of the reasons for withdrawing provides an opportunity to explain the accountant's ethical obligations.

**.A18** When making a determination about whether and how to withdraw from an engagement, the accountant may wish to consult with legal counsel.

### **The Accountant's Compilation Report (Ref: par. .17)**

**.A19** The accountant's written report may become unattached from the financial statements. To minimize the possibility that a user of the financial statements may infer an unintended level of reliance on the financial statements, the accountant may request that management include a reference on each page of the financial statements to the accountant's written report. An example of a reference to the accountant's written report included on each page of the financial statements is "See Accountant's Report" or "See Accountant's Compilation Report."

**.A20** The signature of the accountant or the accountant's firm may be manual, printed, or digital, as appropriate.

**.A21** The city and state where the accountant practices may be indicated on letterhead that contains the issuing office's city and state.

**.A22** Illustrative examples of accountant's compilation reports are presented in exhibit B, "Illustrative Examples of the Accountant's Compilation Reports on Financial Statements."

## The Accountant's Compilation Report on Financial Statements Prepared in Accordance With a Special Purpose Framework (Ref: par. .08, .18, and .20)

**.A23** The description of the special purpose framework may be included in the financial statement titles, in the notes to the financial statements, or otherwise on the face of the financial statements. Although terms such as *balance sheet*, *statement of financial position*, *statement of income*, *statement of operations*, and *statement of cash flows*, or similar unmodified titles, are generally understood to be applicable only to financial statements that are intended to present financial position, results of operations, or cash flows in accordance with GAAP, such titles, with appropriate modification, may be used in connection with financial statements prepared in accordance with a special purpose framework. Suitable financial statement titles for financial statements prepared in accordance with a special purpose framework include, but are not limited to

- a modified cash-basis financial statement that might be titled
  - "Income Statement—Modified Cash-Basis," or
  - "Statement of Cash Receipts and Disbursements."
- financial statements prepared in accordance with the tax-basis of accounting that might be titled
  - "Balance Sheet—Tax-Basis,"
  - "Statement of Assets, Liabilities, and Equity—Tax-Basis,"
  - "Statement of Operations—Tax-Basis," or
  - "Statement of Revenue and Expenses—Tax-Basis."
- a financial statement prepared in accordance with a regulatory-basis of accounting that might be titled "Statement of Income—Regulatory-Basis."

**.A24** Financial statements prepared in accordance with a special purpose framework need not include a summary of significant accounting policies or a description about how the special purpose framework differs from GAAP if such financial statements omit substantially all disclosures, and the omission of substantially all disclosures is not, to the accountant's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements.

**.A25** The description of how the special purpose framework differs from GAAP ordinarily only includes the material differences between GAAP and the special purpose framework. For example, if several items are accounted for differently in accordance with the special purpose framework than they would be in accordance with GAAP, but only the differences in how depreciation is calculated are material, a brief description of the depreciation differences is all that would be necessary, and the remaining differences need not be described or quantified.

**.A26** Financial statements prepared when applying a special purpose framework are not considered appropriate in form unless the financial statements include informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

**.A27** When the financial statements are prepared in accordance with a regulatory- or contractual-basis of accounting, the accountant is required by

paragraph .20*b* to describe the purpose for which the financial statements are prepared or refer to a note in the financial statements that contains that information. This is necessary to avoid misunderstandings when the financial statements are used for purposes other than those for which they were intended. The note to the financial statements may also describe any significant interpretations of the contract on which the financial statements are based.

## Reporting When the Accountant Is Not Independent (Ref: par. .22)

**.A28** An example of a disclosure that an accountant may make to indicate the accountant's lack of independence would be

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

**.A29** The accountant is not precluded from disclosing a description about the reason(s) that the accountant's independence is impaired. The following are examples of descriptions the accountant may use:

- I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (a member of the engagement team) had a direct financial interest in XYZ Company.
- I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because an individual of my immediate family (an immediate family member of one of the members of the engagement team) was employed by XYZ Company.
- I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (we) performed certain accounting services (the accountant may include a specific description of those services) that impaired my (our) independence.

**.A30** Illustrative examples of accountant's compilation reports when the accountant's independence has been impaired are presented in exhibit B.<sup>2</sup>

## Reporting on Financial Statements That Omit Substantially All the Disclosures Required by the Applicable Financial Reporting Framework (Ref: par. .25)

**.A31** When management elects to include disclosures about only a few matters in the notes to the financial statements, such disclosures may be labeled "Selected Information—Substantially All Disclosures Required by [*the applicable financial reporting framework*] Are Not Included."

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<sup>2</sup> Illustration 4, "An Accountant's Compilation Report on Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America When the Accountant's Independence Is Impaired, and the Accountant Determines to Not Disclose the Reasons for the Independence Impairment" and illustration 5, "An Accountant's Compilation Report on Comparative Financial Statements Prepared in Accordance With the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities When the Accountant's Independence Has Been Impaired Due to the Accountant Having a Financial Interest in the Entity, and the Accountant Decides to Disclose the Reasons for the Independence Impairment," of exhibit B, "Illustrative Examples of the Accountant's Compilation Report on Financial Statements."

**.A32** An illustrative example of an accountant's compilation report on financial statements that omit substantially all disclosures required by the applicable financial reporting framework is presented in exhibit B.<sup>3</sup>

### Reporting Known Departures From the Applicable Financial Reporting Framework (Ref: par. .28 and .31)

**.A33** The accountant is precluded from including a statement that the financial statements are not in conformity with the applicable financial reporting framework because such a statement would be tantamount to expressing an adverse opinion on the financial statements as a whole. Such an opinion can be expressed only in the context of an audit engagement.

**.A34** An illustrative example of an accountant's compilation report on financial statements that contain known departures from the applicable financial reporting framework that are not disclosed in the notes to the financial statements is presented in exhibit B.<sup>4</sup>

### Supplementary Information That Accompanies Financial Statements and the Accountant's Compilation Report Thereon (Ref: par. .32–.34)

**.A35** Although not required to perform a compilation engagement on supplementary information that accompanies financial statements and the accountant's compilation report thereon, nothing precludes the accountant from performing a compilation engagement on such information if engaged to do so.

**.A36** The following is an example of how an accountant may word a separate paragraph in the accountant's compilation report addressing supplementary information when the accountant has performed a compilation engagement on both the financial statements and the supplementary information:

#### ***Other Matter***

The [*identify the supplementary information*] is presented for purposes of additional analysis and is not a required part of the basic financial statements. This information is the representation of management. The information was subject to our compilation engagement, however, I (we) have not audited or reviewed the information and, accordingly, do not express an opinion, a conclusion, nor provide any assurance on such information.

**.A37** The following is an example of how an accountant may word a separate paragraph in the accountant's compilation report addressing supplementary information when the accountant has performed a compilation engagement on the financial statements but has not performed a compilation on the supplementary information:

#### ***Other Matter***

The [*identify the supplementary information*] is presented for purposes of additional analysis and is not a required part of the basic financial statements.

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<sup>3</sup> Illustration 3, "An Accountant's Compilation Report on Comparative Financial Statements Prepared in Accordance With the Tax-Basis of Accounting, and Management Has Elected to Omit Substantially All Disclosures Ordinarily Included in Financial Statements Prepared in Accordance With the Tax-Basis of Accounting," of exhibit B.

<sup>4</sup> Illustration 6, "An Accountant's Compilation Report on Comparative Financial Statements, and the Accountant is Aware of Departures From Accounting Principles Generally Accepted in the United States of America," of exhibit B.

This information is the representation of management. The information was not subject to our compilation engagement. I (We) do not express an opinion, a conclusion, nor provide any assurance on such information.

**.A38** Supplementary information may become unattached from the accountant's compilation report. To minimize the possibility that a user of the information may infer, through the accountant's association with the information, an unintended level of reliance on the information, the accountant may request that management include a reference to the accountant's compilation report on each page of the information. An example of a reference to the accountant's compilation report included on each page of the supplementary information is "See Accountant's Report" or "See Accountant's Compilation Report."

### **Required Supplementary Information (Ref: par. .35–.36)**

**.A39** Examples of required supplementary information that may accompany financial statements and the accountant's compilation report thereon include the following:

- With respect to common interest realty associations, estimates of current or future costs of major repairs and replacements of common property that will be required in the future as required by FASB *Accounting Standards Codification* 972-235-50-3
- Management's discussion and analysis and budgetary comparison statements as required by GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*

**.A40** *Prescribed guidelines* are the authoritative guidelines established by the designated accounting standards-setter for the methods of measurement and presentation of the required supplementary information.

**.A41** Because the required supplementary information accompanies the basic financial statements, the accountant's compilation report on the financial statements includes a discussion of the responsibility taken by the accountant on that information. However, if the required supplementary information is omitted by the entity, the accountant does not have a responsibility to present that information.

.A42

## Exhibit A—Illustrative Engagement Letters (Ref: par. .A11)

**Illustration 1**—An Engagement Letter for a Compilation Engagement With Respect to Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America

**Illustration 2**—An Engagement Letter for a Compilation Engagement With Respect to Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America, Except the Financial Statements Omit the Statement of Cash Flows and Substantially All Disclosures Required by U.S. GAAP and in Which the Accountant's Independence Is Impaired

**Illustration 3**—An Engagement Letter for a Compilation Engagement With Respect to Financial Statements Prepared in Accordance With the Tax-Basis of Accounting

The illustrative engagement letters in this exhibit are intended as illustrations that may be used in conjunction with the considerations outlined in Statements on Standards for Accounting and Review Services. The engagement letter will vary according to individual requirements and circumstances, and the illustrations are drafted to refer to a compilation engagement for a single reporting period. The accountant may seek legal advice about whether a proposed letter is suitable.

### **Illustration 1 — An Engagement Letter for a Compilation Engagement With Respect to Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America**

Circumstances include the following:

- The accountant will prepare, as a nonattest service, the financial statements, including related notes, subject to the compilation engagement.
- The financial statements will be prepared in accordance with accounting principles generally accepted in the United States of America and will include all related notes required by accounting principles generally accepted in the United States of America
- The accountant expects that his or her independence will not be impaired

To the appropriate representative of management of ABC Company:<sup>1</sup>

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<sup>1</sup> The addresses and references in the engagement letter would be those that are appropriate in the circumstances of the engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons. See paragraph .A7.

You<sup>2</sup> have requested that we prepare the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements, and perform a compilation engagement with respect to those financial statements.<sup>3, 4</sup> We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter.

### **Our Responsibilities**

The objective of our engagement is to

- a. prepare financial statements in accordance with accounting principles generally accepted in the United States of America based on information provided by you and
- b. apply accounting and financial reporting expertise to assist you in the presentation of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

We will conduct our compilation engagement in accordance with Statements on Standards for Accounting and Review Services (SSARSs) promulgated by the Accounting and Review Services Committee of the AICPA and comply with the AICPA's Code of Professional Conduct, including the ethical principles of integrity, objectivity, professional competence, and due care.

We are not required to, and will not, verify the accuracy or completeness of the information you will provide to us for the engagement or otherwise gather evidence for the purpose of expressing an opinion or a conclusion. Accordingly, we will not express an opinion or a conclusion nor provide any assurance on the financial statements.

Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by fraud or error, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations.

### **Your Responsibilities**

The engagement to be performed is conducted on the basis that you acknowledge and understand that our role is to prepare financial statements in accordance with accounting principles generally accepted in the United States of America and assist you in the presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America. You have the following overall responsibilities that are fundamental to our undertaking the engagement in accordance with SSARSs:

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<sup>2</sup> Throughout this engagement letter, references to *you, we, us, management, and accountant* would be used or amended as appropriate in the circumstances.

<sup>3</sup> If the accountant is to be engaged to prepare financial statements that omit the statement of cash flows and the related notes and perform a compilation engagement with respect to those financial statements, the sentence may be revised to read, "You have requested that we prepare the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income and changes in stockholders' equity, and perform a compilation engagement with respect to those financial statements." The following additional sentence may then be added: "These financial statements will not include a statement of cash flows and related notes to the financial statements."

<sup>4</sup> The accountant may include other nonattest services to be performed as part of the engagement, such as income tax preparation and bookkeeping services.

- a. The selection of accounting principles generally accepted in the United States of America as the financial reporting framework to be applied in the preparation of the financial statements
- b. The preparation and fair presentation of financial statements in accordance with accounting principles generally accepted in the United States of America and the inclusion of all informative disclosures that are appropriate for accounting principles generally accepted in the United States of America
- c. The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements
- d. The prevention and detection of fraud
- e. To ensure that the entity complies with the laws and regulations applicable to its activities
- f. The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement
- g. To provide us with
  - i. access to all information of which you are aware is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters
  - ii. additional information that we may request from you for the purpose of the compilation engagement
  - iii. unrestricted access to persons within the entity of whom we determine it necessary to make inquiries

You are also responsible for all management decisions and responsibilities and for designating an individual with suitable skills, knowledge, and experience to oversee our preparation of your financial statements. You are responsible for evaluating the adequacy and results of the services performed and accepting responsibility for such services.

### **Our Report**

As part of our engagement, we will issue a report that will state that we did not audit or review the financial statements and that, accordingly, we do not express an opinion, a conclusion, nor provide any assurance on them.

You agree to include our accountant's compilation report in any document containing financial statements that indicates that we have performed a compilation engagement on such financial statements and, prior to inclusion of the report, to ask our permission to do so.

### **Other Relevant Information**

Our fees for these services. . . .

*[The accountant may include language, such as the following, regarding limitation of or other arrangements regarding the liability of the accountant or the entity, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements):*

*You agree to hold us harmless and to release, indemnify, and defend us from any liability or costs, including attorney's fees, resulting from management's knowing misrepresentations to us.]*

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our engagement to prepare the financial statements described herein and to perform a compilation engagement with respect to those same financial statements, and our respective responsibilities.

Sincerely yours,

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*[Signature of accountant or accountant's firm]*

Acknowledged and agreed on behalf of ABC Company by:

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*[Signed]*

*[Name and Title]*

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*[Date]*

[Revised, February 2015, to include additional required engagement letter elements.]

**Illustration 2—An Engagement Letter for a Compilation Engagement With Respect to Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America, Except the Financial Statements Omit the Statement of Cash Flows and Substantially All Disclosures Required by U.S. GAAP and in Which the Accountant's Independence Is Impaired**

Circumstances include the following:

- The accountant will prepare, as a nonattest service, the financial statements subject to the compilation engagement.
- The financial statements will be prepared in accordance with accounting principles generally accepted in the United States of America, except the statement of cash flows and substantially all disclosures required by accounting principles generally accepted in the United States of America will be omitted.
- The accountant's independence will be impaired as a result of the performance of the nonattest preparation service.

To the appropriate representative of management of ABC Company:<sup>1</sup>

You<sup>2</sup> have requested that we prepare the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income and changes in stockholders' equity for the year then ended, and perform a compilation engagement with respect to those financial statements.<sup>3</sup> These financial statements will not include a statement of cash flows and related notes to the financial statements. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter.

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<sup>1</sup> The addresses and references in the engagement letter would be those that are appropriate in the circumstances of the engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons. See paragraph .A7.

<sup>2</sup> Throughout this engagement letter, references to *you, we, us, management, and accountant* would be used or amended as appropriate in the circumstances.

<sup>3</sup> The accountant may include other nonattest services to be performed as part of the engagement, such as income tax preparation and bookkeeping service.

**Our Responsibilities**

The objective of our engagement is to

- a. prepare financial statements in accordance with accounting principles generally accepted in the United States of America based on information provided by you and
- b. apply accounting and financial reporting expertise to assist you in the presentation of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

We will conduct our compilation engagement in accordance with Statements on Standards for Accounting and Review Services (SSARs) promulgated by the Accounting and Review Services Committee of the AICPA and comply with the AICPA's Code of Professional Conduct, including the ethical principles of integrity, objectivity, professional competence, and due care.

We are not required to, and will not, verify the accuracy or completeness of the information you will provide to us for the engagement or otherwise gather evidence for the purpose of expressing an opinion or a conclusion. Accordingly, we will not express an opinion, a conclusion, nor provide any assurance on the financial statements.

Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by fraud or error, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations.

**Your Responsibilities**

The compilation engagement to be performed is conducted on the basis that you acknowledge and understand that our role is to prepare financial statements in accordance with accounting principles generally accepted in the United States of America and assist you in the presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America. You have the following overall responsibilities that are fundamental to our undertaking the engagement in accordance with SSARs:

- a. The selection of accounting principles generally accepted in the United States of America as the financial reporting framework to be applied in the preparation of the financial statements
- b. The preparation and fair presentation of financial statements in accordance with accounting principles generally accepted in the United States of America
- c. The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements
- d. The prevention and detection of fraud
- e. To ensure that the entity complies with the laws and regulations applicable to its activities
- f. The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement
- g. To provide us with

- i. access to all information of which you are aware is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters
- ii. additional information that we may request from you for the purpose of the compilation engagement
- iii. unrestricted access to persons within the entity of whom we determine it necessary to make inquiries

### **Our Report**

As part of our engagement, we will issue a report that will state that we did not audit or review the financial statements and that, accordingly, we do not express an opinion, a conclusion, nor provide any assurance on them. We will disclose that we are not independent in our report.

You agree to include our accountant's compilation report in any document containing financial statements that indicates that we have performed a compilation engagement on such financial statements and, prior to inclusion of the report, to ask our permission to do so.

### **Other Relevant Information**

Our fees for these services. . . .

*[The accountant may include language, such as the following, regarding limitation of, or other arrangements regarding, the liability of the accountant or the entity, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements):*

*You agree to hold us harmless and to release, indemnify, and defend us from any liability or costs, including attorneys' fees, resulting from management's knowing misrepresentations to us.]*

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our engagement to prepare the financial statements described herein and to perform a compilation engagement with respect to those same financial statements, and our respective responsibilities.

Sincerely yours,

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*[Signature of accountant or accountant's firm]*

Acknowledged and agreed on behalf of ABC Company by:

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*[Signed]*

*[Name and Title]*

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*[Date]*

[Revised, February 2015, to include additional required engagement letter elements.]

### Illustration 3—An Engagement Letter for a Compilation Engagement With Respect to Financial Statements Prepared in Accordance With the Tax-Basis of Accounting

Circumstances include the following:

- The accountant will prepare, as a nonattest service, the financial statements subject to the compilation engagement.
- The financial statements will be prepared in accordance with the tax-basis of accounting.
- The accountant expects that his or her independence will not be impaired.

To the appropriate representative of management of ABC Company:<sup>1</sup>

You<sup>2</sup> have requested that we prepare the financial statements of ABC Company, which comprise the statement of assets, liabilities, and equity—tax-basis as of December 31, 20XX, and the related statements of operations and related earnings—tax-basis, and cash flows—tax-basis for the year then ended, and the related notes to the financial statements and perform a compilation engagement with respect to those financial statements.<sup>3, 4</sup> We are pleased to confirm our acceptance and our understanding of this compilation engagement by means of this letter.

#### Our Responsibilities

The objective of our engagement is to

- a. prepare financial statements in accordance with the tax-basis of accounting based on information provided by you and
- b. apply accounting and financial reporting expertise to assist you in the presentation of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in accordance with the tax-basis of accounting.

We will conduct our compilation engagement in accordance with Statements on Standards for Accounting and Review Services (SSARs) promulgated by the Accounting and Review Services Committee of the AICPA and comply with the AICPA's Code of Professional Conduct, including the ethical principles of integrity, objectivity, professional competence, and due care.

We are not required to, and will not, verify the accuracy or completeness of the information you will provide to us for the engagement or otherwise gather evidence for the purpose of expressing an opinion or a conclusion. Accordingly,

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<sup>1</sup> The addresses and references in the engagement letter would be those that are appropriate in the circumstances of the engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons. See paragraph .A7.

<sup>2</sup> Throughout this engagement letter, references to *you, we, us, management, and accountant* would be used or amended as appropriate in the circumstances.

<sup>3</sup> If the accountant is to be engaged to prepare financial statements that omit the statement of cash flows—tax-basis and the related notes and perform a compilation engagement with respect to those financial statements, the sentence may be revised to read, "You have requested that we prepare the financial statements of ABC Company, which comprise the statement of assets, liabilities, and equity—tax-basis as of December 31, 20XX, and the related statement of operations and retained earnings—tax-basis, and perform a compilation engagement with respect to those financial statements." The following additional sentence may then be added: "These financial statements will not include a statement of cash flows—tax-basis and related notes to the financial statements."

<sup>4</sup> The accountant may include nonattest services to be performed as part of the engagement, such as income tax preparation and bookkeeping services.

we will not express an opinion, a conclusion, nor provide any assurance on the financial statements.

Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by fraud or error, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations.

### Your Responsibilities

The engagement to be performed is conducted on the basis that you acknowledge and understand that our role is to prepare financial statements in accordance with the tax-basis of accounting and assist you in the presentation of the financial statements in accordance with the tax-basis of accounting. You have the following overall responsibilities that are fundamental to our undertaking the engagement in accordance with SSARSs:

- a. The selection of the tax-basis of accounting as the financial reporting framework to be applied in the preparation of the financial statements
- b. The preparation and fair presentation of financial statements in accordance with the tax-basis of accounting
- c. The inclusion of all informative disclosures that is appropriate for the tax-basis of accounting. This includes
  - i. a description of the tax-basis of accounting, including a summary of significant accounting policies, and how the tax-basis of accounting differs from accounting principles generally accepted in the United States of America, the effects of which need not be quantified and
  - ii. informative disclosures similar to those required by accounting principles generally accepted in the United States of America.<sup>5</sup>
- d. The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements
- e. The prevention and detection of fraud
- f. To ensure that the entity complies with the laws and regulations applicable to its activities
- g. The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the compilation engagement
- h. To provide us with
  - i. access to all information of which you are aware is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters
  - ii. additional information that we may request from you for the purpose of the compilation engagement
  - iii. unrestricted access to persons within the entity of whom we determine it necessary to make inquiries

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<sup>5</sup> The responsibility described in *b(ii)* need not be included if the financial statements omit substantially all disclosures required by the financial reporting framework.

You are also responsible for all management decisions and responsibilities and for designating an individual with suitable skills, knowledge, and experience to oversee our preparation of your financial statements. You are responsible for evaluating the adequacy and results of the services performed and accepting responsibility for such services.

### **Our Report**

As part of our engagement, we will issue a report that will state that we did not audit or review the financial statements and that, accordingly, we do not express an opinion, a conclusion, nor provide any assurance on them.

You agree to include our accountant's compilation report in any document containing financial statements that indicates that we have performed a compilation engagement on such financial statements and, prior to inclusion of the report, to ask our permission to do so.

### **Other Relevant Information**

Our fees for these services. . . .

*[The accountant may include language, such as the following, regarding limitation of, or other arrangements regarding, the liability of the accountant or the entity, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements):*

*You agree to hold us harmless and to release, indemnify, and defend us from any liability or costs, including attorneys' fees, resulting from management's knowing misrepresentations to us.]*

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our engagement to prepare the financial statements described herein and perform a compilation engagement with respect to those same financial statements and our respective responsibilities.

Sincerely yours,

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*[Signature of accountant or accountant's firm]*

Acknowledged and agreed on behalf of ABC Company by:

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*[Signed]*

*[Name and Title]*

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*[Date]*

[Revised, February 2015, to include additional required engagement letter elements.]

.A43

## Exhibit B—Illustrative Examples of the Accountant's Compilation Report on Financial Statements (Ref: par. .A22, .A30, .A32, and .A34)

**Illustration 1**—An Accountant's Compilation Report on Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America

**Illustration 2**—An Accountant's Compilation Report on Comparative Financial Statements Prepared in Accordance With the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities

**Illustration 3**—An Accountant's Compilation Report on Comparative Financial Statements Prepared in Accordance With the Tax-Basis of Accounting, and Management Has Elected to Omit Substantially All Disclosures Ordinarily Included in Financial Statements Prepared in Accordance With the Tax-Basis of Accounting

**Illustration 4**—An Accountant's Compilation Report on Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America When the Accountant's Independence Is Impaired, and the Accountant Determines to Not Disclose the Reasons for the Independence Impairment

**Illustration 5**—An Accountant's Compilation Report on Comparative Financial Statements Prepared in Accordance With the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities When the Accountant's Independence Has Been Impaired Due to the Accountant Having a Financial Interest in the Entity, and the Accountant Decides to Disclose the Reason for the Independence Impairment

**Illustration 6**—An Accountant's Compilation Report on Comparative Financial Statements, and the Accountant Is Aware of Departures From Accounting Principles Generally Accepted in the United States of America

### **Illustration 1—An Accountant's Compilation Report on Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America**

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. I (We) have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (We) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of

the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

*[Signature of accounting firm or accountant, as appropriate]*

*[Accountant's city and state]*

*[Date of the accountant's report]*

### **Illustration 2—An Accountant's Compilation Report on Comparative Financial Statements Prepared in Accordance With the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities**

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the statements of financial position as of December 31, 20X2 and 20X1 and the related statements of operations and cash flows for the years then ended, and the related notes to the financial statements in accordance with the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, and for determining that the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities is an acceptable financial reporting framework. I (We) have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (We) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

I (We) draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

*[Signature of accounting firm or accountant, as appropriate]*

*[Accountant's city and state]*

*[Date of the accountant's report]*

### **Illustration 3—An Accountant's Compilation Report on Comparative Financial Statements Prepared in Accordance With the Tax-Basis of Accounting, and Management Has Elected to Omit Substantially All Disclosures Ordinarily Included in Financial Statements Prepared in Accordance With the Tax-Basis of Accounting**

Management is responsible for the accompanying financial statements of XYZ Partnership, which comprise the statements of assets, liabilities, and partners' capital—tax-basis as of December 31, 20X2 and 20X1 and the related statements of revenue and expenses—tax-basis, and changes in partners' capital—tax-basis for the years then ended in accordance with the tax-basis of accounting, and for determining that the tax-basis of accounting is an acceptable financial reporting framework. I (We) have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (We) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express

an opinion, a conclusion, nor provide any form of assurance on these financial statements.

The financial statements are prepared in accordance with the tax-basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

Management has elected to omit substantially all the disclosures ordinarily included in financial statements prepared in accordance with the 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, the financial statements are not designed for those who are not informed about such matters.

*[Signature of accounting firm or accountant, as appropriate]*

*[Accountant's city and state]*

*[Date of the accountant's report]*

**Illustration 4—An Accountant's Compilation Report on Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America When the Accountant's Independence Is Impaired, and the Accountant Determines to Not Disclose the Reasons for the Independence Impairment**

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. I (We) have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (We) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

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

*[Signature of accounting firm or accountant, as appropriate]*

*[Accountant's city and state]*

*[Date of the accountant's report]*

**Illustration 5—An Accountant's Compilation Report on Comparative Financial Statements Prepared in Accordance With the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities When the Accountant's Independence Has Been Impaired Due to the Accountant Having a Financial Interest in the Entity, and the Accountant Decides to Disclose the Reason for the Independence Impairment**

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the statements of financial position as of December 31, 20X2 and 20X1, and the related statements of operations and cash flows for the years then ended, and the related notes to the financial statements in accordance with the AICPA's Financial Reporting Framework for Small- and

Medium-Sized Entities, and for determining that the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities is an acceptable financial reporting framework. I (We) have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (We) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

I (We) draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

I am (we are) not independent with respect to XYZ Company as during the year ended December 31, 20X2, I (a member of the engagement team) had a direct financial interest in XYZ Company.

*[Signature of accounting firm or accountant, as appropriate]*

*[Accountant's city and state]*

*[Date of the accountant's report]*

#### **Illustration 6—An Accountant's Compilation Report on Comparative Financial Statements, and the Accountant Is Aware of Departures From Accounting Principles Generally Accepted in the United States of America**

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. I (We) have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (We) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Accounting principles generally accepted in the United States of America require that land be stated at cost. Management has informed me (us) that XYZ Company has stated its land at appraised value and that if accounting principles generally accepted in the United States of America had been followed, the land account and stockholders' equity would have been decreased by \$500,000.

*[Signature of accounting firm or accountant, as appropriate]*

*[Accountant's city and state]*

*[Date of the accountant's report]*

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## AR-C Section 90

### *Review of Financial Statements*

Source: SSARS No. 21

Effective for reviews of financial statements for periods ending on or after December 15, 2015.

#### Introduction

#### Scope and Applicability of This Section

**.01** This section addresses the accountant's responsibilities when engaged to review financial statements. This section may also be applied, as necessary in the circumstances, to engagements to review other historical financial information. (Ref: par. .A1–.A2)

**.02** This section does not apply when the accountant is engaged to review interim financial information when

- a. the entity's latest annual financial statements have been audited by the accountant or a predecessor;
- b. the accountant either
  - i. has been engaged to audit the entity's current year financial statements or
  - ii. audited the entity's latest annual financial statements and, in situations in which it is expected that the current year financial statements will be audited, the engagement of another accountant to audit the current year financial statements is not effective prior to the beginning of the period covered by the review; and
- c. the entity prepares its interim financial information in accordance with the same financial reporting framework as that used to prepare the annual financial statements.

AU-C section 930, *Interim Financial Information*, provides guidance for review engagements when the conditions in a–c are met.

#### Effective Date

**.03** This section is effective for reviews of financial statements for periods ending on or after December 15, 2015. Early implementation is permitted.

#### Objective

**.04** The objective of the accountant when performing a review of financial statements is to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework, primarily through the performance of inquiry and analytical procedures. (Ref: par. .A3–.A8)

## Definitions

.05 For purposes of Statements on Accounting and Review Standards (SSARs), the following terms have the meanings attributed as follows:

**Analytical procedures.** Evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass such investigation, as is necessary, of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

**Applicable financial reporting framework.** The financial reporting framework adopted by management and, when appropriate, those charged with governance in the preparation and fair presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

**Designated accounting standard-setter.** A body designated by the Council of the AICPA to promulgate accounting principles generally accepted in the United States of America pursuant to the "Compliance With Standards Rule" (ET sec. 1.310.001) and the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct.

**Designated accounting standard-setter.** A body designated by the Council of the AICPA to promulgate accounting principles generally accepted in the United States of America pursuant to the "Compliance With Standards Rule" (ET sec. 1.310.001) and the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct.

**Emphasis-of-matter paragraph.** A paragraph included in the accountant's review report that is required by SSARs, or is included at the accountant's discretion, and that refers to a matter appropriately presented or disclosed in the financial statements that, in the accountant's professional judgment, is of such importance that it is fundamental to the users' understanding of the financial statements.

**Error.** Mistakes in the financial statements, including arithmetical or clerical mistakes, and mistakes in the application of accounting principles, including inadequate disclosures.

**Experienced accountant.** An individual (whether internal or external to the firm) who has practical review experience and a reasonable understanding of

- a. review processes;
- b. SSARs and applicable legal and regulatory requirements;
- c. the business environment in which the entity operates; and
- d. review and financial reporting issues relevant to the entity's industry.

**Financial reporting framework.** A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements (for example, accounting principles generally accepted in the United States of America [U.S. GAAP], International Financial Reporting Standards promulgated by

the International Accounting Standards Board, or a special purpose framework).

**Financial statements.** A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources and obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term *financial statements* ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework but can also refer to a single financial statement.

**Fraud.** An intentional act that results in a misstatement in financial statements.

**Generally accepted accounting principles (GAAP).** References to GAAP in SSARSs means generally accepted accounting principles promulgated by bodies designated by the Council of the AICPA pursuant to the "Compliance With Standards Rule" (ET sec. 1.310.001) and the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct.

**Historical financial information.** Information expressed in financial terms regarding a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

**Management.** The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance, for example, executive members of a governance board or an owner-manager.

**Misstatement.** A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be presented fairly in accordance with the applicable financial reporting framework. Misstatements can arise from fraud or error.

Misstatements also include those adjustments of amounts, classifications, presentations, or disclosures that, in the accountant's professional judgment, are necessary for the financial statements to be presented fairly, in all material respects.

**Noncompliance.** Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into, by, or in the name of, the entity or on its behalf by those charged with governance, management, or employees. *Noncompliance* does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management, or employees of the entity.

**Other-matter paragraph.** A paragraph included in the accountant's review report that is required by SSARSs, or is included at the accountant's discretion, and that refers to a matter other than those presented or disclosed in the financial statements that, in the accountant's professional judgment, is relevant to users' understanding of the review, the accountant's responsibilities, or the accountant's review report.

**Report release date.** The date the accountant grants the entity permission to use the accountant's review report in connection with the financial statements.

**Required supplementary information.** Information that a designated accounting standards-setter requires to accompany an entity's basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standards-setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established.

**Review documentation.** The record of review procedures performed, relevant review evidence obtained, and conclusions the accountant reached (terms such as *working papers* or *workpapers* are also sometimes used).

**Review evidence.** Information used by the accountant to provide a reasonable basis for obtaining limited assurance.

**Special purpose framework.** A financial reporting framework other than GAAP that is one of the following bases of accounting:

- a. **Cash basis.** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).
- b. **Tax basis.** A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.
- c. **Regulatory basis.** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission). (Ref: par. .A9)
- d. **Contractual basis.** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the accountant.
- e. **Other-basis.** A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

The cash-basis, tax-basis, regulatory-basis, and other-basis of accounting are commonly referred to as *other comprehensive bases of accounting*.

**Specified parties.** The intended users of the accountant's review report.

**Subsequent events.** Events occurring between the date of the financial statements and the date of the accountant's review report.

**Subsequently discovered facts.** Facts that become known to the accountant after the date of the accountant's review report that, had they been known to the accountant at that date, may have caused the accountant to revise the accountant's review report.

**Supplementary information.** Information presented outside the basic financial statements, excluding required supplementary information,

that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework.

**Those charged with governance.** The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel (for example, executive members of a governance board or an owner-manager).

**Updated report.** A report issued by a continuing accountant that takes into consideration information that the accountant becomes aware of during the accountant's current engagement and that re-expresses the accountant's previous conclusions or, depending on the circumstances, expresses different conclusions on the financial statements of a prior period reviewed by the accountant as of the date of the accountant's current report.

**Written representation.** A written statement by management provided to the accountant to confirm certain matters or to support other review evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

## Requirements

### General Principles for Performing and Reporting on Review Engagements

.06 In addition to complying with this section, an accountant is required to comply with section 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*.

### Independence

.07 The accountant must be independent of the entity when performing a review of financial statements in accordance with SSARs. If, during the performance of the review engagement, the accountant determines that the accountant's independence is impaired, the accountant should withdraw from the review engagement. (Ref: par. .A10–.A11)

### Acceptance and Continuance of Client Relationships and Review Engagements

.08 The accountant should not accept a review engagement if, in addition to the requirements in paragraph .24 of section 60, management or those charged with governance impose a limitation on the scope of the accountant's work in terms of a proposed review engagement such that the accountant believes the limitation will result in the accountant being unable to perform review procedures to provide an adequate basis for issuing a review report.

.09 As a condition for accepting an engagement to review an entity's financial statements, in addition to the requirements in paragraph .25 of section 60,

the accountant should obtain the agreement of management that it acknowledges and understands its responsibility

- a. for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and the inclusion of all informative disclosures that are appropriate for the applicable financial reporting framework used to prepare the entity's financial statements. If the financial statements are prepared in accordance with a special purpose framework, this includes (Ref: par. .A12)
  - i. a description of the special purpose framework, including a summary of significant accounting policies, and how the framework differs from GAAP, the effect of which need not be quantified, and informative disclosures similar to those required by GAAP in the case of special purpose financial statements that contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, (Ref: par. .A78)
  - ii. a description of any significant interpretations of the contract on which the special purpose financial statements are prepared in the case of financial statements prepared in accordance with a contractual-basis of accounting, and
  - iii. additional disclosures beyond those specifically required by the framework that may be necessary for the special purpose framework to achieve fair presentation.
- b. to provide the accountant, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.
- c. to include the accountant's review report in any document containing financial statements that indicates that such financial statements have been reviewed by the entity's accountant unless a different understanding is reached. (Ref: par. .A13)

**.10** If the accountant is not satisfied about any of the matters set out in paragraph .25 of section 60 or paragraph .09 of this section as preconditions for accepting a review engagement, the accountant should discuss the matter with management or those charged with governance. If changes cannot be made to satisfy the accountant about those matters, the accountant should not accept the proposed engagement.

## Agreement on Engagement Terms

**.11** The accountant should agree upon the terms of the engagement with management or those charged with governance, as appropriate. The agreed-upon terms of the engagement should be documented in an engagement letter or other suitable form of written agreement and should include the following: (Ref: par. .A14–.A19)

- a. The objectives of the engagement
- b. The responsibilities of management set forth in paragraph .25c of section 60 and paragraph .09 of this section
- c. The responsibilities of the accountant
- d. The limitations of a review engagement
- e. Identification of the applicable financial reporting framework for the preparation of the financial statements

- f.* The expected form and content of the accountant's review report and a statement that there may be circumstances in which the report may differ from its expected form and content

**.12** The engagement letter or other suitable form of written communication should be signed by

- a.* the accountant or the accountant's firm and
- b.* management or those charged with governance, as appropriate. (Ref: par. .A15)

## Communication With Management and Those Charged With Governance

**.13** The accountant should communicate with management or those charged with governance, as appropriate, on a timely basis during the course of the review engagement, all matters concerning the review engagement that, in the accountant's professional judgment, are of significant importance to merit the attention of management or those charged with governance, as appropriate. (Ref: par. .A20–.A26)

## Understanding of the Industry

**.14** To perform the review engagement, the accountant should possess or obtain an understanding of the industry in which the entity operates, including the accounting principles and practices generally used in the industry, sufficient to enable the accountant to review financial statements that are appropriate for an entity operating in that industry. (Ref: par. .A27)

## Knowledge of the Entity

**.15** The accountant should obtain knowledge about the entity, including an understanding of

- a.* the entity's business and
- b.* the accounting principles and practices used by the entity

sufficient to identify areas in the financial statements where there is a greater likelihood that material misstatements may arise and to be able to design procedures to address those areas. (Ref: par. .A28–.A29)

**.16** In obtaining the understanding of the entity's accounting policies and practices, the accountant should be alert to accounting policies and procedures that, based on the accountant's knowledge of the industry, are unusual.

## Designing and Performing Review Procedures

**.17** The accountant should design and perform analytical procedures and make inquiries and perform other procedures, as appropriate, to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with the applicable financial reporting framework based on the accountant's (Ref: par. .A30)

- a.* understanding of the industry,
- b.* knowledge of the entity, and

- c. awareness of the risk that the accountant may unknowingly fail to modify the accountant's review report on financial statements that are materially misstated. (Ref: par. .A31)

**.18** The accountant should focus the analytical procedures and inquiries in those areas where the accountant believes there are increased risks of material misstatements.

## Analytical Procedures

**.19** The accountant should apply analytical procedures to the financial statements 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. Such analytical procedures should include the following: (Ref: par. .A32–.A34)

- a. Comparing the financial statements with comparable information for the prior period, giving consideration to knowledge about changes in the entity's business and specific transactions
- b. Considering plausible relationships among both financial and, when relevant, nonfinancial information (Ref: par. .A35)
- c. Comparing recorded amounts or ratios developed from recorded amounts to expectations developed by the accountant through identifying and using relationships that are reasonably expected to exist, based on the accountant's understanding of the entity and the industry in which the entity operates (Ref: par. .A36)
- d. Comparing disaggregated revenue data, as applicable (Ref: par. .A37)

**.20** When designing and performing analytical procedures, the accountant should (Ref: par. .A38)

- a. determine the suitability of particular analytical procedures;
- b. consider the reliability of data from which the accountant's expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and nature and relevance of information available;
- c. develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to provide the accountant with limited assurance that a misstatement will be identified that, either individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
- d. determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph .21 and compare the recorded amounts, or ratios developed from recorded amounts, with the expectations.

## Investigating Results of Analytical Procedures

**.21** If analytical procedures identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the accountant should investigate such differences by

- a. inquiring of management and
- b. performing other review procedures if considered necessary in the circumstances. (Ref: par. .A39)

## Inquiries of Members of Management Who Have Responsibility for Financial and Accounting Matters

**.22** The accountant should inquire of members of management who have responsibility for financial and accounting matters concerning the financial statements about (Ref: par. .A40)

- a.* whether the financial statements have been prepared and fairly presented in accordance with the applicable financial reporting framework consistently applied.
- b.* unusual or complex situations that may have an effect on the financial statements. (Ref: par. .A41)
- c.* significant transactions occurring or recognized during the period, particularly those in the last several days of the period.
- d.* the status of uncorrected misstatements identified during the previous review (that is, whether adjustments had been recorded subsequent to the periods covered by the prior review and, if so, the amounts recorded and period in which such adjustments were recorded).
- e.* matters about which questions have arisen in the course of applying the review procedures.
- f.* events subsequent to the date of the financial statements that could have a material effect on the fair presentation of such financial statements.
- g.* its knowledge of any fraud or suspected fraud affecting the entity involving
  - i.* management,
  - ii.* employees who have significant roles in internal control, or
  - iii.* others, when the fraud could have a material effect on the financial statements. (Ref: par. .A42)
- h.* whether management is aware of allegations of fraud or suspected fraud affecting the entity communicated by employees, former employees, regulators, or others.
- i.* whether management has disclosed to the accountant all known instances of noncompliance or suspected noncompliance with laws and regulations whose effects should be considered when preparing financial statements.
- j.* significant journal entries and other adjustments.
- k.* communications from regulatory agencies, if applicable.
- l.* related parties and significant new related party transactions.
- m.* any litigation, claims, and assessments that existed at the date of the balance sheet being reported on and during the period from the balance sheet date to the date of management's response to the accountant's inquiry.
- n.* whether management believes that significant assumptions used by it in making accounting estimates are reasonable.
- o.* actions taken at meetings of stockholders, the board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements. (Ref: par. .A43)
- p.* any other matters that the accountant may consider necessary.

**.23** 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. However, the accountant is not required to corroborate management's responses with other evidence.

## Reading the Financial Statements

**.24** The accountant should read the financial statements and consider whether any information has come to the accountant's attention to indicate that such financial statements do not conform to the applicable financial reporting framework.

## Using the Work of Other Accountants

**.25** If other accountants have issued a report on the financial statements of significant components, such as subsidiaries and investees, the accountant should obtain and read reports from such other accountants.

## Reconciling the Financial Statements to the Underlying Accounting Records

**.26** The accountant should obtain evidence that the financial statements agree or reconcile with the accounting records. (Ref: par. .A44)

## Evaluating Evidence Obtained From the Procedures Performed

**.27** The accountant should accumulate misstatements, including inadequate disclosure, identified by the accountant in performing the review procedures or brought to the accountant's attention during the performance of the review.

**.28** The accountant should evaluate, individually and in the aggregate, misstatements, including inadequate disclosure, accumulated in accordance with paragraph .27 to determine whether material modification should be made to the financial statements for them to be in accordance with the applicable financial reporting framework. (Ref: par. .A5 and .A45–.A46)

**.29** If, during the performance of review procedures, the accountant becomes aware that information coming to the accountant's attention is incorrect, incomplete, or otherwise unsatisfactory, the accountant should

- a. request that management consider the effect of those matters on the financial statements and communicate the results of its consideration to the accountant and
- b. consider the results communicated to the accountant by management and whether such results indicate that the financial statements may be materially misstated.

**.30** If the accountant believes that the financial statements may be materially misstated, the accountant should perform additional procedures deemed necessary to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in accordance with the applicable financial reporting framework.

**.31** The accountant should evaluate whether sufficient appropriate review evidence has been obtained from the procedures performed and, if not, the accountant should perform other procedures judged by the accountant to be

necessary in the circumstances to be able to form a conclusion on the financial statements. (Ref: par. .A47)

## Written Representations

### *Written Representations as Review Evidence*

**.32** *Written representations* are necessary information that the accountant requires in connection with a review of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are review evidence. (Ref: par. .A48)

### *Management From Whom Written Representations Are Requested*

**.33** The accountant should request written representations from members of management who have appropriate responsibilities for the financial statements and knowledge of the matters concerned. (Ref: par. .A49–.A51)

### *Specific Written Representations*

**.34** For all financial statements presented and all periods covered by the review, the accountant should request management to provide written representations that are dated as of the date of the accountant's review report stating that (Ref: par. .A52–.A58)

- a. management has fulfilled its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework, as set out in the terms of the engagement.
- b. management acknowledges its responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of financial statements, including its responsibility to prevent and detect fraud.
- c. management has provided the accountant with all relevant information and access, as agreed upon in the terms of the engagement.
- d. management has responded fully and truthfully to all of the accountant's inquiries
- e. all transactions have been recorded and are reflected in the financial statements.
- f. management has disclosed to the accountant its knowledge of fraud or suspected fraud affecting the entity involving
  - i. management,
  - ii. employees who have significant roles in internal control, or
  - iii. others, when the fraud could have a material effect on the financial statements.
- g. management has disclosed to the accountant its knowledge of any allegations of fraud or suspected fraud affecting the entity's financial statements communicated by employees, former employees, regulators, or others.
- h. management has disclosed to the accountant all known instances of noncompliance or suspected noncompliance with laws and regulations whose effects should be considered when preparing financial statements.

- i. whether management believes that the effects of uncorrected misstatements are immaterial, individually and in the aggregate, to the financial statements as a whole. A summary of such items should be included in, or attached to, the written representation.
- j. management has disclosed to the accountant all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements, and it has appropriately accounted for and disclosed such litigation and claims in accordance with the applicable financial reporting framework.
- k. whether management believes that significant assumptions used by it in making accounting estimates are reasonable.
- l. management has disclosed to the accountant the identity of the entity's related parties and all of the related party relationships and transactions of which it is aware, and it has appropriately accounted for and disclosed such relationships and transactions.
- m. all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

**.35** If, in addition to the representations required by paragraph .34, the accountant determines that it is necessary to obtain one or more written representations to support other review evidence relevant to the financial statements, the accountant should request such other written representations. (Ref: par. .A59)

### ***Form of Written Representations***

**.36** The written representations should be in the form of a representation letter addressed to the accountant. (Ref: par. .A60–.A61)

### ***Concerns About the Reliability of Written Representations and Requested Written Representations Not Provided***

**.37** If, in relation to the written representations required by paragraphs .34–.35

- a. management does not provide the written representations, or
- b. the accountant concludes that there is cause to doubt management's integrity such that the written representations provided are not reliable

the accountant should discuss the matter with management and those charged with governance, as appropriate. If management does not provide the required representations or the accountant continues to doubt management's integrity such that the written representations provided may not be reliable, the accountant should withdraw from the engagement.

## **Reporting on the Financial Statements**

**.38** The accountant's review report should be in writing. (Ref: par. .A62–.A64)

### ***Accountant's Review Report***

**.39** The written review report should include (Ref: par. .A77)

- a. a title that includes the word *independent* to clearly indicate that it is the report of an independent accountant. (Ref: par. .A65)

- b. an addressee, as appropriate for the circumstances of the engagement. (Ref: par. .A66)
- c. an introductory paragraph that (Ref: par. .A67–.A69)
  - i. identifies the entity whose financial statements have been reviewed,
  - ii. states that the financial statements identified in the report were reviewed,
  - iii. identifies the financial statements,
  - iv. specifies the date or period covered by each financial statement,
  - v. includes a statement that a review includes primarily applying analytical procedures to management's (owner's) financial data and making inquiries of company management (owners), and
  - vi. includes 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 as a whole, and that, accordingly, the accountant does not express such an opinion.
- d. a section with the heading "Management's Responsibility for the Financial Statements" that includes an explanation that management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; this responsibility includes the design, implementation, and maintenance of internal control sufficient to provide a reasonable basis for the preparation and fair presentation of financial statements in accordance with the applicable financial reporting framework. (Ref: par. .A70)
- e. a section with the heading "Accountant's Responsibility" that includes the following statements:
  - i. The accountant's responsibility is to conduct the review engagement in accordance with SSARs promulgated by the Accounting and Review Services Committee of the AICPA. The accountant's review report should also explain that those standards require that the accountant perform the procedures to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework. (Ref: par. .A71–.A73)
  - ii. The accountant believes that the review evidence the accountant has obtained is sufficient and appropriate to provide a basis for the accountant's conclusion.
- f. a concluding section with an appropriate heading that includes a statement about whether the accountant is aware of any material modifications that should be made to the accompanying financial statements for them to be in accordance with the applicable financial reporting framework and that identifies the country of origin of those accounting principles, if applicable. (Ref: par. .A46)
- g. the manual or printed signature of the accountant's firm.
- h. the city and state where the accountant practices. (Ref: par. .A74)

- i. the date of the review report, which should be dated no earlier than the date on which the accountant completed procedures sufficient to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework, including evidence that
  - i. all the statements that the financial statements comprise, including the related notes, have been prepared and
  - ii. management has asserted that they have taken responsibility for those financial statements. (Ref: par. .A75–.A76)

### **Accountant's Review Report on Financial Statements Prepared in Accordance With a Special Purpose Framework**

**.40** The accountant should modify the review report when the accountant becomes aware that the financial statements do not include

- a. a description of the special purpose framework. (Ref: par. .A78)
- b. a summary of significant accounting policies.
- c. an adequate description about how the special purpose framework differs from GAAP. The effects of these differences need not be quantified. (Ref: par. .A79)
- d. informative disclosures similar to those required by GAAP when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP. (Ref: par. .A80)

**.41** In the case of financial statements prepared in accordance with a contractual-basis of accounting, the accountant should modify the review report if the financial statements do not adequately describe any significant interpretations of the contract on which the financial statements are based.

**.42** The accountant's review report on financial statements prepared in accordance with a special purpose framework should

- a. make reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances when management has a choice of financial reporting frameworks in the preparation of such financial statements.
- b. describe the purpose for which the financial statements are prepared or refer to a note in the financial statements that contains that information when the financial statements are prepared in accordance with a regulatory- or contractual-basis of accounting. (Ref: par. .A81)

**.43** The accountant's review report on financial statements prepared in accordance with a special purpose framework should include an emphasis-of-matter paragraph, under an appropriate heading, that

- a. indicates that the financial statements are prepared in accordance with the applicable special purpose framework,
- b. refers to the note to the financial statements that describes the framework, and
- c. states that the special purpose framework is a basis of accounting other than GAAP.

.44 The accountant's review report on special purpose financial statements should include, in accordance with paragraph .54, an other-matter paragraph, under an appropriate heading, that, in accordance with paragraphs .61–.62, restricts the use of the accountant's review report when the special purpose financial statements are prepared in accordance with (Ref: par. .A82)

- a. a contractual-basis of accounting,
- b. a regulatory-basis of accounting, or
- c. an other-basis of accounting when required pursuant to paragraph .61a–b.

## **Comparative Financial Statements**

.45 Comparative financial statements may be required by the applicable financial reporting framework, or management may elect to provide such information. When comparative financial statements are presented, the accountant's report should refer to each period for which financial statements are presented. (Ref: par. .A83–.A84)

### ***Updating the Report***

.46 When reporting on all periods presented, a continuing accountant should update the report on one or more prior periods presented on a comparative basis with those of the current period. The accountant's report on comparative financial statements should not be dated earlier than the date that the accountant completed procedures sufficient to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework with respect to the current period. (Ref: par. .A85)

.47 When issuing an updated report, the continuing accountant should consider information that the accountant has become aware of during the review of the current period financial statements.

.48 If, during the current engagement, circumstances or events come to the accountant's attention that may affect the prior-period financial statements presented, the accountant should consider the effects on the review report.

### ***Changed Reference to a Departure From the Applicable Financial Reporting Framework***

.49 When the accountant's report on the financial statements of the prior period contains a changed reference to a departure from the applicable financial reporting framework, the accountant's review report should include an other-matter paragraph indicating (Ref: par. .A86)

- a. the date of the accountant's previous review report.
- b. the circumstances or events that caused the reference to be changed.
- c. when applicable, that the financial statements of the prior period have been changed.

### ***Reporting When One Period Is Audited***

.50 When the prior period financial statements were audited and the auditor's report on the prior period financial statements is not reissued, the review report on the current period financial statements should include an other-matter paragraph indicating

- a. that the financial statements of the prior period were previously audited;
- b. the date of the auditor's report on the prior period financial statements;
- c. the type of opinion issued on the prior period financial statements;
- d. if the opinion was modified, the substantive reasons for the modification; and
- e. that no auditing procedures were performed after the date of the previous report.

## Communicating to Management and Others Regarding Fraud or Noncompliance With Laws and Regulations

.51 If the accountant becomes aware that fraud (including misappropriation of assets) may have occurred, the accountant should communicate the matter as soon as practicable to the appropriate level of management (at a level above those involved with the suspected fraud, if possible). If the accountant becomes aware of matters involving identified or suspected noncompliance with laws and regulations whose effects should be considered when preparing financial statements, the accountant should communicate the matters to management, other than when matters are clearly inconsequential. If the fraud or noncompliance with laws or regulations involves senior management or results in a material misstatement of the financial statements, the accountant should communicate the matter directly to those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that (Ref: par. .A87–.A89)

- a. the financial statements are not materially misstated due to fraud or
- b. the entity is in compliance with laws and regulations, and in the accountant's professional judgment, the effect of the suspected noncompliance may be material to the financial statements

the accountant should consider the need to obtain legal advice and take appropriate action, including potential withdrawal. (Ref: par. .A90)

## Emphasis-of-Matter and Other-Matter Paragraphs in the Accountant's Review Report

### *Emphasis-of-Matter Paragraphs in the Accountant's Review Report*

.52 If the accountant considers it necessary to draw users' attention to a matter appropriately presented or disclosed in the financial statements that, in the accountant's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the accountant should include an emphasis-of-matter paragraph in the accountant's review report, provided that the accountant does not believe that the financial statements may be materially misstated. Such a paragraph should refer only to information presented or disclosed in the financial statements. (Ref: par. .A91–.A93)

.53 When the accountant includes an emphasis-of-matter paragraph in the accountant's review report, the accountant should

- a. include it immediately after the accountant's conclusion paragraph in the accountant's review report,

- b. use the heading "Emphasis of a Matter" or other appropriate heading, (Ref: par. .A94)
- c. include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements, and
- d. indicate that the accountant's conclusion is not modified with respect to the matter emphasized. (Ref: par. .A95)

### ***Other-Matter Paragraphs in the Accountant's Review Report***

**.54** If the accountant considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the accountant's professional judgment, is relevant to the users' understanding of the review, the accountant's responsibilities, or the accountant's review report, the accountant should do so in a paragraph in the accountant's review report with the heading "Other Matter" or other appropriate heading. The accountant should include this paragraph immediately after the accountant's conclusion paragraph and any emphasis-of-matter paragraph. (Ref: par. .A91, .A94, and .A96–.A98)

### ***Communication With Management***

**.55** If the accountant expects to include an emphasis-of-matter or other-matter paragraph in the accountant's review report, the accountant should communicate with management regarding this expectation and the proposed wording of this paragraph. (Ref: par. .A99–.A100)

## **Known Departures From the Applicable Financial Reporting Framework**

**.56** When the accountant becomes aware of a departure from the applicable financial reporting framework (including inadequate disclosure) that is material to the financial statements and if the financial statements are not revised, the accountant should consider whether modification of the standard report is adequate to disclose the departure.

**.57** If the accountant concludes that modification of the standard report is adequate, the departure should be disclosed in a separate paragraph of the report under the heading "Known Departures From the [*identify the applicable financial reporting framework*]," including disclosure of the effects of the departure on the financial statements if such effects have been determined by management or are known to the accountant as the result of the accountant's procedures. (Ref: par. .A101 and .A106)

**.58** If the effects of the departure have not been determined by management or are not known to the accountant as a result of the accountant's procedures, the accountant is not required to determine the effects of a departure; however, in such circumstances, the accountant should state in the report that such determination has not been made.

**.59** If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements as a whole, the accountant should withdraw from the review engagement. (Ref: par. .A102)

**.60** The accountant should not modify the standard report to include a statement that the financial statements are not in accordance with the applicable financial reporting framework. (Ref: par. .A103–.A105)

## Alert That Restricts the Use of the Accountant's Review Report

**.61** An accountant's review report should include an alert, in a separate paragraph, that restricts its use when the subject matter of the accountant's review report is based on (Ref: par. .A107–.A109)

- a. measurement or disclosure criteria that are determined by the accountant to be suitable only for a limited number of users who can be presumed to have an adequate understanding of the criteria or
- b. measurement or disclosure criteria that are available only to the specified parties.

**.62** The alert that restricts the use of the accountant's review report required by paragraph .61 should

- a. state that the accountant's review report is intended solely for the information and use of the specified parties.
- b. identify the specified parties for whom use is intended.
- c. state that the accountant's review report is not intended to be, and should not be, used by anyone other than the specified parties. (Ref: par. .A110)

### ***Adding Other Specified Parties***

**.63** When, in accordance with paragraph .61, the accountant includes an alert that restricts the use of the accountant's review report to certain specified parties and the accountant is requested to add other parties as specified parties, the accountant should determine whether to agree to add the other parties as specified parties. (Ref: par. .A111)

**.64** If the other parties are added after the release of the accountant's review report, the accountant should either:

- a. Amend the accountant's review report to add the other parties and, in such circumstances, not change the original date of the accountant's review report.
- b. Provide a written acknowledgment to management and the other parties that such parties have been added as specified parties and state in the acknowledgment that no procedures were performed subsequent to the original date of the accountant's review report.

## The Accountant's Consideration of an Entity's Ability to Continue as a Going Concern

### ***Consideration of Conditions or Events That Indicate That There Could Be an Uncertainty About the Entity's Ability to Continue as a Going Concern***

**.65** The accountant should consider whether, during the performance of review procedures, evidence or information came to the accountant's attention indicating that there could be an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time. A reasonable period of time is the same period of time required of management to assess going concern when specified by the applicable financial reporting framework. If the applicable financial reporting framework does not specify a period of time for management, a reasonable period is one year from the date of the financial

statements being reviewed (hereinafter referred to as a *reasonable period of time*). (Ref: par. .A112)

### **Consideration of Financial Statement Effects**

**.66** If, after considering the evidence or information from paragraph .65, the accountant believes that there is an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time, 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. (Ref: par. .A113)

**.67** 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 disclosure.

### **Consideration of the Effects on the Accountant's Review Report**

**.68** If the accountant determines that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from the applicable financial reporting framework exists, and the accountant should follow the guidance in paragraphs .56–.60. (Ref: par. .A114–.A116)

## **Subsequent Events and Subsequently Discovered Facts**

### **Subsequent Events**

**.69** When evidence or information that subsequent events that require adjustment of, or disclosure in, the financial statements comes to the accountant's attention, the accountant should request that management consider whether each such event is appropriately reflected in the financial statements in accordance with the applicable financial reporting framework. (Ref: par. .A117)

**.70** If the accountant determines that the subsequent event is not adequately accounted for in the financial statements or disclosed in the notes, the accountant should follow the guidance in paragraphs .56–.60.

### **Subsequently Discovered Facts That Become Known to the Accountant Before the Report Release Date**

**.71** The accountant is not required to perform any review procedures regarding the financial statements after the date of the accountant's review report. However, if a subsequently discovered fact becomes known to the accountant before the report release date, the accountant should

- a. discuss the matter with management and, when appropriate, those charged with governance and
- b. determine whether the financial statements need revision and, if so, inquire how management intends to address the matter in the financial statements.

**.72** If management revises the financial statements, the accountant should perform the review procedures necessary in the circumstances on the revision. The accountant also should either

- a. date the accountant's review report as of a later date or
- b. include an additional date in the accountant's review report on the revised financial statements that is limited to the revision

(that is, dual-date the accountant's review report for that revision), thereby indicating that the accountant's review procedures subsequent to the original date of the accountant's review report are limited solely to the revision of the financial statements described in the relevant note to the financial statements.

**.73** If management does not revise the financial statements in circumstances when the accountant believes they need to be revised, the accountant should modify the accountant's review report, as appropriate.

***Subsequently Discovered Facts That Become Known to the Accountant After the Report Release Date***

**.74** If a subsequently discovered fact becomes known to the accountant after the report release date, the accountant should (Ref: par. .A118–.A119)

- a. discuss the matter with management and, when appropriate, those charged with governance and
- b. determine whether the financial statements need revision and, if so, inquire how management intends to address the matter in the financial statements.

**.75** If management revises the financial statements, the accountant should

- a. apply the requirements of paragraph .72.
- b. if the reviewed financial statements (before revision) have been made available to third parties, assess whether the steps taken by management are timely and appropriate to ensure that anyone in receipt of those financial statements is informed of the situation, including that the reviewed financial statements are not to be used. If management does not take the necessary steps, the accountant should apply the requirements of paragraph .76. (Ref: par. .A120)
- c. if the accountant's conclusion on the revised financial statements differs from the accountant's conclusion on the original financial statements, disclose in an emphasis-of-matter paragraph, in accordance with paragraphs .52–.53
  - i. the date of the accountant's previous report,
  - ii. a description of the revisions, and
  - iii. the substantive reasons for the revisions.

**.76** If management does not revise the financial statements in circumstances when the accountant believes they need to be revised, then

- a. if the reviewed financial statements have not been made available to third parties, the accountant should notify management and those charged with governance, unless all of those charged with governance are involved in managing the entity, not to make the reviewed financial statements available to third parties before the necessary revisions have been made and a new accountant's review report on the revised financial statements has been provided. If the reviewed financial statements are, nevertheless, subsequently made available to third parties without the necessary revisions, the accountant should apply the requirements of paragraph .76b.
- b. if the reviewed financial statements have been made available to third parties, the accountant should assess whether the steps taken by management are timely and appropriate to ensure that

anyone in receipt of the reviewed financial statements is informed of the situation, including that the reviewed financial statements are not to be used. If management does not take the necessary steps, the accountant should apply the requirements of paragraph .77. (Ref: par. .A118)

**.77** If management does not take the necessary steps to ensure that anyone in receipt of the financial statements is informed of the situation, as provided by paragraph .75*b* or paragraph .76*b*, the accountant should notify management and those charged with governance, unless all of those charged with governance are involved in managing the entity, that the accountant will seek to prevent future use of the accountant's review report. If, despite such notification, management or those charged with governance do not take the necessary steps, the accountant should take appropriate action to seek to prevent use of the accountant's review report. (Ref: par. .A121–.A124)

### **Reference to the Work of Other Accountants in an Accountant's Review Report**

**.78** If other accountants audited or reviewed the financial statements of significant components, such as consolidated and unconsolidated subsidiaries and investees, and the accountant of the reporting entity decides not to assume responsibility for the audit or review performed by the other accountants, the accountant of the reporting entity should make reference to the review or audit of such other accountants in the accountant's review report. In that instance, the accountant should clearly indicate in the accountant's review report that the accountant used the work of other accountants and should include the magnitude of the portion of the financial statements audited or reviewed by the other accountants. (Ref: par. .A125–.A127)

**.79** Regardless of whether the accountant of the reporting entity decides to make reference to the review or audit of other accountants, the accountant of the reporting entity should communicate with the other accountants and ascertain

- a.* that the other accountants are aware that the financial statements of the component that the other accountants have audited or reviewed are to be included in the financial statements on which the accountant of the reporting entity will report and that the other accountants' report thereon will be relied upon (and, where applicable, referred to) by the accountant of the reporting entity.
- b.* that the other accountants are familiar with the applicable financial reporting framework and with SSARs or auditing standards generally accepted in the United States of America, as applicable, and will conduct the review or audit in accordance therewith.
- c.* that a review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.

### **Supplementary Information That Accompanies Reviewed Financial Statements**

**.80** When supplementary information accompanies reviewed financial statements and the accountant's review report thereon, the accountant should

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clearly indicate the degree of responsibility, if any, the accountant is taking with respect to such information in either (Ref: par. .A128)

- a. an other-matter paragraph in the accountant's review report on the financial statements or
- b. a separate report on the supplementary information

**.81** When the accountant has reviewed both the financial statements and the supplementary information, the other-matter paragraph in the accountant's review report on the financial statements or the separate report on the supplementary information should state that (Ref: par. .A129 and .A131)

- a. the information is presented for purposes of additional analysis and is not a required part of the financial statements;
- b. the information is the representation of management;
- c. the accountant has reviewed the information, and, based on the accountant's review, whether the accountant is aware of any material modifications that should be made to the information in order for it to be in accordance with the applicable financial reporting framework; and
- d. the accountant has not audited the information and, accordingly, does not express an opinion on such information.

**.82** When the accountant has reviewed the financial statements but not the supplementary information, the other-matter paragraph in the accountant's review report on the financial statements or the separate report on the supplementary information should state that (Ref: par. .A130–.A131)

- a. the information is presented for purposes of additional analysis and is not a required part of the financial statements;
- b. the information is the representation of management; and
- c. the accountant has not audited or reviewed the information and, accordingly, does not express an opinion, a conclusion, nor provide any assurance on such information.

### Required Supplementary Information

**.83** Concerning the requirement in paragraph .80, with respect to required supplementary information, the accountant should include an other-matter paragraph in the accountant's review report on the financial statements. The other matter-paragraph should include language to explain the following circumstances, as applicable: (Ref: par. .A132)

- a. The required supplementary information is included, and the accountant performed a compilation engagement on the required supplementary information.
- b. The required supplementary information is included, and the accountant reviewed the required supplementary information.
- c. The required supplementary information is included, and the accountant did not perform a compilation, review, or audit on the required supplementary information.
- d. The required supplementary information is omitted.
- e. Some required supplementary information is missing, and some is presented in accordance with the prescribed guidelines (Ref: par. .A133)
- f. The accountant has identified departures from the prescribed guidelines.

- g. The accountant has unresolved doubts about whether the required supplementary information is presented in accordance with prescribed guidelines.

**.84** If the entity has presented all or some of the required supplementary information and the accountant did not perform a compilation or review on the required supplementary information, the other-matter paragraph referred to in paragraph .80 should include the following elements: (Ref: par. .A134)

- a. A statement that *[identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]* require that the *[identify the required supplementary information]* be presented to supplement the basic financial statements
- b. A statement that such information, although not a part of the basic financial statements, is required by *[identify designated accounting standards-setter]*, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context
- c. A statement that the accountant did not perform a compilation, review, or audit on the required supplementary information and, accordingly, does not express an opinion or provide any assurance on the information
- d. If some of the required supplementary information is omitted
  - i. a statement that management has omitted *[description of the missing required supplementary information]* that *[identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]* require to be presented to supplement the basic financial statements
  - ii. a statement that such missing information, although not a part of the basic financial statements, is required by *[identify designated accounting standards-setter]*, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context
- e. If the measurement or presentation of the required supplementary information departs materially from the prescribed guidelines, a statement that material departures from prescribed guidelines exist *[describe the material departures from the applicable financial reporting framework]*
- f. If the accountant has unresolved doubts about whether the required supplementary information is measured or presented in accordance with prescribed guidelines, a statement that the accountant has doubts about whether material modifications should be made to the required supplementary information for it to be presented in accordance with guidelines established by *[identify designated accounting standards-setter]*

**.85** If all the required supplementary information is omitted, the other-matter paragraph should include the following elements:

- a. A statement that management has omitted *[description of the missing required supplementary information]* that *[identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]*

require to be presented to supplement the basic financial statements

- b. A statement that such missing information, although not a part of the basic financial statements, is required by [*identify designated accounting standards-setter*], who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context

## Change in Engagement From Audit to Review

**.86** If the accountant, who was engaged to perform an audit engagement in accordance with generally accepted auditing standards, has been requested to change the engagement to a review engagement, the accountant should consider the following before deciding whether to agree to the change: (Ref: par. .A135–.A136)

- a. The reason given for the request, particularly the implications of a restriction on the scope of the audit engagement, whether imposed by management or by circumstances (Ref: par. .A137)
- b. The additional audit effort required to complete the audit engagement
- c. The estimated additional cost to complete the audit engagement

**.87** In all circumstances, if the audit procedures are substantially complete or the cost to complete such procedures is relatively insignificant, the accountant should consider the propriety of accepting a change in the engagement.

**.88** If the accountant concludes, based upon the accountant's professional judgment, that reasonable justification exists to change the engagement, and if the accountant complies with the standards applicable to a review engagement, the accountant should issue an appropriate review report.

**.89** The report should not include reference to

- a. the original engagement,
- b. any audit procedures that may have been performed, or
- c. scope limitations that resulted in the changed engagement.

**.90** When the accountant has been engaged to audit an entity's financial statements and management refuses to allow the accountant to correspond with the entity's legal counsel, the accountant, except in rare circumstances, is precluded from accepting an engagement to review those financial statements.

## Review Documentation

**.91** The accountant should prepare review documentation that is sufficient to enable an experienced accountant, having no previous connection to the review, to understand (Ref: par. .A138–.A142)

- a. the nature, timing, and extent of the review procedures performed to comply with SSARs;
- b. the results of the review procedures performed and the review evidence obtained; and
- c. significant findings or issues arising during the review, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

**.92** In addition to the requirements in paragraph .91, the review documentation should include the following:

- a.* The engagement letter or other suitable form of written documentation with management, as described in paragraphs .11–.12 (Ref: par. .A17 and .A19)
- b.* Communications to management and others regarding fraud or noncompliance with laws and regulations as required by paragraph .51
- c.* Communications with management regarding the accountant's expectation to include an emphasis-of-matter or other-matter paragraph in the accountant's review report as required by paragraph .55
- d.* Communications with other accountants that have audited or reviewed the financial statements of significant components as required by paragraph .79
- e.* The representation letter
- f.* A copy of the reviewed financial statements and the accountant's review report thereon

## Application and Other Explanatory Material

### Scope and Applicability of This Section (Ref: par. .01)

**.A1** Examples of other historical financial information that an accountant may be engaged to review include, but are not limited to, the following:

- Specified elements, accounts, or items of a financial statement, such as schedules of rentals, royalties, profit participation, or provision for income taxes
- Supplementary information
- Required supplementary information
- Financial information contained in a tax return

**.A2** The accountant may review a single financial statement, such as a balance sheet, and not other related financial statements, such as the statements of income, retained earnings, and cash flows, if the scope of the accountant's inquiry and analytical procedures have not been restricted.

### Objective (Ref: par. .04 and .28)

**.A3** A review differs significantly from an audit of financial statements in which the auditor obtains reasonable assurance, which is a high, but not absolute level of assurance, that the financial statements are free of material misstatement. A review does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents; or other procedures ordinarily performed in an audit. Accordingly, in a review, the accountant does not obtain assurance that he or she will become aware of all significant matters that would be disclosed in an audit. Therefore, a review is designed to obtain only limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements

in order for the statements to be in accordance with the applicable financial reporting framework.

**Materiality**

**.A4** The accountant's consideration of materiality is made in the context of the applicable financial reporting framework. Some financial reporting frameworks discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that

- misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement or a combination of both; and
- judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

**.A5** If present in the applicable financial reporting framework, a discussion of the concept of materiality provides a frame of reference to the accountant in determining, as required by paragraph .28, whether there are any material modifications that should be made to the financial statements in order for the statements to be in accordance with the applicable financial reporting framework. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph .A4 provide the accountant with such a frame of reference.

**.A6** The accountant's determination of materiality is a matter of professional judgment and is affected by the accountant's perception of the needs of the intended users of the financial statements. In this context, it is reasonable for the accountant to assume that users

- have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- understand that financial statements are prepared, presented, and reviewed to levels of materiality;
- recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and
- make reasonable economic decisions on the basis of the information in the financial statements.

Further, unless the review engagement is undertaken for financial statements that are intended to meet the particular needs of specific users, the possible effect of misstatements on specific users, whose information needs may vary widely, is not ordinarily considered.

**.A7** The accountant's judgment about what is material in relation to the financial statements as a whole is the same regardless of the level of assurance

obtained by the accountant as a basis for expressing a conclusion on the financial statements.

### **Revising Materiality**

**.A8** The accountant's determination of materiality for the financial statements as a whole may need to be revised during the engagement as a result of

- a change in the circumstances that occurred during the review (for example, a decision to dispose of a major part of the entity's business).
- new information, or a change in the accountant's understanding of the entity and its environment as a result of performing review procedures (for example, if during the review it appears actual financial results are likely to be substantially different from anticipated period-end financial results that were used initially to consider materiality for the financial statements as a whole).

### **Definitions (Ref: par. .05)**

**.A9** Certain regulators, including state and local government legislators, regulatory agencies, or departments, require financial statements to be prepared in accordance with a financial reporting framework that is based on GAAP but does not comply with all of the requirements of GAAP. Such frameworks are regulatory-bases of accounting, as defined in paragraph .05. In some circumstances, however, the cash- or tax-basis of accounting may be permitted by a regulator. For purposes of this section, the cash-and tax-bases of accounting are not regulatory-bases of accounting.

### **Independence (Ref: par. .07)**

**.A10** The AICPA Code of Professional Conduct provides guidance with respect to independence.

**.A11** Nothing prohibits an accountant who is unable to complete a review engagement due to a determination that the accountant's independence is impaired from performing a compilation engagement on those financial statements.

### **Acceptance and Continuance of Client Relationships and Review Engagements (Ref: par. .09)**

**.A12** A review in accordance with SSARs is conducted on the premise that management has acknowledged and understands that it has the responsibility set out in paragraph .25c of section 60. The preparation of financial statements, in whole or in part, is a nonattest service subject to the provisions of the "Nonattest Services" subtopic of the "Independence Rule" (ET sec. 1.295) of the AICPA Code of Professional Conduct. To avoid misunderstanding, agreement is reached with management that it acknowledges and understands that it has such responsibilities as part of agreeing and documenting the terms of the review engagement as required by paragraphs .11–.12.

**.A13** Documents containing financial statements that may include an indication that such financial statements have been reviewed by the entity's accountant includes documents submitted to bonding companies.

## Agreement on Engagement Terms (Ref: par. .11–.12 and .92)

**.A14** Both management and the accountant have an interest in documenting the agreed-upon terms of the review engagement before the commencement of the review engagement to help avoid misunderstandings with respect to the review engagement. For example, it reduces the risk that management may inappropriately rely on or expect the accountant to protect management against certain risks or perform certain functions, including those that are management's responsibility.

**.A15** The roles of management and those charged with governance in agreeing upon the terms of the review engagement for the entity depend on the governance structure of the entity and relevant law or regulation. Depending on the entity's structure, the agreement may be with management, those charged with governance, or both. When the agreement on the terms of engagement is only with those charged with governance, nonetheless, in accordance with paragraph .25c of section 60, the accountant is required to obtain management's agreement that it acknowledges and understands its responsibilities.

**.A16** When a third party has contracted for a review of the entity's financial statements, agreeing the terms of the review with management of the entity is necessary in order to establish that the preconditions for a review are present.

**.A17** A contract is another suitable form of written communication. The understanding with management regarding the services to be performed for review engagements is required by paragraph .11 to be in a documented form, and, accordingly, a verbal understanding is insufficient. An engagement letter is the most common and usually the most convenient method for documenting the understanding with management regarding the services to be performed for review engagements.

**.A18** Although the accountant may prepare the financial statements, in whole or in part, the financial statements are representations of management, and the fairness of their presentation in accordance with the applicable financial reporting framework is management's responsibility.

**.A19** Illustrations of engagement letters for a review of financial statements are presented in exhibit A, "Illustrative Engagement Letters."

## Communication With Management and Those Charged With Governance (Ref: par. .13)

**.A20** In a review engagement, the accountant's communications with management and those charged with governance take the form of

- a. inquiries the accountant makes in the course of performing the procedures for the review and
- b. other communications, in the context of having effective two-way communication to understand matters arising and to develop a constructive working relationship for the engagement.

**.A21** The appropriate timing for communications will vary with the circumstances of the engagement. Relevant factors include the significance and nature of the matter and any action expected to be taken by management or those charged with governance. For example, it may be appropriate to communicate a significant difficulty encountered during the review as soon as practicable if management or those charged with governance are able to assist the accountant to overcome the difficulty.

**.A22** Law or regulation may restrict the accountant's communication of certain matters with those charged with governance. For example, law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the accountant's obligations of confidentiality and obligations to communicate may be complex. In such cases, the accountant may consider obtaining legal advice.

### ***Communicating Matters Concerning the Review***

**.A23** Matters to be communicated to management or those charged with governance, as appropriate, in accordance with this section may include the following:

- The accountant's responsibilities in the review engagement, as included in the engagement letter or other suitable form of written agreement.
- Significant findings from the review, for example
  - the accountant's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates, and financial statement disclosures.
  - significant findings from the performance of procedures, including situations when the accountant considered performance of additional procedures necessary in accordance with this section. The accountant may need to confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.
  - Matters arising that may lead to modification of the accountant's review report.
  - Significant difficulties, if any, encountered during the review, for example, unavailability of expected information, unexpected inability to obtain evidence that the accountant considers necessary for the review, or restrictions imposed on the accountant by management. In some circumstances, such difficulties may lead to the accountant's withdrawal from the engagement.

**.A24** In some entities, different persons are responsible for the management and governance of an entity. In these circumstances, management may have the responsibility to communicate matters of governance interest to those charged with governance. Communication by management with those charged with governance of matters that the accountant is required to communicate does not relieve the accountant of the responsibility to also communicate with those charged with governance. However, communication of these matters by management may affect the form or timing of the accountant's communication with those charged with governance.

### ***Communication With Third Parties***

**.A25** The accountant may be required by law or regulation to, for example

- notify a regulatory or enforcement body of certain matters communicated with those charged with governance.

- submit copies of certain reports prepared for those charged with governance to relevant regulatory or funding bodies or, in some cases, make such reports publicly available.

**.A26** Unless required by law or regulation to provide a third party with a copy of the accountant's written communications with those charged with governance, the accountant may need the prior consent of management or those charged with governance before doing so.

### Understanding of the Industry (Ref: par. .14)

**.A27** The requirement that the accountant possess a level of knowledge of the industry in which the entity operates does not prevent the accountant from accepting a review engagement for an entity in an industry with which the accountant has no previous experience. It does, however, place upon the accountant a responsibility to obtain the required level of knowledge. The accountant may do so, for example, by consulting AICPA guides, industry publications, financial statements of other entities in the industry, textbooks and periodicals, appropriate continuing professional education, or individuals knowledgeable about the industry.

### Knowledge of the Entity (Ref: par. .15)

**.A28** The accountant may obtain knowledge of the entity through inquiry of the entity's personnel, the review of documents prepared by the entity, or experience with the entity or the entity's industry. Such knowledge includes the following:

- An understanding of the entity's business
- An understanding of the accounting principles and practices used by the entity in measuring, recognizing, recording, and disclosing all significant accounts and disclosures in the financial statements

**.A29** The accountant's understanding of the entity's business encompasses a general understanding of the entity's organization; its operating characteristics; and the nature of its assets, liabilities, revenues, and expenses.

### Designing and Performing Review Procedures (Ref: par. .17)

**.A30** Review evidence obtained through the performance of analytical procedures and inquiry will ordinarily provide the accountant with a reasonable basis for obtaining limited assurance. However, in addition to analytical procedures and inquiries, in certain circumstances and based on the accountant's professional judgment, the accountant may perform procedures ordinarily performed in an audit. In such instances, the engagement remains a review, and the accountant is not required to perform an audit of the financial statements.

**.A31** The results of the accountant's analytical procedures and inquiries may modify the accountant's risk awareness. For example, the response to an inquiry that a related party transaction is not disclosed may revise the accountant's awareness of risk relative to related party transactions.

### Analytical Procedures (Ref: par. .19–.20)

**.A32** Examples of analytical procedures that an accountant may consider performing when conducting a review of financial statements are contained in appendix A, "Analytical Procedures the Accountant May Consider Performing When Conducting a Review of Financial Statements."

**.A33** Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the accountant, such as an estimation of depreciation
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable and gross margin percentages with industry averages or other entities of comparable size in the same industry

**.A34** Analytical procedures also include consideration of relationships, for example:

- Among elements of financial information, such as gross margin percentages, that would be expected to conform to a predictable pattern based on recent history of the entity and industry
- Between financial information and relevant nonfinancial information, such as payroll costs to number of employees

**.A35** When considering plausible relationships, the accountant may wish to consider information developed and used by the entity (for example, analyses prepared for management or those charged with governance).

**.A36** Expectations developed by the accountant in performing analytical procedures in connection with a review of financial statements may be less precise than those developed in an audit. Also, in a review, the accountant is not required to corroborate management's responses with other evidence.

**.A37** To compare disaggregated revenue data, the accountant may compare, for example, revenue reported by month and product line or operating segment during the current period with that of comparable prior periods.

**.A38** Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses. Analytical procedures may be performed at the financial statement level or at the detailed account level. The nature, timing, and extent of analytical procedures are a matter of professional judgment.

### ***Investigating Results of Analytical Procedures (Ref: par. .21b)***

**.A39** Although the accountant is not required to corroborate management's responses with other evidence, the need to perform other review procedures may arise when, for example, management is unable to provide an explanation, or the explanation is not considered adequate.

## **Inquiries of Members of Management Who Have Responsibility for Financial and Accounting Matters (Ref: par. .22)**

**.A40** In addition to members of management who have responsibility for financial and accounting matters, the accountant may determine to direct inquiries to others within the entity and those charged with governance, if appropriate.

**.A41** Examples of unusual or complex situations about which the accountant may inquire of management are contained in appendix B, "Unusual or Complex Situations to Be Considered by the Accountant When Performing Inquiry Procedures in a Review of Financial Statements."

**.A42** Management may obtain knowledge of fraud or suspected fraud affecting the entity involving management or others when the fraud could have a material effect on the financial statements through, among other things, communications received from employees, former employees, or others.

**.A43** The accountant may obtain and read minutes from meetings of stockholders, the board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements as an effective and efficient procedure to meet the requirement in paragraph .22o to inquire of members of management who have responsibility for financial and accounting matters concerning the financial statements about actions taken at such meetings.

## **Reconciling the Financial Statements to the Underlying Accounting Records (Ref: par. .26)**

**.A44** To obtain evidence that the financial statements agree or reconcile with the accounting records, the accountant may compare the financial statements to

- the accounting records, such as the general ledger;
- a consolidating schedule derived from the accounting records; or
- other supporting data in the entity's records.

## **Evaluating Evidence Obtained From the Procedures Performed (Ref: par. .28, .31, and .39f)**

**.A45** Considerations that may affect the evaluation of whether uncorrected misstatements, individually or in the aggregate, are material include the following:

- The nature, cause (if known), and amount of the misstatements
- Whether the misstatements originated in the preceding year
- The potential effect of the misstatements on future periods
- The appropriateness of offsetting a misstatement of an estimated amount with a misstatement of an item capable of precise measurement
- Recognition that an accumulation of immaterial misstatements in the balance sheet could contribute to material misstatements in future periods

**.A46** The accountant's reporting responsibilities when the accountant concludes that the financial statements are materially misstated are addressed in paragraphs .56–.60 with respect to known departures from the applicable financial reporting framework.

**.A47** In some circumstances, the accountant may not have obtained the evidence that the accountant had expected to obtain through the design of primarily inquiry and analytical procedures and procedures addressing specific circumstances. In these circumstances, the accountant considers that the evidence obtained from the procedures performed is not sufficient and appropriate to be able to form a conclusion on the financial statements. The accountant may

- extend the work performed or
- perform other procedures judged by the practitioner to be necessary in the circumstances.

When neither of these is practicable in the circumstances, the accountant will not be able to obtain sufficient appropriate evidence to be able to form a conclusion and is required by this section to determine the effect on the accountant's ability to complete the engagement. This situation may arise even though the accountant has not become aware of a matter(s) that causes the accountant to believe the financial statements may be materially misstated.

## Written Representations

### *Written Representations as Review Evidence (Ref: par. .32)*

**.A48** Written representations are an important source of review evidence. If management modifies or does not provide the requested written representations, it may alert the accountant to the possibility that one or more significant issues may exist. Further, a request for written, rather than oral, representations, in many cases, may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

### *Management From Whom Written Representations Are Requested (Ref: par. .33)*

**.A49** Written representations are requested from those with overall responsibility for financial and operating matters whom the accountant believes are responsible for, and knowledgeable about, directly or through others in the organization, the matters covered by the representations, including the preparation and fair presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity; however, management (rather than those charged with governance) is often the responsible party. Written representations may, therefore, be requested from the entity's CEO and CFO or other equivalent persons in entities that do not use such titles. However, in some circumstances, other parties, such as those charged with governance, also are responsible for the preparation and fair presentation of the financial statements.

**.A50** Due to its responsibility for the preparation and fair presentation of the financial statements and its responsibility for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing the financial statements on which to base the written representations.

**.A51** In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of its knowledge and belief. It is reasonable for the accountant to accept such wording if, in the accountant's judgment, the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.

### *Specific Written Representations (Ref: par. .34–.35)*

**.A52** Review evidence obtained during the review that management has acknowledged the responsibilities referred to in paragraph .34a–b is not sufficient without obtaining representation from management that it believes that it has fulfilled those responsibilities. This is because the accountant is not able to judge solely on other review evidence whether management has prepared and fairly presented the financial statements and provided information to the accountant on the basis of the agreed acknowledgment and understanding of its responsibilities.

**.A53** The written representations relating to fraud required by paragraph .34f–g are important for the accountant to obtain, regardless of the size of the entity, because of the nature of fraud and the difficulties encountered by accountants in detecting material misstatements in the financial statements resulting from fraud.

**.A54** Because the preparation of financial statements requires management to adjust the financial statements to correct material misstatements, the accountant is required to request that management provide a written representation about uncorrected misstatements. In some circumstances, management may not believe that certain uncorrected misstatements are misstatements. For that reason, management may want to add to their written representation words such as "We do not agree that items . . . and . . . constitute misstatements because [*description of reasons*]."

**.A55** Circumstances in which it may be appropriate to obtain written representations about related parties from those charged with governance in addition to management include the following:

- When they have approved specific related party transactions that
  - materially affect the financial statements or
  - involve management
- When they have made specific oral representations to the accountant on details of certain related party transactions
- When they have financial or other interests in the related parties or the related party transactions

**.A56** Because written representations are necessary review evidence, the accountant has not obtained limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with the applicable financial reporting framework and the accountant's review report cannot be dated before the date of the written representations. Furthermore, because the accountant is concerned with events occurring up to the date of the accountant's review report that may require adjustment to, or disclosure in, the financial statements, the written representations are dated as of the date of the accountant's review report on the financial statements.

**.A57** The written representations cover all periods referred to in the accountant's review report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The accountant and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

**.A58** Situations may arise in which current management was not present during all periods referred to in the accountant's review report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the accountant to request from them written representations that cover the whole of the relevant period(s) still applies.

**.A59** The accountant may request additional representations regarding matters specific to the entity's business or industry. In addition, the accountant

is not precluded from obtaining representations regarding services performed in addition to the review engagement.

### ***Form of Written Representations (Ref: par. .36)***

**.A60** Occasionally, circumstances may prevent management from signing the representation letter and returning it to the accountant on the date of the accountant's review report. In those circumstances, the accountant may accept management's oral confirmation, on or before the date of the accountant's review report, that management has reviewed the final representation letter and will sign the representation letter without exception as of the date of the accountant's review report. Possession of the signed management representation letter prior to releasing the accountant's review report is necessary because paragraph .36 requires that the representations be in the form of a written letter from management. Furthermore, when there are delays in releasing the report, a fact may become known to the accountant that, had it been known to the accountant at the date of the accountant's review report, might affect the accountant's review report and result in the need for updated representations.

**.A61** Exhibit B, "Illustrative Representation Letter," provides an illustrative example of a representation letter.

### ***Reporting on the Financial Statements (Ref: par. .38)***

**.A62** A written report encompasses reports issued in hard copy format and those using an electronic medium.

**.A63** Financial statements that the accountant has reviewed may become unattached from the accountant's review report. To minimize the possibility that a user of the reviewed financial statements may infer, through the accountant's association with the reviewed financial statements, an unintended level of reliance on the reviewed financial statements, the accountant may consider including a reference on each page of the reviewed financial statements to the accountant's review report. An example of a reference to the accountant's review report included on each page of the reviewed financial statements is "See independent accountant's review report."

**.A64** When the accountant is unable to perform the inquiry, analytical procedures, and other review procedures the accountant considers necessary to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with the applicable financial reporting framework, or management does not provide the accountant with a representation letter, the review will be incomplete. A review that is incomplete does not provide an adequate basis for issuing a review report.

### ***Accountant's Review Report (Ref: par. .39)***

#### *Title*

**.A65** An appropriate title would be "Independent Accountant's Review Report."

#### *Addressee*

**.A66** The accountant's review report is normally addressed to those for whom the report is prepared. The report may be addressed to the entity whose financial statements are being reviewed or to those charged with governance. A report on financial statements of an unincorporated entity may be addressed as circumstances dictate (for example, to the partners, general partner, or proprietor). Occasionally, an accountant may be retained to review the financial

statements of an entity that is not a client; in such a case, the report may be addressed to the entity and not to those charged with governance of the entity whose financial statements are being reviewed.

#### *Introductory Paragraph*

**.A67** The introductory paragraph states, for example, that the accountant has "reviewed the accompanying financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity and cash flows for the year then ended, and the related notes to the financial statements." If the financial statements include a separate statement of changes in stockholders' equity accounts or a separate statement of comprehensive income, paragraph .39c(iii) requires such statements to be identified in the introductory paragraph of the report as a statement to which the financial statements are comprised.

**.A68** When the accountant is aware that the reviewed financial statements will be included in a document that contains other information, such as an annual report, the accountant may consider, if the form of presentation allows, identifying the page numbers on which the reviewed financial statements are presented. This helps users identify the financial statements to which the accountant's review report relates.

**.A69** The identification of the title for each statement that the financial statements comprise may be achieved by referencing the table of contents.

#### *Management's Responsibility*

**.A70** Management, and when appropriate, those charged with governance, accept responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including their fair presentation. Management also accepts responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the accountant's review report includes reference to both responsibilities because it helps explain to users the premise on which a review is conducted.

#### *Accountant's Responsibility*

**.A71** The accountant's review report states that the accountant's responsibility is to conduct the review engagement in accordance with SSARSs promulgated by the Accounting and Review Services Committee of the AICPA in order to contrast it to management's responsibility for the financial statements.

**.A72** The reference to the standards used conveys to users of the accountant's review report that the review engagement has been conducted in accordance with established standards.

**.A73** The accountant is not permitted to represent compliance with SSARSs in the accountant's review report unless the accountant has complied with the relevant requirements within the body of SSARSs.

#### *Accountant's Address*

**.A74** The city and state where the accountant practices may be indicated on letterhead that contains the issuing office's city and state.

#### *Date of the Accountant's Review Report*

**.A75** The date of the accountant's review report informs users of the accountant's review report that the accountant has considered the effect of events and transactions of which the accountant became aware and that occurred up

to that date. The accountant's responsibility for events and transactions after the date of the accountant's review report is addressed in paragraphs .71–.77.

**.A76** Because the accountant's conclusion is provided on the financial statements, and the financial statements are the responsibility of management, the accountant is not in a position to conclude that the accountant has obtained limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework until evidence is obtained that all the statements that the financial statements comprise, including the related notes, have been prepared, and management has accepted responsibility for them.

**.A77** Exhibit C, "Illustrations of Accountant's Review Reports on Financial Statements," contains illustrations of accountant's review reports on financial statements incorporating the elements required by paragraph .39.

### **Accountant's Review Report on Financial Statements Prepared in Accordance With a Special Purpose Framework (Ref: par. .09, .40, .42, and .44)**

**.A78** The description of the special purpose framework may be included in the financial statement titles, in the notes to the financial statements, or otherwise on the face of the financial statements. Although terms such as *balance sheet*, *statement of financial position*, *statement of income*, *statement of operations*, and *statement of cash flows* or similar unmodified titles, are generally understood to be applicable only to financial statements that are intended to present financial position, results of operations, or cash flows in accordance with GAAP, such titles, with appropriate modification, may be used in connection with financial statements prepared in accordance with a special purpose framework. Suitable financial statement titles for financial statements prepared in accordance with a special purpose framework include, but are not limited to

- a modified cash-basis financial statement that might be titled
  - "Income Statement—Modified Cash-Basis," or
  - "Statement of Cash Receipts and Disbursements."
- financial statements prepared in accordance with the tax-basis of accounting that might be titled
  - "Balance Sheet—Tax-Basis,"
  - "Statement of Assets, Liabilities, and Equity—Tax-Basis,"
  - "Statement of Operations—Tax-Basis," or
  - "Statement of Revenue and Expenses—Tax-Basis."
- a financial statement prepared in accordance with a regulatory-basis of accounting that might be titled "Statement of Income—Regulatory-Basis."

**.A79** The description of how the special purpose framework differs from GAAP ordinarily includes only the material differences between GAAP and the special purpose framework. For example, if several items are accounted for differently in accordance with the special purpose framework than they would be in accordance with GAAP, but only the differences in how depreciation is calculated are material, a brief description of the depreciation differences is all

that would be necessary, and the remaining differences need not be described. The differences need not be quantified.

**.A80** Financial statements prepared when applying a special purpose framework are not considered appropriate in form unless the financial statements include informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

**.A81** When the financial statements are prepared in accordance with a regulatory- or contractual-basis of accounting or an other-basis of accounting that requires an alert that restricts the use of the accountant's review report pursuant to paragraph .61a–b, the accountant is required by paragraph .42 to describe the purpose for which the financial statements are prepared or refer to a note in the financial statements that contains that information. This is necessary to avoid misunderstandings when the financial statements are used for purposes other than those for which they were intended. The note to the financial statements may also describe any significant interpretations of the contract on which the financial statements are based.

**.A82** When use of the accountant's review report is restricted, the intended users are the specified parties. The restriction on use of the accountant's review report is necessary due to the nature of the report and the potential for the report to be misunderstood when taken out of the context in which it was intended to be used. For example, special purpose financial statements prepared in accordance with a contractual-basis of accounting are developed for and directed only to the parties to the contract or agreement. Paragraphs .63–.64 address the addition of other parties as specified parties.

### **Comparative Financial Statements (Ref: par. .45)**

**.A83** The level of information included for the prior periods in comparative financial statements is comparable with that of financial statements of the current period.

**.A84** If one firm of accountants merges with another firm, and the new firm becomes the accountant of a client of one of the two former firms, the new firm may accept responsibility and issue a review report on the financial statements for the prior period(s) as well as for those of the current period. The new firm may indicate in the accountant's review report or as part of the signature that a merger took place and may name the firm with whom it was merged.

#### ***Updating the Report (Ref: par. .46)***

**.A85** An updated report is issued in conjunction with the continuing accountant's report on the current period financial statements.

#### ***Changed Reference to a Departure From the Applicable Financial Reporting Framework (Ref: par. .49)***

**.A86** A changed reference includes the removal of a prior reference or the inclusion of a new reference.

### **Communicating to Management and Others Regarding Fraud or Noncompliance With Laws and Regulations (Ref: par. .51)**

**.A87** The communication of matters involving identified or suspected non-compliance may describe the act of identified or suspected noncompliance, the circumstances of its occurrence, and the effect on the financial statements.

The accountant may reach agreement in advance with management and those charged with governance, if applicable, on the nature and amount of matters that would be considered not material and, thus, need not be communicated.

**.A88** The disclosure of any evidence or information that comes to the accountant's attention during the performance of review procedures that fraud or noncompliance with laws or regulations may have occurred to parties other than the entity's senior management (or those charged with governance, if applicable) ordinarily is not part of the accountant's responsibility and, ordinarily, would be precluded by the accountant's ethical or legal obligations of confidentiality.

**.A89** A duty to disclose to parties outside of the entity may exist in the following circumstances:

- To comply with certain legal and regulatory requirements
- To a successor accountant when management has given permission for communication between the predecessor accountant and the successor accountant
- In response to a subpoena

In such circumstances, the accountant may consider it appropriate to consult with legal counsel.

**.A90** The accountant may consider whether withdrawal from the engagement is necessary when

- management or those charged with governance do not take the remedial action that the accountant considers necessary in the circumstances or
- matters regarding fraud or noncompliance with laws or regulations involve an owner of the business.

When deciding whether withdrawal from the engagement is necessary, the accountant may consider seeking legal advice.

## **Emphasis-of-Matter and Other-Matter Paragraphs in the Accountant's Review Report (Ref: par. .52 and .54)**

**.A91** The accountant is required to include an emphasis-of-matter or other-matter paragraph in the accountant's review report relating to the following matters:

- In accordance with paragraphs .43–.44 with respect to financial statements prepared in accordance with a special purpose framework
- In accordance with paragraph .49 with respect to a changed reference to a departure from the applicable financial reporting framework when reporting on comparative financial statements
- In accordance with paragraph .50 with respect to reporting on comparative financial statements when the prior period is audited
- In accordance with paragraph .57 with respect to reporting a known departure from the applicable financial reporting framework that is material to the financial statements
- In accordance with paragraph .75c with respect to reporting when management revises financial statements for a subsequently discovered fact that became known to the accountant after the report

release date and the accountant's review report on the revised financial statements differs from the accountant's review report on the original financial statements

- In accordance with paragraph .80 with respect to supplementary information that accompanies reviewed financial statements and the accountant's review report thereon
- In accordance with paragraph .83 with respect to required supplementary information

### ***Emphasis-of-Matter Paragraphs in the Accountant's Review Report (Ref: par. .52-.54)***

**.A92** In addition to the required emphasis-of-matter paragraphs listed in paragraph .A91, the following are examples of circumstances when the accountant may consider it necessary to include an emphasis-of-matter paragraph:

- An uncertainty regarding the entity's ability to continue as a going concern for a reasonable period of time
- An uncertainty relating to the future outcome of unusually important litigation or regulatory action
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position
- Significant transactions with related parties
- Unusually important subsequent events

**.A93** Paragraph .52 requires that an emphasis-of-matter paragraph refer only to matters appropriately presented or disclosed in the financial statements. To include information in an emphasis-of-matter paragraph about a matter beyond what is presented or disclosed in the financial statements may raise questions about the appropriateness of such presentation or disclosure.

**.A94** Another heading may be considered appropriate if it adequately describes the nature of the matter being disclosed or communicated.

**.A95** The inclusion of an emphasis-of-matter paragraph in the accountant's review report does not affect the accountant's conclusion. An emphasis-of-matter paragraph is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make.

### ***Other-Matter Paragraphs in the Accountant's Review Report (Ref: par. .54)***

**.A96** If not properly presented or disclosed in the financial statements, a matter cannot be included in an emphasis-of-matter paragraph. However, if the matter is relevant to users' understanding of the review, the accountant's responsibilities, or the accountant's review report, the matter can be disclosed in an other-matter paragraph.

**.A97** An entity may prepare one set of financial statements in accordance with a general purpose framework (for example, accounting principles generally accepted in the United States of America) and another set of financial statements in accordance with another general purpose framework (for example, International Financial Reporting Standards promulgated by the International Accounting Standards Board) and may engage the accountant to review both sets of financial statements. If the accountant has determined that the frameworks are acceptable in the respective circumstances, the accountant may include an other-matter paragraph in the accountant's review report referring

to the fact that another set of financial statements has been prepared by the same entity in accordance with another general purpose framework and that the accountant has issued a review report on those financial statements.

**.A98** The content of an other-matter paragraph reflects clearly that such other matter is not required to be presented and disclosed in the financial statements. An other-matter paragraph does not include information that the accountant is prohibited from providing by law, regulation, or other professional standards (for example, ethical standards relating to the confidentiality of information). An other-matter paragraph does not include information that is required to be provided by management.

### ***Communication With Management (Ref: par. .55)***

**.A99** The accountant's communication with management, as described in paragraph .55, enables management to be made aware of the nature of any specific matters that the accountant intends to highlight in the accountant's review report and provides them with an opportunity to obtain further clarification from the accountant, when necessary. When the inclusion of an other-matter paragraph on a particular matter in the accountant's review report recurs on each successive engagement, the accountant may determine that it is unnecessary to repeat the communication on each engagement.

**.A100** In addition to management, the accountant may also consider it appropriate to communicate with those charged with governance regarding the expectation of including an other-matter paragraph in the accountant's review report and the proposed wording of this paragraph.

## **Known Departures From the Applicable Financial Reporting Framework (Ref: par. .57 and .59–.60)**

**.A101** Examples of headings that an accountant may use to disclose departures from an applicable financial reporting framework in the accountant's review report include the following:

- Known Departures From Accounting Principles Generally Accepted in the United States of America
- Known Departures From International Financial Reporting Standards as Promulgated by the International Accounting Standards Board
- Known Departures From the Cash-Basis of Accounting
- Known Departures From the Tax-Basis of Accounting

**.A102** Prior to withdrawing from a review engagement in those circumstances when the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements as a whole, the accountant may wish to consult with legal counsel.

**.A103** Including a statement that the financial statements are not in accordance with the applicable financial reporting framework would be tantamount to expressing an adverse opinion on the financial statements. Such an opinion can be expressed only in the context of an audit engagement. Furthermore, such a statement in an accountant's review report may confuse users because it would contradict the statement required in paragraph .39*f* about whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework.

**.A104** Depending on the accountant's assessment of the possible dollar magnitude of the effect of the departures, the significance of the affected items to the entity, the pervasiveness and overall impact of the misstatements, and whether disclosure has been made of the effect of the departures, the accountant may, in accordance with paragraphs .52–.55, include a separate paragraph in the accountant's review report stating the limitations of the financial statements. The following is an illustration of such a separate paragraph with respect to an accountant's review report on financial statements prepared in accordance with accounting principles generally accepted in the United States of America:

***Limitations of the financial statements***

Because the significance and pervasiveness of the matters described in the Known Departures From Accounting Principles Generally Accepted in the United States of America paragraphs makes it difficult to assess their impact on the financial statements, users of the accompanying 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 accordance with accounting principles generally accepted in the United States of America.

**.A105** Inclusion of a separate paragraph, such as that illustrated in paragraph .A104 in the accountant's review report is not a substitute for disclosure of the specific departures or the effects of such departures if such effects have been determined by management or are known as a result of the accountant's procedures.

**.A106** Exhibit C, "Illustrations of Accountant's Review Reports on Financial Statements," contains an illustrative example of an accountant's review report that discloses a departure from the applicable financial reporting framework.<sup>1</sup>

## **Alert That Restricts the Use of the Accountant's Review Report (Ref: par. .61)**

**.A107** The need for an alert that restricts the use of the accountant's review report arises from the potential for the accountant's review report to be misunderstood if taken out of the context in which the accountant's review report is intended to be used.

**.A108** Accountant's review reports on financial statements prepared in accordance with a general purpose framework ordinarily do not include an alert that restricts their use. A general purpose framework is a financial reporting framework designed to meet the common financial information needs of a wide range of users. However, nothing in SSARs precludes an accountant from including an alert in any accountant's review report. For example, financial statements prepared specifically for use in an acquisition may be prepared in accordance with a general purpose framework because the parties involved in the transaction have agreed that such general purpose financial statements are appropriate for their purposes. Nevertheless, when the terms of the engagement to review those financial statements require the accountant to supply the accountant's review report only to specified parties, the accountant may consider it necessary in the circumstances to include an other-matter paragraph in

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<sup>1</sup> Illustration 5, "An Accountant's Review Report on Comparative Financial Statements Disclosing a Departure From Accounting Principles Generally Accepted in the United States of America," of exhibit C, "Illustrations of Accountant's Review Reports on Financial Statements."

the accountant's review report that restricts the use of the accountant's review report.

### ***Distribution of the Accountant's Review Report (Ref: par. .61)***

**.A109** An accountant is not responsible for controlling, and cannot control, distribution of the accountant's review report after its release. The alert that restricts the use of the accountant's review report is designed to avoid misunderstandings related to the use of the accountant's review report, particularly if the accountant's review report is taken out of the context in which the accountant's review report is intended to be used. An accountant may consider informing the entity or other specified parties that the accountant's review report is not intended for distribution to parties other than those specified in the accountant's review report. The accountant may, in connection with establishing the terms of the engagement, reach an understanding with the entity that the intended use of the accountant's review report will be restricted and may obtain the entity's agreement that the entity and specified parties will not distribute such accountant's review report to parties other than those identified therein.

### ***Illustrative Alert Language (Ref: par. .62)***

**.A110** The alert that restricts the use of the accountant's review report may list the specified parties or refer to the specified parties listed elsewhere in the accountant's review report. The following illustrates language that includes the elements required by paragraph .62:

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

### ***Adding Other Specified Parties (Ref: par. .63)***

**.A111** When the accountant is requested to add other parties as specified parties, the accountant may agree to add other parties as specified parties based on the accountant's consideration of factors such as the identity of the other parties and the intended use of the accountant's review report.

## **The Accountant's Consideration of an Entity's Ability to Continue as a Going Concern**

### ***Consideration of Conditions or Events That Indicate That There Could Be an Uncertainty About the Entity's Ability to Continue as a Going Concern (Ref: par. .65)***

**.A112** In performing review procedures, the accountant may identify information about certain conditions or events that, when considered in the aggregate, indicate there could be an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. The following are examples of such conditions and events:

- *Negative trends.* For example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, adverse key financial ratios
- *Other indications of possible financial difficulties.* For example, default on loan or similar agreements, arrearages in dividends,

denial of usual trade credit from suppliers, restructuring of debt, noncompliance with statutory capital requirements, need to seek new sources or methods of financing or to dispose of substantial assets

- *Internal matters.* For example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, need to significantly revise operations
- *External matters that have occurred.* For example, legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; uninsured or underinsured catastrophe, such as a drought, earthquake, or flood

### **Consideration of Financial Statement Effects (Ref: par. .66)**

.A113 In considering the adequacy of disclosure, some of the information that might be disclosed includes the following:

- Principal conditions and events giving rise to the assessment of an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time
- The possible effects of such conditions and events
- Management's evaluation of the significance of those conditions and events and any mitigating factors
- Possible discontinuance of operations
- Management's plans (including relevant prospective financial information)
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities

### **Consideration of the Effects on the Accountant's Review Report (Ref: par. .68)**

.A114 If, after considering the evidence or information from paragraph .65 and management's consideration of the possible effects of the going concern uncertainty on the financial statements from paragraph .66, the accountant concludes that management has adequately disclosed the issue, the accountant may include an emphasis-of-matter paragraph in the accountant's review report pursuant to paragraphs .52–.53 and .54. The accountant is not required to include an emphasis-of-matter paragraph with respect to a going concern uncertainty.

.A115 The following is an illustration of an emphasis-of-matter paragraph the accountant may include in the accountant's review report when the accountant concludes that management has adequately disclosed an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time and determines to include an emphasis-of-matter paragraph with respect to the going concern uncertainty:

#### ***Emphasis of Matter***

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 raises an uncertainty 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. Our conclusion is not modified with respect to this matter.

**.A116** Examples of inappropriate wording in an emphasis-of-matter paragraph when the accountant concludes that management has adequately disclosed an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time and determines to include an emphasis-of-matter paragraph with respect to the going concern uncertainty include the following:

- If the company continues to suffer recurring losses from operations and continues to have a net capital deficiency, there may be an uncertainty about its ability to continue as a going concern.
- The company has been unable to renegotiate its expiring credit agreements. Unless the company is able to obtain financial support, there is an uncertainty about its ability to continue as a going concern.

## Subsequent Events and Subsequently Discovered Facts

### *Subsequent Events (Ref: par. .69)*

**.A117** Evidence or information that subsequent events that require adjustment of, or disclosure in, the financial statements may come to the accountant's attention in the following ways:

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

### *Subsequently Discovered Facts That Became Known to the Accountant After the Report Release Date (Ref: par. .74–.77)*

**.A118** New information may come to the accountant's attention that, had such information been known to the accountant at the date of the accountant's review report, may have caused the accountant to revise the accountant's review report. When such information becomes known to the accountant after the report release date, the requirements in paragraphs .74–.77 apply, even if the accountant has withdrawn or been discharged.

**.A119** Because of the variety of conditions that might be encountered, the specific procedures or actions to be taken in a particular case may vary somewhat in light of the circumstances. For example, when determining whether the financial statements need revision, as required by paragraph .74b, the accountant may consider, in addition to the requirements of the applicable financial reporting framework, whether the accountant believes persons are currently using, or are likely to use, the financial statements and who would attach importance to the subsequently discovered facts. Consideration may be given, among other things, to the issuance of reviewed or audited financial statements for a subsequent period, the time elapsed since the financial statements were issued and the date of the accountant's review report released, and any legal implications.

**.A120** The steps taken by management to ensure that anyone in receipt of the reviewed financial statements is informed of the situation, including that the reviewed financial statements are not to be used, depend on the circumstances. Management's steps may include the following:

- Notify anyone who is known to be using, or who is likely to use, the financial statements and the accountant's review report that they are not to be used and that revised financial statements, together with a new accountant's review report, will be issued. This may be necessary when the issuance of revised financial statements and a new accountant's review report is not imminent.
- Issue, as soon as practicable, revised financial statements with appropriate disclosure of the matter.
- Issue the subsequent period's financial statements with appropriate disclosure of the matter. This may be appropriate when issuance of the subsequent period's reviewed or audited financial statements is imminent.

**.A121** If management made the reviewed financial statements available to third parties despite the accountant's notification not to do so, or if the accountant believes that management or those charged with governance have failed to take the necessary steps to prevent use of the accountant's review report on the previously issued reviewed financial statements despite the accountant's prior notification that the accountant will take action to seek to prevent such use, the accountant's course of action depends upon the accountant's legal and ethical rights and obligations. Consequently, the accountant may consider it appropriate to seek legal advice.

**.A122** The actions that the accountant may take to seek to prevent use of the accountant's review report may depend upon the degree of certainty of the accountant's knowledge that persons or entities exist who are currently using, or who will use, the reviewed financial statements, and who would attach importance to the information, and the accountant's ability as a practical matter to communicate with them. In addition to seeking legal advice, the accountant may consider taking the following steps to the extent applicable:

- Notify management and those charged with governance that the accountant's review report is not to be used.
- Notify regulatory agencies having jurisdiction over the entity that the accountant's review report is not to be used, including a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure.
- Notify anyone known to the accountant to be using the financial statements that the accountant's review report is not to be used. In some instances, it will not be practicable for the accountant to give appropriate individual notification to stockholders or investors at large whose identities are unknown to the accountant; notification to a regulatory agency having jurisdiction over the entity will usually be the only practical means for the accountant to provide appropriate disclosure, together with a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure.

**.A123** Depending on the circumstances, if the accountant is able to determine that the financial statements need revision, the accountant's notification to anyone in receipt of the reviewed financial statements may, if permitted by law, regulation, and relevant ethical requirements

- include a description of the nature of the matter and of its effect on the financial statements, avoiding comments concerning the conduct or motives of any person.

- describe the effect that the matter would have had on the accountant's review report if it had been known to the accountant at the date of the report and had not been reflected in the financial statements.

**.A124** If the accountant was not able to determine whether the financial statements need revision, the notification to anyone in receipt of the reviewed financial statements may indicate that information became known to the accountant and that, if the information is true, the accountant believes that the accountant's review report is not to be used. The specific matter may not be permitted by law, regulation, and ethical requirement to be detailed in the notification.

### Reference to the Work of Other Accountants in an Accountant's Review Report (Ref: par. .78)

**.A125** The accountant of the reporting entity may make reference to any or all other accountants who audited or reviewed significant components. For example, if a significant component is audited or reviewed by an other accountant and a second significant component is audited or reviewed by a different other accountant, the accountant of the reporting entity may decide to make reference to one of the other accountants, both of the other accountants, or neither. The decision is solely at the discretion and judgment of the accountant of the reporting entity.

**.A126** The disclosure of the magnitude of the portion of the financial statements audited or reviewed by other accountants may be achieved by stating the dollar amounts or percentages of total assets, total revenues, other appropriate criteria, or a combination of these, whichever most clearly describes the portion of the financial statements audited or reviewed by other accountants. When two or more other accountants participate in the audit or review, the dollar amounts or the percentages covered by the other accountants may be stated in the aggregate.

**.A127** Exhibit C contains an example of appropriate reporting in the accountant's review report when reference is made to the audit or review of significant components, such as consolidated and unconsolidated subsidiaries and investees, by other accountants.<sup>2</sup>

### Supplementary Information That Accompanies Reviewed Financial Statements (Ref: par. .80–.82)

**.A128** Although not required to perform a compilation or review on supplementary information, nothing precludes the accountant from performing a compilation or review on such information if engaged to do so.

**.A129** The following is an example of how an accountant may word an other-matter paragraph addressing supplementary information when the accountant has reviewed both the financial statements and the supplementary information:

#### ***Other Matter***

The [*identify the supplementary information*] is presented for purposes of additional analysis and is not a required part of the basic financial statements.

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<sup>2</sup> Illustration 6, "An Accountant's Review Report on Comparative Consolidated Financial Statements in Which the Accountant Makes Reference to the Work of Other Accountants Who Were Engaged to Review the Financial Statements of a Significant Component," of exhibit C.

The information is the representation of management. I (We) have reviewed the information and, based on my (our) review, I am (we are) not aware of any material modifications that should be made to the information in order for it to be in accordance with [*the applicable financial reporting framework*]. I (We) have not audited the information and, accordingly, do not express an opinion on such information.

**.A130** The following is an example of how an accountant may word an other-matter paragraph addressing supplementary information when the accountant has reviewed the financial statements but has not reviewed the supplementary information:

***Other Matter***

The [*identify the supplementary information*] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have not audited or reviewed such information and, accordingly, I (we) do not express an opinion, a conclusion, nor provide any assurance on it.

**.A131** Supplementary information on which the accountant has performed a compilation or review may become unattached from the accountant's review report. To minimize the possibility that a user of the information may infer, through the accountant's association with the information, an unintended level of reliance on the information, the accountant may consider including a reference to the accountant's review report on each page of the information. An example of a reference to the accountant's review report included on each page of the supplementary information is "See independent accountant's review report."

## **Required Supplementary Information (Ref: par. .83–.84)**

**.A132** Examples of required supplementary information that may accompany reviewed financial statements include the following:

- With respect to common interest realty associations, estimates of current or future costs of major repairs and replacements of common property that will be required in the future as required by FASB *Accounting Standards Codification* 972-235-50-3
- Management's discussion and analysis and budgetary comparison statements as required by GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*

**.A133** *Prescribed guidelines* are the authoritative guidelines established by the designated accounting standard-setter for the methods of measurement and presentation of the required supplementary information.

**.A134** Because the required supplementary information accompanies the basic financial statements, the accountant's review report on the financial statements includes a discussion of the responsibility taken by the accountant on that information. However, if the required supplementary information is omitted by the entity, the accountant does not have a responsibility to present that information.

## **Change in Engagement From Audit to Review (Ref: par. .86)**

**.A135** A request to change the engagement may result from a change in circumstances affecting the entity's requirement for an audit engagement; a

misunderstanding regarding the nature of an audit or review engagement; or a restriction on the scope of the audit engagement, whether imposed by management or caused by circumstances.

**.A136** A change in circumstances that affects the entity's requirement for an audit engagement or a misunderstanding concerning the nature of an audit or review engagement would ordinarily be considered a reasonable basis for requesting a change in the engagement.

**.A137** The implications of a restriction on the scope of the audit engagement include the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory.

### **Review Documentation (Ref: par. .91)**

**.A138** Review documentation may be recorded on paper or on electronic or other media.

**.A139** The accountant need not include in review documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

**.A140** The accountant is not precluded from supporting the review report by other means in addition to the review documentation. Such other means might include written documentation contained in other engagement files (for example, compilation or nonattest services) or quality control files (for example, consultation files) and, in limited situations, oral explanations. On their own, oral explanations by the accountant do not represent adequate support for the work the accountant performed or conclusions reached, but they may be used to explain or clarify information contained in the review documentation.

**.A141** In the case of a review in which the engagement partner performs all the review work, the engagement partner is still required to comply with the overriding requirement in paragraph .91 to prepare review documentation that can be understood by an experienced accountant because the review documentation may be subject to review by external parties.

**.A142** Findings or issues that, in the accountant's professional judgment, are significant may include the results of review procedures that indicate that the financial statements could be materially misstated, including actions taken to address such findings and the basis for the final conclusions.

## Appendix A—Analytical Procedures the Accountant May Consider Performing When Conducting a Review of Financial Statements (Ref: par. .A32)

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. Examples of analytical procedures that an accountant may consider performing in a review of financial statements include the following:

- Comparing current financial statements with the financial statements of the prior period.
- Comparing current financial statements 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 statements with corresponding information in [a] budgets, using expected rates, and [b] financial statements for prior periods). Caution is necessary when comparing and evaluating current financial statements 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.
- Comparing current financial statements 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 statements and comparing the results with corresponding information for prior periods). Examples of key ratios and indicators are the current ratio, receivable 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 statements with corresponding relationships in the financial statements 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).
- Comparing disaggregated data. The following are examples of how data may be disaggregated:
  - By period (for example, financial statement items disaggregated into quarterly, monthly, or weekly amounts)
  - By product line or operating segment
  - By location (for example, subsidiary, division, or branch)

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.

.A144

## **Appendix B—Unusual or Complex Situations to Be Considered by the Accountant When Performing Inquiry Procedures in a Review of Financial Statements (Ref: par. .A41)**

The following are examples of situations about which the accountant may inquire of management:

- Business combinations
- New or complex revenue recognition methods
- Impairment of assets
- Disposal of a segment of a business
- Use of derivative instruments and hedging activities
- Sales and transfers that may call into question the classification of investments in securities, including management's intent and ability with respect to the remaining securities classified as held to maturity
- Adoption of new stock compensation plans or changes to existing plans
- Restructuring charges taken in the current and prior periods
- Significant, unusual, or infrequently occurring transactions
- Changes in litigation or contingencies
- Changes in major contracts with customers or suppliers
- Application of new accounting principles
- Changes in accounting principles or the methods of applying them
- Trends and developments affecting accounting estimates, such as allowances for bad debts and excess or obsolete inventories, provisions for warranties and employee benefits, and realization of unearned income and deferred charges
- Compliance with debt covenants
- Changes in related parties or significant new related party transactions
- Material off-balance sheet transactions, special purpose entities, and other equity investments
- Unique terms for debt or capital stock that could affect classification

.A145

## Exhibit A—Illustrative Engagement Letters (Ref: par. .A19)

**Illustration 1**—An Engagement Letter for a Review Engagement With Respect to Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America

**Illustration 2**—An Engagement Letter for a Review Engagement With Respect to Financial Statements Prepared in Accordance With the Tax-Basis of Accounting

The illustrative engagement letters in this exhibit are intended as illustrations that may be used in conjunction with the considerations outlined in Statements on Standards for Accounting and Review Services. The engagement letter will vary according to individual requirements and circumstances, and the illustrations are drafted to refer to a review engagement for a single reporting period. The accountant may seek legal advice about whether a proposed letter is suitable.

### **Illustration 1—An Engagement Letter for a Review Engagement With Respect to Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America**

Circumstances include the following:

- The accountant will prepare, as a nonattest service, the financial statements, including related notes, subject to the review engagement.
- The financial statements will be prepared in accordance with accounting principles generally accepted in the United States of America.

To the appropriate representative of management of ABC Company:<sup>1</sup>

You<sup>2</sup> have requested that we prepare the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements and perform a review engagement with respect to those financial statements.<sup>3</sup> We are pleased to confirm our acceptance and understanding of this engagement by means of this letter.

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<sup>1</sup> The addresses and references in the engagement letter would be those that are appropriate in the circumstances of the review engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons. See paragraph .A15.

<sup>2</sup> Throughout this engagement letter, references to *you, we, us, management, and accountant* would be used or amended as appropriate in the circumstances.

<sup>3</sup> The accountant may include other nonattest services to be performed as part of the engagement, such as income tax preparation and bookkeeping services.

### **Our Responsibilities**

The objective of our engagement is to

- a. prepare financial statements in accordance with accounting principles generally accepted in the United States of America based on information provided by you and
- b. obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with accounting principles generally accepted in the United States of America.

We will conduct our engagement in accordance with Statements on Standards for Accounting and Review Services (SSARSs) promulgated by the Accounting and Review Services Committee of the AICPA and comply with the AICPA's Code of Professional Conduct, including ethical principles of integrity, objectivity, professional competence, and due care.

A review engagement includes primarily applying analytical procedures to your financial data and making inquiries of company management. A review engagement is substantially less in scope than an audit engagement, the objective of which is the expression of an opinion regarding the financial statements as a whole. A review engagement does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents; or other procedures ordinarily performed in an audit engagement. Accordingly, we will not express an opinion regarding the financial statements.

Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by error or fraud, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations. However, we will inform the appropriate level of management of any material errors and any evidence or information that comes to our attention during the performance of our review procedures that indicates fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our review procedures regarding noncompliance with laws and regulations that may have occurred, unless they are clearly inconsequential.

### **Your Responsibilities**

The engagement to be performed is conducted on the basis that you acknowledge and understand that our role is to prepare financial statements in accordance with accounting principles generally accepted in the United States of America and to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with accounting principles generally accepted in the United States of America. You have the following overall responsibilities that are fundamental to our undertaking the engagement in accordance with SSARSs:

- a. The selection of accounting principles generally accepted in the United States of America as the financial reporting framework to be applied in the preparation of the financial statements
- b. The preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the

United States of America and the inclusion of all informative disclosures that are appropriate for accounting principles generally accepted in the United States of America

- c. The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements
- d. The prevention and detection of fraud
- e. To ensure that the entity complies with the laws and regulations applicable to its activities
- f. The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement
- g. To provide us with
  - i. access to all information of which you are aware is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters
  - ii. additional information that we may request from you for the purpose of the review engagement
  - iii. unrestricted access to persons within the entity of whom we determine it necessary to make inquiries
- h. To provide us, at the conclusion of the engagement, with a letter that confirms certain representations made during the review

You are also responsible for all management decisions and responsibilities, and for designating an individual with suitable skills, knowledge, and experience to oversee our preparation of your financial statements. You are responsible for evaluating the adequacy and results of services performed and accepting responsibility for such services.

### **Our Report**

*[Insert appropriate reference to the expected form and content of the accountant's review report. Example follows.]*

We will issue a written report upon completion of our review of ABC Company's financial statements. Our report will be addressed to the board of directors of ABC Company. We cannot provide assurance that an unmodified accountant's review report will be issued. Circumstances may arise in which it is necessary for us to report known departures from accounting principles generally accepted in the United States of America, add an emphasis-of-matter or other-matter paragraph(s), or withdraw from the engagement. If, for any reason, we are unable to complete the review of your financial statements, we will not issue a report on such statements as a result of this engagement.

You agree to include our accountant's review report in any document containing financial statements that indicates that such financial statements have been reviewed by us and, prior to inclusion of the report, to ask our permission to do so.

### **Other Relevant Information**

Our fees for these services . . .

*[The accountant may include language, such as the following, regarding limitation of or other arrangements regarding the liability of the accountant or the entity, such as indemnification to the accountant for liability arising from*

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*knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements):*

*You agree to hold us harmless and to release, indemnify, and defend us from any liability or costs, including attorney's fees, resulting from management's knowing misrepresentations to us.]*

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our engagement to prepare the financial statements described herein and to perform a review of those same financial statements and our respective responsibilities.

Sincerely yours,

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[Signature of accountant or accountant's firm]

Acknowledged and agreed on behalf of ABC Company by:

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[Signed]

[Name and Title]

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[Date]

[Revised, February 2015, to include additional required engagement letter elements.]

### **Illustration 2—An Engagement Letter for a Review Engagement With Respect to Financial Statements Prepared in Accordance With the Tax-Basis of Accounting**

Circumstances include the following:

- The accountant will prepare, as a nonattest service, the financial statements, including related notes, subject to the review engagement.
- The financial statements will be prepared in accordance with the tax-basis of accounting.

To the appropriate representative of management of ABC Company:<sup>1</sup>

You<sup>2</sup> have requested that we prepare the financial statements of ABC Company, which comprise the statement of assets, liabilities, and equity—tax-basis as of December 31, 20XX, and the related statements of operations and retained earnings—tax-basis, and cash flows—tax-basis for the year then ended, and the related notes to the financial statements and to perform a review engagement with respect to those financial statements.<sup>3</sup> We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter.

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<sup>1</sup> The addresses and references in the engagement letter would be those that are appropriate in the circumstances of the review engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons. See paragraph .A15.

<sup>2</sup> Throughout this engagement letter, references to *you*, *we*, *us*, *management*, and *accountant* would be used or amended as appropriate in the circumstances.

<sup>3</sup> The accountant may include other nonattest services to be performed as part of the engagement, such as income tax preparation and bookkeeping services.

### **Our Responsibilities**

The objective of our engagement is to

- a. prepare financial statements in accordance with the tax-basis of accounting based on information provided by you and
- b. obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with the tax-basis of accounting.

We will conduct our review engagement in accordance with Statements on Standards for Accounting and Review Services (SSARSs) promulgated by the Accounting and Review Services Committee of the AICPA and comply with the AICPA's Code of Professional Conduct, including ethical principles of integrity, objectivity, professional competence, and due care.

A review engagement includes primarily applying analytical procedures to your financial data and making inquiries of company management. A review engagement is substantially less in scope than an audit engagement, the objective of which is the expression of an opinion regarding the financial statements as a whole. A review engagement does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents; or other procedures ordinarily performed in an audit engagement. Accordingly, we will not express an opinion regarding the financial statements.

Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by error or fraud, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations. However, we will inform the appropriate level of management of any material errors and any evidence or information that comes to our attention during the performance of our review procedures that indicates fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our review procedures regarding noncompliance with laws and regulations that may have occurred, unless they are clearly inconsequential.

### **Your Responsibilities**

The engagement to be performed is conducted on the basis that you acknowledge and understand that our role is to prepare financial statements in accordance with the tax-basis of accounting and to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with the tax-basis of accounting. You have the following overall responsibilities that are fundamental to our undertaking the engagement in accordance with SSARSs:

- a. The selection of the tax-basis of accounting as the financial reporting framework to be applied in the preparation of the financial statements
- b. The preparation and fair presentation of the financial statements in accordance with the tax-basis of accounting and the inclusion of all informative disclosures that are appropriate for the tax-basis of accounting. This includes
  - i. a description of the tax-basis of accounting, including a summary of significant accounting policies, and how the tax-basis of accounting differs from accounting principles

- generally accepted in the United States of America, the effects of which need not be qualified
- ii. informative disclosures similar to those required by accounting principles generally accepted in the United States of America
  - c. The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements
  - d. The prevention and detection of fraud
  - e. To ensure that the entity complies with the laws and regulations applicable to its activities
  - f. The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement
  - g. To provide us with
    - i. access to all information of which you are aware is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters
    - ii. additional information that we may request from you for the purpose of the review engagement
    - iii. unrestricted access to persons within the entity of whom we determine it necessary to make inquiries
  - h. To provide us, at the conclusion of the engagement, with a letter that confirms certain representations made during the review

You are also responsible for all management decisions and responsibilities and for designating an individual with suitable skills, knowledge, and experience to oversee our preparation of your financial statements. You are responsible for evaluating the adequacy and results of the services performed and accepting responsibility for such services.

### **Our Report**

*[Insert appropriate reference to the expected form and content of the accountant's review report. Example follows.]*

We will issue a written report upon completion of our review of ABC Company's financial statements. Our report will be addressed to the board of directors of ABC Company. We cannot provide assurance that an unmodified accountant's review report will be issued. Circumstances may arise in which it is necessary of us to report known departures from the tax-basis of accounting, add an emphasis-of-matter or other-matter paragraph(s), or withdraw from the engagement. If, for any reason, we are unable to complete the review of your financial statements, we will not issue a report on such statements as a result of this engagement.

You agree to include our accountant's review report in any document containing financial statements that indicates that such financial statements have been reviewed by us and, prior to inclusion of the report, to ask our permission to do so.

**Other Relevant Information**

Our fees for these services . . .

*[The accountant may include language, such as the following, regarding limitation of or other arrangements regarding the liability of the accountant or the entity, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements):*

*You agree to hold us harmless and to release, indemnify, and defend us from any liability or costs, including attorney's fees, resulting from management's knowing misrepresentations to us.]*

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our engagement to prepare the financial statements described herein and to perform a review with respect to those same financial statements and our respective responsibilities.

Sincerely yours,

\_\_\_\_\_  
*[Signature of accountant or accountant's firm]*

Acknowledged and agreed on behalf of ABC Company by:

\_\_\_\_\_  
*[Signed]*

*[Name and Title]*

\_\_\_\_\_  
*[Date]*

[Revised, February 2015, to include additional required engagement letter elements.]

.A146

## Exhibit B—Illustrative Representation Letter (Ref: par. .A61)

The following illustrative letter is intended as an illustration that may be used to comply with the requirements of section 90. The representation letter will vary according to individual requirements and circumstances.

It is assumed in this illustration that the applicable financial reporting framework is accounting principles generally accepted in the United States of America, that no conditions or events exist that might be indicative of the entity's inability to continue as a going concern, and that no exceptions exist to the requested written representations. If circumstances differ from these assumptions, the representations would need to be modified to reflect the actual circumstances.

(Entity Letterhead)

(To Accountant)

(Date)

This representation letter is provided in connection with your review of the financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity and cash flows for the years then ended, and the related notes to the financial statements, for the purpose of obtaining limited assurance as a basis for reporting whether you are aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with accounting principles generally accepted in the United States of America.

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 represent that *[to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves] [as of (date of accountant's review report)]*:

### Financial Statements

- We acknowledge our responsibility and have fulfilled our responsibilities for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America.
- We acknowledge our responsibility and have fulfilled our responsibilities for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
- We acknowledge our responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.

- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of accounting principles generally accepted in the United States of America.
- Guarantees, whether written or oral, under which the company is contingently liable have been properly accounted for and disclosed in accordance with the requirements of accounting principles generally accepted in the United States of America.
- Significant estimates and material concentrations known to management that are required to be disclosed in accordance with FASB *Accounting Standards Codification (ASC) 275, Risks and Uncertainties*, have been properly accounted for and disclosed in accordance with the requirements of accounting principles generally accepted in the United States of America. [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*.]
- All events subsequent to the date of the financial statements and for which accounting principles generally accepted in the United States of America requires adjustment or disclosure have been adjusted or disclosed.
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole.
- The effects of all known actual or possible litigation and claims have been accounted for and disclosed in accordance with accounting principles generally accepted in the United States of America.

[Any other matters that the accountant may consider appropriate.]

### Information Provided

- We have responded fully and truthfully to all inquiries made to us by you during your review.
- We have provided you with
  - access to all information, of which we are aware, that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters;
  - minutes of meetings of stockholders, directors, and committees of directors or summaries of actions of recent meetings for which minutes have not yet been prepared;
  - additional information that you have requested from us for the purpose of the review; and
  - unrestricted access to persons within the entity from whom you determined it necessary to obtain review evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have [no knowledge of any] [disclosed to you all information that we are aware of regarding] fraud or suspected fraud that affects the entity and involves

- management,
  - employees who have significant roles in internal control, or
  - others when the fraud could have a material effect on the financial statements.
- We have *[no knowledge of any]* *[disclosed to you all information that we are aware of regarding]* allegations of fraud, or suspected fraud, affecting the entity's financial statements as a whole communicated by employees, former employees, analysts, regulators, or others.
  - We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.
  - We have disclosed to you all known instances of noncompliance or suspected noncompliance with laws or regulations whose effects should be considered when preparing financial statements.
  - We *[have disclosed to you all known actual or possible]* *[are not aware of any pending or threatened]* litigation and claims whose effects should be considered when preparing the financial statements *[and we have not consulted legal counsel concerning litigation or claims]*
  - We have disclosed to you any other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450, *Contingencies*.
  - We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware.
  - No material losses exist (such as from obsolete inventory or purchase or sale commitments) that have not been properly accrued or disclosed in the financial statements.
  - The company has satisfactory title to all owned assets, and no liens or encumbrances on such assets exist, nor has any asset been pledged as collateral, except as disclosed to you and reported in the financial statements.
  - We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
  - We are in agreement with the adjusting journal entries that you have recommended, and they have been posted to the company's accounts (if applicable).

*[Any other matters that the accountant may consider necessary.]*

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*[Name of Chief Executive Officer and Title]*

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*[Name of Chief Financial Officer and Title]*

Representation letters ordinarily are tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry.

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## Exhibit C—Illustrations of Accountant's Review Reports on Financial Statements (Ref: par. .A77, .A106, and .A127)

The illustrative accountant's review reports in this exhibit are intended as illustrations that may be used to comply with the requirements of section 90. The accountant's review report will vary according to individual requirements and circumstances.

**Illustration 1**—An Accountant's Review Report on Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America When a Review Has Been Performed for Both Periods

**Illustration 2**—An Accountant's Review Report on Single Year Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America

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**Illustration 5**—An Accountant's Review Report on Comparative Financial Statements Disclosing a Departure From Accounting Principles Generally Accepted in the United States of America

**Illustration 6**—An Accountant's Review Report on Comparative Consolidated Financial Statements in Which the Accountant Makes Reference to the Work of Other Accountants Who Were Engaged to Review the Financial Statements of a Significant Component

### **Illustration 1—An Accountant's Review Report on Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America When a Review Has Been Performed for Both Periods**

Circumstances include the following:

- Review of a complete set of comparative financial statements.
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

#### **Independent Accountant's Review Report**

[Appropriate Addressee]

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

### ***Management's Responsibility for the Financial Statements***

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

### ***Accountant's Responsibility***

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

### ***Accountant's Conclusion***

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 accordance with accounting principles generally accepted in the United States of America.

*[Signature of accounting firm or accountant, as appropriate]*

*[Accountant's city and state]*

*[Date of the accountant's review report]*

## **Illustration 2—An Accountant's Review Report on Single Year Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America**

Circumstances include the following:

- Review of a complete set of financial statements (single year).
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

### **Independent Accountant's Review Report**

*[Appropriate Addressee]*

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the

expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

### ***Management's Responsibility for the Financial Statements***

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

### ***Accountant's Responsibility***

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

### ***Accountant's Conclusion***

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 accordance with accounting principles generally accepted in the United States of America.

*[Signature of accounting firm or accountant, as appropriate]*

*[Accountant's city and state]*

*[Date of the accountant's review report]*

### **Illustration 3—An Accountant's Review Report on Single Year Financial Statements Prepared in Accordance With the Tax-Basis of Accounting**

Circumstances include the following:

- Review of a complete set of financial statements (single year).
- The financial statements are of a partnership and prepared in accordance with the basis of accounting the partnership uses for income tax purposes (that is, a special purpose framework).
- Management has a choice of financial reporting frameworks.

#### **Independent Accountant's Review Report**

*[Appropriate Addressee]*

I (We) have reviewed the accompanying financial statements of XYZ Partnership, which comprise the statement of assets, liabilities, and partners' capital—tax-basis as of December 31, 20XX, and the related statements of revenue and expenses—tax-basis, and partners' capital—tax-basis for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (partners') financial data and making inquiries of partnership management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statement as a whole. Accordingly, I (we) do not express such an opinion.

***Management's Responsibility for the Financial Statements***

Management (Partners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with the basis of accounting the partnership uses for income tax purposes; this includes determining that the basis of accounting the partnership uses for income tax purposes is an acceptable basis for the preparation of financial statements in the circumstances. Management (Partners) is (are) also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

***Accountant's Responsibility***

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

***Accountant's Conclusion***

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 accordance with the basis of accounting the partnership uses for income tax purposes.

***Basis of Accounting***

I (We) draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the basis of accounting the partnership uses for income tax purposes, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our conclusion is not modified with respect to this matter.

*[Signature of accounting firm or accountant, as appropriate]*

*[Accountant's city and state]*

*[Date of the accountant's review report]*

**Illustration 4—An Accountant's Review Report on Interim Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America**

Circumstances include the following:

- Review of a complete set of financial statements for the period ended September 30, 20XX, and for the three and nine months then ended.
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.
- The accountant appropriately performs the engagement in accordance with SSARs (that is, AU-C section 930, *Interim Financial Information* [AICPA, *Professional Standards*], is not applicable).

**Independent Accountant's Review Report**

[Appropriate Addressee]

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of September 30, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the three and nine months then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

***Management's Responsibility for the Financial Statements***

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

***Accountant's Responsibility***

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

***Accountant's Conclusion***

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 accordance with accounting principles generally accepted in the United States of America.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

**Illustration 5—An Accountant's Review Report on Comparative Financial Statements Disclosing a Departure From Accounting Principles Generally Accepted in the United States of America**

Circumstances include the following:

- Review of a complete set of comparative financial statements.
- The financial statements contain a departure from accounting principles generally accepted in the United States of America.

**Independent Accountant's Review Report**

[Appropriate Addressee]

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

***Management's Responsibility for the Financial Statements***

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

***Accountant's Responsibility***

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

***Accountant's Conclusion***

Based on my (our) reviews, except for the issue noted in the Known Departure From Accounting Principles Generally Accepted in the United States of America 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 accordance with accounting principles generally accepted in the United States of America.

***Known Departure From Accounting Principles Generally Accepted in the United States of America***

As disclosed in Note X to these financial statements, accounting principles generally accepted in the United States of America require that inventory cost consist of material, labor, and overhead. Management has informed me (us) that the inventory of finished goods and work in process is stated in the accompanying financial statements at material and labor cost only, and that the effects of this departure from accounting principles generally accepted in the United States of America on financial position, results of operations, and cash flows have not been determined.

or

As disclosed in Note X to these financial statements, the company has adopted [description of newly adopted method], whereas it previously used [description of previous method]. Although the [description of newly adopted method] is in

accordance with accounting principles generally accepted in the United States of America, the company does not appear to have reasonable justification for making a change as required by FASB *Accounting Standards Codification* 250, *Accounting Changes and Error Corrections*.

[*Signature of accounting firm or accountant, as appropriate*]

[*Accountant's city and state*]

[*Date of the accountant's review report*]

### **Illustration 6—An Accountant's Review Report on Comparative Consolidated Financial Statements in Which the Accountant Makes Reference to the Work of Other Accountants Who Were Engaged to Review the Financial Statements of a Significant Component**

Circumstances include the following:

- Review of a complete set of comparative consolidated financial statements.
- The financial statements of B Company, a wholly-owned subsidiary, whose financial statements reflect total assets constituting 20 percent and 22 percent, respectively, of consolidated total assets at December 31, 20X2 and 20X1, and total revenues constituting 18 percent and 20 percent, respectively, of consolidated total revenues for the years then ended, were reviewed by other accountants, and the accountant has decided to make reference to the work of other accountants in the accountant's review report.

#### **Independent Accountant's Review Report**

[*Appropriate Addressee*]

I (We) have reviewed the accompanying consolidated financial statements of XYZ Company and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 20X2 and 20X1, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

#### ***Management's Responsibility for the Financial Statements***

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

#### ***Accountant's Responsibility***

My (Our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services (SSARSs) promulgated by the Accounting and Review Services Committee of the AICPA. We have not reviewed the financial statements of B Company, a wholly-owned subsidiary, whose financial statements reflect total assets constituting 20 percent and 22 percent, respectively, of consolidated total assets at December 31,

20X2 and 20X1, and total revenues constituting 18 percent and 20 percent, respectively, of consolidated total revenues for the years then ended. These statements were reviewed by other accountants, whose report has been furnished to me (us), and our conclusion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other accountants.

SSARs require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the consolidated financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

***Accountant's Conclusion***

Based on my (our) reviews, and the report of other accountants, I am (we are) not aware of any material modifications that should be made to the accompanying consolidated financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

*[Signature of accounting firm or accountant, as appropriate]*

*[Accountant's city and state]*

*[Date of the accountant's review report]*

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# AR-C APPENDIXES

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*[Reserved.]*

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**ET Section**

**CODE OF PROFESSIONAL CONDUCT [ET]**

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**Effective December 15, 2014, unless early implemented.**

For a feature-enhanced version of this content, visit <http://pub.aicpa.org/codeofconduct>.

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## ET Preface

### *Applicable to All Members*

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## 0.100 Overview of the Code of Professional Conduct

.01 The AICPA Code of Professional Conduct (the code) begins with this preface, which applies to all *members*. The term *member*, when used in part 1 of the code, applies to and means a *member in public practice*; when used in part 2 of the code, applies to and means a *member in business*; and when used in part 3 of the code, applies to and means all other *members*, such as those *members* who are retired or unemployed.

.02 A *member* may have multiple roles, such as a *member in business* and a *member in public practice*. In such circumstances, the *member* should consult all applicable parts of the code and apply the most restrictive provisions. [No prior reference: new content]

### **Effective Date**

.03 Effective December 15, 2014.

## 0.100.010 Principles and Rules of Conduct

.01 The AICPA membership adopted the Code of Professional Conduct (the code) to provide guidance and rules to all *members* in the performance of their professional responsibilities. The code consists of principles and rules as well as *interpretations* and other guidance which are discussed in 0.100.020. The principles provide the framework for the rules that govern the performance of their professional responsibilities.

.02 The AICPA bylaws require that *members* adhere to the rules of the code. Compliance with the rules depends primarily on *members'* understanding and voluntary actions; secondarily on reinforcement by peers and public opinion; and ultimately on disciplinary proceedings, when necessary, against *members* who fail to comply with the rules. *Members* must be prepared to justify departures from these rules.

## 0.100.020 Interpretations and Other Guidance

.01 *Interpretations* of the rules of conduct are adopted after exposure to the membership, state societies, state boards, and other interested parties. The *interpretations* of the rules of conduct, "Definitions" [0.400], "Application of the AICPA Code" [0.200.020], and "Citations" [0.200.030], provide guidelines about the scope and application of the rules but are not intended to limit such scope or application. A *member* who departs from the *interpretations* shall have the burden of justifying such departure in any disciplinary hearing. *Interpretations* that existed before the adoption of the code on January 12, 1988, will remain in effect until further action is deemed necessary by the appropriate senior committee.

.02 A *member* should also consult the following, if applicable:

- The ethical requirements of the *member's* state CPA society and authoritative regulatory bodies such as state board(s) of accountancy
- The Securities and Exchange Commission (SEC)
- The Public Company Accounting Oversight Board (PCAOB)
- The Government Accountability Office (GAO)
- The Department of Labor (DOL)
- Federal, state and local taxing authorities

- Any other body that regulates a *member* who performs *professional services* for an entity when the *member* or entity is subject to the rules and regulations of such regulatory body. [Prior reference: Introduction]

## 0.200 Structure and Application of the AICPA Code

### 0.200.010 Structure of the AICPA Code

.01 A variety of topics appear in parts 1–3 of the code. When applicable, topics are aligned with the relevant rule or rules of conduct. Topics may be further divided into subtopics, and some subtopics include one or more sections. Topics, subtopics, and sections interpret the rules of conduct (see "Interpretations and Other Guidance" [0.100.020]).

.02 Defined terms (see "Definitions" [0.400]) as well as the plurals and possessives thereof, are shown in *italics* throughout the code. When a defined term is used in the code but is not shown in *italics*, the definition in 0.400 should not be applied. [No prior reference: new content]

#### **Effective Date**

.03 Effective December 15, 2014.

### 0.200.020 Application of the AICPA Code

.01 The Code of Professional Conduct (the code) was originally adopted on January 12, 1988, and was periodically revised through June 1, 2014. On June 1, 2014, the AICPA issued a codification of the code's principles, rules, *interpretations* and rulings (revised code). The revised code will be effective December 15, 2014, excluding the Conceptual Framework sections. These sections, "Conceptual Framework for Members in Public Practice" [1.000.010] and "Conceptual Framework for Members in Business" [2.000.010], will be effective December 15, 2015. *Members* are permitted to implement the revised code prior to December 15, 2014, but a member may not implement the relevant Conceptual Framework prior to implementing the entire revised code. Revisions made subsequent to June 1, 2014, are identified in appendix C, the Revision History Table, which notes the month and year of the change, the effective date of the change, the purpose for the revision, and when possible, a link to the marked revision of the content that appeared in the *Journal of Accountancy*. If the interpretation or paragraph does not contain a specific effective date or a reference to the revision history table, then the content was effective prior to June 1, 2014. [No prior reference: new content.]

.02 When used in the preface of the code, the term *member* includes *members*, *associate members*, and *affiliate members*, as well as international associates of the AICPA.

- .03 The rules of conduct apply to all *professional services* performed, except
- a. when the wording of the rule indicates otherwise.
  - b. that a *member* who is practicing outside the United States will not be considered in violation of a particular rule for departing from any of the rules stated herein, as long as the *member's* conduct is in accordance with the rules of the organized accounting profession in the country in which he or she is practicing. However,

when a *member* is associated with *financial statements* under circumstances that would lead the reader to assume that practices of the United States were followed, the *member* must comply with the "Compliance With Standards Rule" [1.310.001 for *members in public practice* and 2.310.001 for *members in business*] and the "Accounting Principles Rule" [1.320.001 for *members in public practice* and 2.320.001 for *members in business*].

- c. that a *member* who is a member of a group engagement team (see the clarified Statement on Auditing Standards *Special Considerations—Audits of Group Financial Statements [Including the Work of Component Auditors]* [AICPA, *Professional Standards*, AU-C sec. 600]) will not be considered in violation of a particular rule if a foreign component auditor (accountant) departed from any of the rules stated herein with respect to the audit or review of group *financial statements* or other *attest engagement*, as long as the foreign component auditor's (accountant's) conduct, at a minimum, is in accordance with the ethics and *independence* requirements set forth in the International Ethics Standards Board for Accountants' (IESBA's) Code of Ethics for Professional Accountants, and the members of the group engagement team are in compliance with the rules stated therein.
- d. that the *independence* of the *member's firm* will not be considered *impaired* if another *firm* or entity located outside the United States that is within the *member firm's network* departed from any of the rules stated herein, as long as the other *firm* or entity's conduct, at a minimum, is in accordance with the *independence* requirements set forth in the IESBA's Code of Ethics for Professional Accountants.

**.04** A *member* shall not knowingly permit a person whom the *member* has the authority or capacity to control to carry out on his or her behalf, either with or without compensation, acts that, if carried out by the *member*, would place the *member* in violation of the rules. Further, a *member* may be held responsible for the acts of all persons associated with the *member* in *public practice* whom the *member* has the authority or capacity to control.

**.05** The *independence* of a *member* in *public practice* or a *covered member* may be *impaired* with respect to a *client* as the result of the actions or relationships, as described in the "Independence Rule" [1.200.001] and its *interpretations*, of certain persons or entities whom the *member* or *covered member* does not have the authority or capacity to control. Even if the *member* is unable to control the actions or relationships of such persons or entities, the *member's independence* may still be *impaired*. [Prior reference: ET section 91]

### **Effective Date**

**.06** The "Breach of an Independence Interpretation" [1.298.010] of the "Independence Rule" [1.200.001] contains guidance with which a *member* should comply if the *member* identifies a breach of an *independence interpretation* of the code. If a *member* identifies a breach of any other provision of this code, the *member* should evaluate the significance of the breach and its effect on the *member's* ability to comply with the rules of the code. The *member* should take whatever actions may be available, as soon as practicable, to satisfactorily address the consequences of the breach. The *member* should determine whether to report the breach, for example, to those who may have been affected by the breach, a professional body, relevant regulator, or oversight authority. In

making the evaluation and in determining what actions should be taken, the *member* should exercise professional judgment and take into account whether a reasonable and informed third party, weighing the significance of the breach, the action to be taken, and all the specific facts and circumstances available to the *member* at that time, would be likely to conclude that the *member* is able to comply with the rules of the code. A *member's* determination that the *member* has satisfactorily addressed the consequences of the breach will not, however, preclude an investigation or enforcement action concerning the underlying breach of the code and the *member* should be prepared to justify such determination.

### **Effective Date**

.07 Paragraph .01 is effective December 15, 2014. Paragraph .06 is effective March 31, 2016, with early implementation allowed.

[See Revision History Table.]

## **0.200.030 Citations**

### **Prior ET Sections**

.01 The code has been revised by codifying the principles, rules, *interpretations*, and rulings. These revisions are effective December 15, 2014. To facilitate implementation of the revised code, the prior ET references from the professional standards of the AICPA will be included for a four-year period (until December 15, 2018) in appendix D, "Mapping Document," and in bracketed text at the end of standards, where applicable.

### **Numeric Citations**

.02 The numbering system for the code is "ET section X.XXX.XXX." The single digit that begins the citation identifies the part wherein the content resides. Accordingly, content from the preface begins with the single digit 0.XXX.XXX, whereas content for part 1 begins with a 1.XXX.XXX, part 2 with 2.XXX.XXX, and part 3 with a 3.XXX.XXX.

.03 Next are two sets of three digit numbers that identify the topics and, when applicable, subtopics or sections. When a topic, subtopic or section appears in two or more parts of the code, the same number is used. For example, the "Acts Discreditable Rule" appears in parts 1, 2, and 3 and the citations for this rule are 1.400.001, 2.400.001, and 3.400.001, respectively. Accordingly, the two sets of three digit numbers remain the same with only the first digit changing.

.04 When only two digits appear, those digits represent the paragraph number. For example, the complete citation for this paragraph would be 0.200.030.04.

.05 All bracketed section references, such as [0.200.030.04] refer to sections within the Code of Professional Conduct. [No prior reference: new content]

### **Effective Date**

.06 Effective December 15, 2014.

## 0.200.040 Transition Provisions

.01 The text of the transition provisions in effect as of May 31, 2013, has not been codified because the transition provisions apply to a limited number of situations. Nevertheless, these transition provisions are still authoritative. The texts of these transition provisions are available at <http://aicpa.org/InterestAreas/ProfessionalEthics/Community/DownloadableDocuments/Transition%20Periods.pdf>. [No prior reference: new content]

### **Effective Date**

.02 Effective December 15, 2014.

## 0.200.050 Drafting Conventions

.01 The code utilizes certain drafting conventions to enhance the clarity of the interpretations and definitions. For example, when the term "should consider" is used in connection with a specified procedure or action, consideration of the procedure or action by the member is presumptively required. Actual performance of the action or procedure is up to the member, based upon the outcome of the member's consideration and the member's professional judgment. Other drafting conventions used in the code include use of the terms "consider," "evaluate," and "determine," as follows:

- a. "Consider" is used when the member is required to think about several matters.
- b. "Evaluate" is used when the member has to assess and weigh the significance of a matter.
- c. "Determine" is used when the member has to come to a conclusion and make a decision on a matter. [No prior reference: new content]

### **Effective Date**

.02 Effective December 15, 2014.

A complete nonauthoritative guide, *Drafting Guide—Drafting Guidelines for Integrating the Conceptual Framework and Drafting Conventions and Style Guidance*, is also available at <http://aicpa.org/InterestAreas/ProfessionalEthics/Community/DownloadableDocuments/Drafting%20Guide.pdf>.

## 0.300 Principles of Professional Conduct

### 0.300.010 Preamble

.01 Membership in the American Institute of Certified Public Accountants is voluntary. By accepting membership, a *member* assumes an obligation of self-discipline above and beyond the requirements of laws and regulations.

.02 These Principles of the Code of Professional Conduct of the American Institute of Certified Public Accountants express the profession's recognition of its responsibilities to the public, to *clients*, and to colleagues. They guide *members* in the performance of their professional responsibilities and express

the basic tenets of ethical and professional conduct. The Principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage. [Prior reference: ET section 51]

### 0.300.020 Responsibilities

**.01** *Responsibilities principle.* In carrying out their responsibilities as professionals, *members* should exercise sensitive professional and moral judgments in all their activities.

**.02** As professionals, *members* perform an essential role in society. Consistent with that role, *members* of the American Institute of Certified Public Accountants have responsibilities to all those who use their *professional services*. *Members* also have a continuing responsibility to cooperate with each other to improve the art of accounting, maintain the public's confidence, and carry out the profession's special responsibilities for self-governance. The collective efforts of all *members* are required to maintain and enhance the traditions of the profession. [Prior reference: ET section 52]

### 0.300.030 The Public Interest

**.01** *The public interest principle.* *Members* should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate a commitment to professionalism.

**.02** A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession's public consists of *clients*, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of *members* to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on *members*. The public interest is defined as the collective well-being of the community of people and institutions that the profession serves.

**.03** In discharging their professional responsibilities, *members* may encounter conflicting pressures from each of those groups. In resolving those conflicts, *members* should act with integrity, guided by the precept that when *members* fulfill their responsibility to the public, *clients'* and employers' interests are best served.

**.04** Those who rely on *members* expect them to discharge their responsibilities with integrity, objectivity, due professional care, and a genuine interest in serving the public. They are expected to provide quality services, enter into fee arrangements, and offer a range of services—all in a manner that demonstrates a level of professionalism consistent with these Principles of the Code of Professional Conduct.

**.05** All who accept membership in the American Institute of Certified Public Accountants commit themselves to honor the public trust. In return for the faith that the public reposes in them, *members* should seek to continually demonstrate their dedication to professional excellence. [Prior reference: ET section 53]

### 0.300.040 Integrity

**.01** *Integrity principle.* To maintain and broaden public confidence, *members* should perform all professional responsibilities with the highest sense of integrity.

**.02** Integrity is an element of character fundamental to professional recognition. It is the quality from which the public trust derives and the benchmark against which a *member* must ultimately test all decisions.

**.03** Integrity requires a *member* to be, among other things, honest and candid within the constraints of *client* confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. Integrity can accommodate the inadvertent error and honest difference of opinion; it cannot accommodate deceit or subordination of principle.

**.04** Integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance or in the face of conflicting opinions, a *member* should test decisions and deeds by asking: "Am I doing what a person of integrity would do? Have I retained my integrity?" Integrity requires a *member* to observe both the form and the spirit of technical and ethical standards; circumvention of those standards constitutes subordination of judgment.

**.05** Integrity also requires a *member* to observe the principles of objectivity and independence and of due care. [Prior reference: ET section 54]

### 0.300.050 Objectivity and Independence

**.01** *Objectivity and independence principle.* A *member* should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A *member* in public practice should be independent in fact and appearance when providing auditing and other attestation services.

**.02** Objectivity is a state of mind, a quality that lends value to a *member's* services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. *Independence* precludes relationships that may appear to *impair* a *member's* objectivity in rendering attestation services.

**.03** *Members* often serve multiple interests in many different capacities and must demonstrate their objectivity in varying circumstances. *Members* in public practice render attest, tax, and management advisory services. Other *members* prepare *financial statements* in the employment of others, perform internal auditing services, and serve in financial and management capacities in industry, education, and government. They also educate and train those who aspire to admission into the profession. Regardless of service or capacity, *members* should protect the integrity of their work, maintain objectivity, and avoid any subordination of their judgment.

**.04** For a *member* in public practice, the maintenance of objectivity and *independence* requires a continuing assessment of *client* relationships and public responsibility. Such a *member* who provides auditing and other attestation services should be independent in fact and appearance. In providing all other services, a *member* should maintain objectivity and avoid conflicts of interest.

**.05** Although *members* not in public practice cannot maintain the appearance of *independence*, they nevertheless have the responsibility to maintain objectivity in rendering *professional services*. *Members* employed by others to prepare *financial statements* or to perform auditing, tax, or consulting services are charged with the same responsibility for objectivity as *members* in public practice and must be scrupulous in their application of generally accepted accounting principles and candid in all their dealings with *members* in public practice. [Prior reference: ET section 55]

### 0.300.060 Due Care

**.01** *Due care principle.* A *member* should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the *member's* ability.

**.02** The quest for excellence is the essence of due care. Due care requires a *member* to discharge professional responsibilities with competence and diligence. It imposes the obligation to perform *professional services* to the best of a *member's* ability, with concern for the best interest of those for whom the services are performed, and consistent with the profession's responsibility to the public.

**.03** Competence is derived from a synthesis of education and experience. It begins with a mastery of the common body of knowledge required for designation as a certified public accountant. The maintenance of competence requires a commitment to learning and professional improvement that must continue throughout a *member's* professional life. It is a *member's* individual responsibility. In all engagements and in all responsibilities, each *member* should undertake to achieve a level of competence that will assure that the quality of the *member's* services meets the high level of professionalism required by these Principles.

**.04** Competence represents the attainment and maintenance of a level of understanding and knowledge that enables a *member* to render services with facility and acumen. It also establishes the limitations of a *member's* capabilities by dictating that consultation or referral may be required when a professional engagement exceeds the personal competence of a *member* or a *member's* firm. Each *member* is responsible for assessing his or her own competence of evaluating whether education, experience, and judgment are adequate for the responsibility to be assumed.

**.05** *Members* should be diligent in discharging responsibilities to *clients*, employers, and the public. Diligence imposes the responsibility to render services promptly and carefully, to be thorough, and to observe applicable technical and ethical standards.

**.06** Due care requires a *member* to plan and supervise adequately any professional activity for which he or she is responsible. [Prior reference: ET section 56]

### 0.300.070 Scope and Nature of Services

**.01** *Scope and nature of services principle.* A *member* in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

**.02** The public interest aspect of *members'* services requires that such services be consistent with acceptable professional behavior for *members*. Integrity requires that service and the public trust not be subordinated to personal gain and advantage. Objectivity and *independence* require that *members* be free from conflicts of interest in discharging professional responsibilities. Due care requires that services be provided with competence and diligence.

**.03** Each of these Principles should be considered by *members* in determining whether or not to provide specific services in individual circumstances. In some instances, they may represent an overall constraint on the nonaudit services that might be offered to a specific *client*. No hard-and-fast rules can be

developed to help *members* reach these judgments, but they must be satisfied that they are meeting the spirit of the Principles in this regard.

**.04** In order to accomplish this, *members* should

- a. Practice in *firms* that have in place internal quality control procedures to ensure that services are competently delivered and adequately supervised.
- b. Determine, in their individual judgments, whether the scope and nature of other services provided to an audit *client* would create a conflict of interest in the performance of the audit function for that *client*.
- c. Assess, in their individual judgments, whether an activity is consistent with their role as professionals. [Prior reference: ET section 57]

## 0.400 Definitions

Pursuant to its authority under the bylaws (paragraph .01 [3.6.2.2] of BL section 360, *Committees* [AICPA, *Professional Standards*]) to interpret the code, the Professional Ethics Executive Committee has issued the following definitions of terms appearing in the code.

**.01 Acceptable level.** In connection with *independence*, an acceptable level is a level at which a reasonable and informed third party who is aware of the relevant information would be expected to conclude that a *member's independence* is not *impaired*. When used in connection with any rule but the "Independence Rule" [1.200.001] an acceptable level is a level at which a reasonable and informed third party who is aware of the relevant information would be expected to conclude that a *member's* compliance with the rules is not compromised. [Prior reference: ET section 100-1 and new content]

### **Effective Date**

When this definition is used in connection with any rule but the "Independence Rule" [1.200.001] it is effective December 15, 2014.

**.02 Affiliate.** The following entities are affiliates of a *financial statement attest client*:

- a. An entity (for example, subsidiary, partnership, or limited liability company [LLC]) that a *financial statement attest client* can control.
- b. An entity in which a *financial statement attest client* or an entity controlled by the *financial statement attest client* has a *direct financial interest* that gives the *financial statement attest client* *significant influence* over such entity and that is material to the *financial statement attest client*.
- c. An entity (for example, parent, partnership, or LLC) that controls a *financial statement attest client* when the *financial statement attest client* is material to such entity.
- d. An entity with a *direct financial interest* in the *financial statement attest client* when that entity has *significant influence* over the *financial statement attest client*, and the interest in the *financial statement attest client* is material to such entity.

- e. A sister entity of a *financial statement attest client* if the *financial statement attest client* and sister entity are each material to the entity that *controls* both.
- f. A trustee that is deemed to *control* a trust *financial statement attest client* that is not an investment company.
- g. The sponsor of a single employer employee benefit plan *financial statement attest client*.
- h. Any union or participating employer that has *significant influence* over a multiple or multiemployer employee benefit plan *financial statement attest client*.
- i. An employee benefit plan sponsored by either a *financial statement attest client* or an entity *controlled* by the *financial statement attest client*. A *financial statement attest client* that sponsors an employee benefit plan includes, but is not limited to, a union whose members participate in the plan and participating employers of a multiple or multiemployer plan.
- j. An investment adviser, a general partner, or a trustee of an investment company *financial statement attest client* (fund) if the fund is material to the investment adviser, general partner, or trustee that is deemed to have either *control* or *significant influence* over the fund. When considering materiality, *members* should consider investments in, and fees received from, the fund.

[Prior reference: paragraph .20 of ET section 101]

**.03 Attest client.** A *client* that engages a *member* to perform an *attest engagement* or with respect to which a *member* performs an *attest engagement*. [No prior reference: new content]

See paragraph .06 of the "Client Affiliate" interpretation [1.224.010] for acquisitions and business combinations that involve a *financial statement attest client*.

### **Effective Date**

This definition is effective December 15, 2014.

[See Revision History Table.]

**.04 Attest engagement.** An engagement that requires *independence*, as set forth in the AICPA Statements on Auditing Standards (SASs), Statements on Standards for Accounting and Review Services (SSARSs), and Statements on Standards for Attestation Engagements (SSAEs). [Prior reference: paragraph .01 of ET section 92]

**.05 Attest engagement team.** Those individuals participating in the *attest engagement*, including those who perform concurring and engagement quality reviews. The attest engagement team includes all employees and contractors retained by the *firm* who participate in the *attest engagement*, regardless of their functional classification (for example, audit, tax, or management consulting services). The attest engagement team excludes specialists, as discussed in AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), and individuals who perform only routine clerical functions, such as word processing and photocopying. [Prior reference: paragraph .02 of ET section 92]

**.06 Beneficially owned.** Describes a *financial interest* of which an individual or entity is not the record owner but has a right to some or all of the underlying benefits of ownership. These benefits include the authority to direct

the voting or disposition of the interest or to receive the economic benefits of the ownership of the interest. [Prior reference: paragraph .17 of ET section 101]

**.07 Client.** Any person or entity, other than the *member's* employer, that engages a *member* or *member's firm* to perform *professional services* and, if different, the person or entity with respect to which *professional services* are performed. For purposes of this definition, the term employer does not include the following:

- a. Person or entity engaged in *public practice*.
- b. Federal, state, and local government or component unit thereof, provided that the *member* performing *professional services* with respect to the entity is
  - i. directly elected by voters of the government or component unit thereof with respect to which *professional services* are performed;
  - ii. an individual who is (1) appointed by a legislative body and (2) subject to removal by a legislative body; or
  - iii. appointed by someone other than the legislative body, so long as the appointment is confirmed by the legislative body and removal is subject to oversight or approval by the legislative body.

[Prior reference: paragraph .03 of ET section 92]

**.08 Close relative.** A parent, sibling, or nondependent child. [Prior reference: paragraph .04 of ET section 92]

**.09 Confidential client information.** Any information obtained from the *client* that is not available to the public. Information that is available to the public includes, but is not limited to, information

- a. in a book, periodical, newspaper, or similar publication;
- b. in a *client* document that has been released by the *client* to the public or that has otherwise become a matter of public knowledge;
- c. on publicly accessible websites, databases, online discussion forums, or other electronic media by which members of the public can access the information;
- d. released or disclosed by the *client* or other third parties in media interviews, speeches, testimony in a public forum, presentations made at seminars or trade association meetings, panel discussions, earnings press release calls, investor calls, analyst sessions, investor conference presentations, or a similar public forum;
- e. maintained by, or filed with, regulatory or governmental bodies that is available to the public; or
- f. obtained from other public sources.

Unless the particular *client* information is available to the public, such information should be considered confidential client information. *Members* are advised that federal, state, or local statutes, rules, or regulations concerning confidentiality of *client* information may be more restrictive than the requirements in the code. [Prior reference: paragraph .05 of ET section 92]

**.10 Control (s) (led).** As used in FASB *Accounting Standards Codification* (ASC) 810, *Consolidation*. When used in the "Client Affiliates" interpretation [1.224.010] of the "Independence Rule" [1.200.001], control depends upon the entity in question. For example, when used for not-for-profit entities, control is as used in FASB ASC 958-805-20; for commercial entities, control is as used in

FASB ASC 810. [Prior reference: numerous ET sections; also see "Breakdown of the Term Control in the Code" at AICPA.org [www.aicpa.org/InterestAreas/ProfessionalEthics/Community/DownloadableDocuments/breakdown-of-the-term-control.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Community/DownloadableDocuments/breakdown-of-the-term-control.pdf)]

**.11 Council.** The AICPA Council. [Prior reference: paragraph .06 of ET section 92]

**.12 Covered member.** All of the following:

- a. an individual on the *attest engagement team*.
- b. an *individual in a position to influence the attest engagement*.
- c. a *partner, partner equivalent, or manager* who provides more than 10 hours of nonattest services to the *attest client* within any fiscal year. Designation as *covered member* ends on the later of (i) the date that the *firm* signs the report on the *financial statements* for the fiscal year during which those services were provided or (ii) the date he or she no longer expects to provide 10 or more hours of nonattest services to the *attest client* on a recurring basis.
- d. a *partner or partner equivalent in the office* in which the lead *attest engagement partner or partner equivalent* primarily practices in connection with the *attest engagement*.
- e. the *firm*, including the *firm's* employee benefit plans.
- f. an entity whose operating, financial, or accounting policies can be *controlled* by any of the individuals or entities described in items a–e or two or more such individuals or entities if they act together. [Prior reference: paragraph .07 of ET section 92]

### Effective Date

The addition of partner equivalents to this definition is effective for engagements covering periods beginning on or after December 15, 2014.

**.13 Direct financial interest.** A *financial interest* that is

- a. owned directly by an individual or entity, including those managed on a discretionary basis by others.
- b. under the control of an individual or entity, including those managed on a discretionary basis by others.
- c. *beneficially owned* through an investment vehicle, estate, trust, or other intermediary when the beneficiary
  - i. controls the intermediary or
  - ii. has the authority to supervise or participate in the intermediary's investment decisions.

When used in this definition, the term control includes situations in which the *covered member* has the ability to exercise such control, either individually or acting together with his or her *firm* or other *partners* or professional employees of his or her *firm*. [Prior reference: paragraph .17 of ET section 101]

**.14 Employing organization.** Any entity that employs the *member* or engages the *member* on a contractual or volunteer basis in an executive, a staff, a governance, an advisory, or an administrative capacity to provide *professional services*. [No prior reference: new content]

### Effective Date

This definition is effective December 15, 2014.

**.15 Financial interest.** 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. [Prior reference: paragraph .17 of ET section 101]

**.16 Financial statement attest client.** An entity whose *financial statements* are audited, reviewed, or compiled when the *member's* compilation report does not disclose a lack of *independence*. This term is used in the "Client Affiliates" interpretation [1.224.010] of the "Independence Rule" [1.200.001] and in the definition of an affiliate [0.400.02]. [Prior reference: paragraph .20 of ET section 101]

**.17 Financial statements.** A presentation of financial data, including accompanying disclosures, if any, intended to communicate an entity's economic resources or obligations, or both, at a point in time or the changes therein for a period of time, in accordance with the applicable financial reporting framework. Incidental financial data to support recommendations to a *client* or in (a) documents for which the reporting is governed by SSAEs and (b) tax returns and supporting schedules do not, for this purpose, constitute financial statements. The statement, affidavit, or signature of preparers required on tax returns neither constitutes an opinion on financial statements nor requires a disclaimer of such opinion. [Prior reference: paragraph .10 of ET section 92]

**.18 Firm.** A form of organization permitted by law or regulation whose characteristics conform to resolutions of the *Council* and that is engaged in *public practice*. A firm includes the individual *partners* thereof, except for purposes of applying the "Independence Rule" [1.200.001] and related *interpretations*. For purposes of applying the "Independence Rule," a firm includes a *network firm* when the engagement is either a *financial statement* audit or review engagement and the audit or review report is not restricted, as set forth in the AICPA SASs and SSARs (AICPA, *Professional Standards*). [Prior reference: paragraph .11 of ET section 92]

**.19 Immediate family.** A spouse, spousal equivalent, or dependent (regardless of whether the dependent is related). [Prior reference: paragraph .13 of ET section 92]

**.20 Impair(ed)(ing).** In connection with *independence*, to effectively extinguish *independence*. When a *member's independence* is impaired, the *member* is not independent. [Prior reference: paragraph .09 of ET section 100-1]

**.21 Independence.** Consists of two elements, defined as follows:

- a. Independence of mind is the state of mind that permits a *member* to perform 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.
- b. Independence in appearance is the avoidance of circumstances that would cause a reasonable and informed third party who has knowledge of all relevant information, including the *safeguards* applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a *firm* or member of the *attest engagement team* is compromised.

This definition should not be interpreted as an absolute. For example, the phrase "without being affected by influences that compromise professional judgment" is not intended to convey that the *member* must be free of any and all influences that might compromise objective judgment. Instead, the *member* should determine whether such influences, if present, create a *threat* that is

not at an *acceptable level* that a *member* would not act with integrity and exercise objectivity and professional skepticism in the conduct of a particular engagement or would be perceived as not being able to do so by a reasonable and informed third party with knowledge of all relevant information. [Prior reference: paragraphs .06–.08 of ET section 100-1]

**.22 Indirect financial interest.** A *financial interest* *beneficially owned* through an investment vehicle, an estate, a trust, or an other intermediary when the beneficiary neither controls the intermediary nor has the authority to supervise or participate in the intermediary's investment decisions. When used in this definition, control includes situations in which the *covered member* has the ability to exercise such control, either individually or acting together with his or her *firm* or other *partners* or professional employees of his or her *firm*. [Prior reference: paragraph .17 of ET section 101]

**.23 Individual in a position to influence the attest engagement.** One who

- a. evaluates the performance or recommends the compensation of the *attest engagement partner*;
- b. directly supervises or manages the *attest engagement partner*, including all successively senior levels above that individual through the *firm's* chief executive;
- c. consults with the *attest engagement team* regarding technical or industry-related issues specific to the *attest engagement*; or
- d. participates in or oversees, at all successively senior levels, quality control activities, including internal monitoring, with respect to the specific *attest engagement*.

[Prior reference: paragraph .14 of ET section 92]

**.24 Institute.** The AICPA. [Prior reference: paragraph .15 of ET section 92]

**.25 Interpretation.** Pronouncements issued by the division of professional ethics to provide guidelines concerning the scope and application of the rules of conduct. [Prior reference: paragraph .16 of ET section 92]

**.26 Joint closely held investment.** An investment in an entity or a property by the *member* and *client* (or the *client's* officers or directors or any owner who has the ability to exercise *significant influence* over the *client*) that enables them to *control* the entity or property. [Prior reference: paragraph .17 of ET section 92]

**.27 Key position.** A position in which an individual has

- a. primary responsibility for significant accounting functions that support material components of the *financial statements*;
- b. primary responsibility for the preparation of the *financial statements*; or
- c. 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, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

For purposes of *attest engagements* not involving a *client's financial statements*, a key position is one in which an individual is primarily responsible for, or able to

influence, the subject matter of the *attest engagement*, as previously described. [Prior reference: paragraph .18 of ET section 92]

**.28 Lending institution.** An entity that, as part of its normal business operations, makes *loans*. This definition is not meant to include an organization that might schedule payment for services for a client over a period of time. Examples of such entities are banks, credit unions, certain retailers, and insurance and finance companies. For example, for automobile leases addressed by the "Loans and Leases With Lending Institutions" interpretation [1.260.020] of the "Independence Rule" [1.200.001], an entity is considered a lending institution if it leases automobiles as part of its normal business operations. [Prior reference: paragraph .09 of ET section 92]

### **Effective Date**

This revised definition is effective December 15, 2014.

**.29 Loan.** A contractual obligation to pay or right to receive money on demand or on a fixed or determinable date and includes a stated or implied rate of return to the lender. For purposes of this definition, loans include, among other things, a guarantee of a loan, a letter of credit, a line of credit, or a loan commitment. However, for purposes of this definition, a loan would not include debt securities (which are considered a *financial interest*) or lease arrangements. [Prior reference: paragraph .19 of ET section 92]

### **Effective Date**

This revised definition is effective December 15, 2014.

**.30 Manager.** A professional employee of the *firm* who has continuing responsibility for the planning and supervision of engagements for specified *clients*. [Prior reference: paragraph .20 of ET section 92]

**.31 Member.** A member, associate member, affiliate member, or international associate of the AICPA. When the term member is used in part 1 of the code, it means a member in *public practice*; when used in part 2 of the code, it means a *member in business*; and when used in part 3 of the code, it means all other members. [Prior reference: paragraph .21 of ET section 92]

**.32 Member(s) in business.** A *member* who is employed or engaged on a contractual or volunteer basis in a(n) executive, staff, governance, advisory, or administrative capacity in such areas as industry, the public sector, education, the not-for-profit sector, and regulatory or professional bodies. This does not include a *member* engaged in *public practice*. [Prior reference: paragraph .22 of ET section 92]

**.33 Network.** For purposes of the "Network and Network Firms" interpretation [1.220.010] of the "Independence Rule" [1.200.001], a network is an association of entities that includes one or more *firms* that (a) cooperate for the purpose of enhancing the *firms'* capabilities to provide *professional services* and (b) share one or more of the following characteristics:

- a. The use of a common brand name, including common initials, as part of the *firm* name
- b. Common *control* among the *firms* through ownership, management, or other means
- c. Profits or costs, excluding costs of operating the association; costs of developing audit methodologies, manuals, and training courses; and other costs that are immaterial to the *firm*

- d. A common business strategy that involves ongoing collaboration amongst the *firms* whereby the *firms* are responsible for implementing the association's strategy and are held accountable for performance pursuant to that strategy
- e. A significant part of professional resources
- f. Common quality control policies and procedures that *firms* are required to implement and that are monitored by the association

A network may comprise a subset of entities within an association only if that subset of entities cooperates and shares one or more of the characteristics set forth in the preceding list. [Prior reference: paragraph .23 of ET section 92]

**.34 Network firm.** A *firm* or other entity that belongs to a *network*. This includes any entity (including another *firm*) that the network firm, by itself or through one or more of its owners, *controls*, is *controlled* by, or is under common *control* with. [Prior reference: paragraph .24 of ET section 92]

**.35 Normal lending procedures, terms, and requirements.** In connection with a *covered member's* *loan* from a *lending institution*, lending procedures, terms, and requirements that are reasonably comparable with those relating to *loans* of a similar character committed to other borrowers during the period in which the *loan* to the *covered member* is committed. Accordingly, in making such comparison and evaluating whether a *loan* was made under normal lending procedures, terms, and requirements, the *covered member* should consider all the circumstances under which the *loan* was granted, including the following:

- a. The amount of the *loan* in relation to the value of the collateral pledged as security and the credit standing of the *covered member*
- b. Repayment terms
- c. Interest rate, including points
- d. Closing costs
- e. General availability of such *loans* to the public

Related prohibitions that may be more restrictive are prescribed by certain state and federal agencies having regulatory authority over such *lending institutions*. Broker-dealers, for example, are subject to regulation by the SEC. [Prior reference: paragraph .25 of ET section 92]

**.36 Office.** A reasonably distinct subgroup within a *firm*, whether constituted by formal organization or informal practice, in which personnel who make up the subgroup generally serve the same group of *clients* or work on the same categories of matters. Substance should govern the office classification. For example, the expected regular personnel interactions and assigned reporting channels of an individual may well be more important than an individual's physical location. [Prior reference: paragraph .26 of ET section 92]

**.37 Partner.** A proprietor, a shareholder, an equity or a nonequity partner, or any individual who assumes the risks and benefits of *firm* ownership or is otherwise held out by the *firm* to be the equivalent of any of the aforementioned. [Prior reference: paragraph .27 of ET section 92]

**.38 Partner equivalent.** A professional employee who is not a *partner* of the *firm* but who either

- a. has the ultimate responsibility for the conduct of an *attest engagement*, including the authority to sign or affix the *firm's* name to an attest report or issue, or authorize others to issue, an attest report on behalf of the *firm* without *partner* approval; or

- b. has the authority to bind the *firm* to conduct an *attest engagement* without *partner* approval. For example, the professional employee has the authority to sign or affix the *firm's* name to an *attest engagement* letter or contract to conduct an *attest engagement* without *partner* approval.

Firms may use different titles to refer to professional employees with this authority, although a title is not determinative of a partner equivalent. For purposes of this definition, *partner* approval does not include any partner approvals that are part of the *firm's* normal approval and quality control review procedures applicable to a partner.

This definition is solely for the purpose of applying the "Independence Rule" [1.200.001] and its *interpretations* and should not be used or relied upon in any other context, including the determination of whether the partner equivalent is an owner of the *firm*. [Prior reference: paragraph .28 of ET section 92.]

### **Effective Date**

This definition is effective for engagements covering periods beginning on or after December 15, 2014.

**.39 Period of the professional engagement.** The period begins when a *member* either signs an initial engagement letter or other agreement to perform attest services or begins to perform an *attest engagement* for a *client*, whichever is earlier. The period lasts for the entire duration of the professional relationship, which could cover many periods, and ends with the formal or informal notification, either by the *member* or *client*, of the termination of the professional relationship or by the issuance of a report, whichever is later. Accordingly, the period does not end with the issuance of a report and recommence with the beginning of the following year's *attest engagement*. [Prior reference: paragraph .29 of ET section 92]

**.40 Professional services.** Include all services requiring accountancy or related skills that are performed by a *member* for a *client*, an employer, or on a volunteer basis. These services include, but are not limited to accounting, audit and other attest services, tax, bookkeeping, management consulting, financial management, corporate governance, personal financial planning, business valuation, litigation support, educational, and those services for which standards are promulgated by bodies designated by *Council*. [Prior reference: paragraph .31 of ET section 92]

**.41 Public interest entities.** All of the following:

- a. All listed entities, including entities that are outside the United States whose shares, stock, or debt are quoted or listed on a recognized stock exchange or marketed under the regulations of a recognized stock exchange or other equivalent body.
- b. Any entity for which an audit is required by regulation or legislation to be conducted in compliance with the same *independence* requirements that apply to an audit of listed entities (for example, requirements of the SEC, the PCAOB, or other similar regulators or standard setters).

*Members* may wish to consider whether additional entities should also be treated as public interest entities because they have a large number and wide range of stakeholders. Factors to be considered may include

- the nature of the business, such as the holding of assets in a fiduciary capacity for a large number of stakeholders;

- size; and
- number of employees.

*Members* should refer to the *independence* regulations of applicable authoritative regulatory bodies when a *member* performs attest services and is required to be independent of the *client* under such regulations. [Prior reference: paragraph .20 of ET section 100-1]

**.42 Public practice.** Consists of the performance of *professional services* for a *client* by a *member* or *member's firm*. [Prior reference: paragraph .30 of ET section 92]

**.43 Safeguards.** Actions or other measures that may eliminate a *threat* or reduce a *threat* to an *acceptable level*. [Prior reference: paragraph .20 of ET section 100-1]

**.44 Share-based compensation arrangements.** As defined in the FASB ASC glossary under the term share-based payment arrangements. [Prior reference: paragraph .02 ET section 101]

**.45 Significant influence.** As defined in FASB ASC 323-10-15. [Prior reference: paragraph .32 of ET section 92]

**.46 Source documents.** The documents upon which evidence of an accounting transaction are initially recorded. Source documents are often followed by the creation of many additional records and reports that do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll time cards, and customer orders. [Prior reference: footnote 17 in paragraph .05 of ET section 101]

**.47 Third-party service provider.** All of the following:

- a. An entity that the *member* does not *control*, individually or collectively with his or her *firm* or with *members* of his or her *firm*.
- b. An individual not employed by the *member* who assists the *member* in providing *professional services* to *clients* (for example, bookkeeping, tax return preparation, consulting, or attest services, including related clerical and data entry functions). [Prior reference: paragraphs .224–.225 of ET section 191, .023–.024 of ET section 291, and .001–.002 of ET section 391]

**.48 Those charged with governance.** The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel (for example, executive members of a governance board or an owner-manager).

When an *interpretation* requires communicating with those charged with governance, the *member* should determine the appropriate person(s) within the entity's governance structure with whom to communicate, based on the nature and importance of the particular circumstances and matter to be communicated. If the *member* communicates with a subgroup of those charged with governance (for example, an audit committee or an individual), the *member* should determine whether communication with all of those charged with governance is also necessary, so that they are adequately informed. [Prior reference: paragraph .33 of ET section 92]

### **Effective Date**

This definition is effective April 30, 2014.

**.49 Threat(s).** In connection with independence, threats are relationships or circumstances that could *impair independence*. In connection with any rule but the "Independence Rule" [1.200.001], threats are relationships or circumstances that could compromise a *member's* compliance with the rules. [Prior reference: paragraph .10 of ET section 100-1]

### **Effective Date**

When this definition is used in connection with any rule but the "Independence Rule" it is effective December 15, 2014.

## **0.500 Nonauthoritative Guidance**

**.01** The code is the only authoritative source of AICPA ethics rules and *interpretations*. The staff of the Professional Ethics Division has issued nonauthoritative guidance to assist *members* and others in their implementation of the code. Such guidance does not amend or override the code. Further, the guidance is not meant to be exhaustive and does not establish best practices, set standards, or serve as official pronouncements of the AICPA. These documents were not approved in accordance with normal due process, which requires proposed changes to be exposed to the public and requires consideration of *members'* and others' comments.

**.02** References to relevant nonauthoritative guidance, when available, are provided throughout the code in boxed text at the end of the applicable *interpretation*. [No prior reference: new content]

### **Effective Date**

**.03** Effective December 15, 2014.

## **0.600 New, Revised, and Pending Interpretations and Other Guidance**

### **0.600.010 New and Revised Interpretations and Other Guidance**

**.01** Periodically, new or revised authoritative ethics *interpretations* and other guidance are issued. Publication of the text of a new or revised pronouncement or a notice with a link to the text of a new or revised authoritative *interpretation* and other guidance in the *Journal of Accountancy* constitutes notice to *members*. Hence, the effective date of the *interpretation* and other guidance is the last day of the month in which the pronouncement or notice is published in the *Journal of Accountancy*, unless otherwise noted. The Professional Ethics Division takes into consideration the time that would have been reasonable for the *member* to comply with the pronouncement. This section lists the citation and title of any new or revised *interpretation* or other guidance for a period of 12 months after its effective date. When an *interpretation* or other guidance is not yet effective, it will appear as a pending *interpretation* or other guidance (see "Pending Interpretations and Other Guidance" [0.600.020]).

- "Individual in a Campaign Treasurer or Similar Financial Position" [1.275.025]. (Revised April 2015. Effective April 30, 2015.)
- "Client Affiliates" [1.224.010]. (Revised April 2015. Effective April 30, 2015.)
- Revised paragraph .03 of "Definitions" [0.400]. (Revised April 2015. Effective April 30, 2015.)

- "Application of AICPA Code" [0.200.020]. (Revised June 2014. Effective September 30, 2014.)
- "Conflicts of Interest for Members in Public Practice" [1.110.010]. (Issued June 2014. Effective September 30, 2014.)
- "Conflicts of Interest for Members in Business" [2.110.010]. (Issued June 2014. Effective September 30, 2014.)
- "Council Resolution Concerning the Form of Organization and Name Rule" [Appendix B]. (Issued January 2015. Effective October 19, 2014.)
- "Overview of the Code of Professional Conduct" [0.100]. (Issued June 2014. Effective December 15, 2014.)
- "Structure of the AICPA Code" [0.200.010]. (Issued June 2014. Effective December 15, 2014.)
- "Application of the AICPA Code" [0.200.020.01]. (Issued June 2014. Effective December 15, 2014.)
- "Citations" [0.200.030]. (Issued June 2014. Effective December 15, 2014.)
- "Transition Provisions" [0.200.040]. (Issued June 2014. Effective December 15, 2014.)
- "Drafting Conventions" [0.200.050]. (Issued June 2014. Effective December 15, 2014.)
- "Acceptable level" under "Definitions" [0.400.01]. (Issued June 2014. When this definition is used in connection with any rule but the "Independence Rule" [1.200.001], it is effective December 15, 2014.)
- "Attest client" under "Definitions" [0.400.03]. (Issued June 2014. Effective December 15, 2014.)
- "Employing organization" under "Definitions" [0.400.14]. (Issued June 2014. Effective December 15, 2014.)
- "Lending institution" under "Definitions" [0.400.28] (Revised June 2014. Effective December 15, 2014)
- "Loan" under "Definitions" [0.400.29] (Revised June 2014. Effective December 15, 2014.)
- "Threats" under "Definitions" [0.400.49]. (Issued June 2014. When this definition is used in connection with any rule but the "Independence Rule," it is effective December 15, 2014.)
- "Nonauthoritative Guidance" [0.500]. (Issued June 2014. Effective December 15, 2014.)
- "New, Revised, and Pending Interpretations and Other Guidance" [0.600]. (Issued June 2014. Effective December 15, 2014.)
- "Deleted Interpretations and Other Guidance" [0.700]. (Issued June 2014. Effective December 15, 2014.)
- "Members in Public Practice—Introduction" [1.000]. (Issued June 2014. Effective December 15, 2014.)
- "Members in Public Practice—Ethical Conflicts" [1.000.020]. (Issued June 2014. Effective December 15, 2014.)

- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.100.005] of the "Integrity and Objectivity Rule" (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "Director Positions" [1.110.020]. (Revised June 2014. Effective December 15, 2014.)
- "Application of the Conceptual Framework for Independence and Ethical Conflicts" interpretation [1.200.005.03] of the "Independence Rule." (Issued June 2014. Effective December 15, 2014)
- "Fees and Other Types of Remuneration" [1.230.020]. (Issued June 2014. Effective December 15, 2014.)
- "Trust Investments" [1.245.020]. (Revised June 2014. Effective December 15, 2014.)
- "Tax Services" [1.295.160.06]. (Revised June 2014. Effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.300.005] of the "General Standards Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.310.005] of the "Compliance with Standards Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.320.005] of the "Accounting Standards Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.400.005] of the "Acts Discreditable Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "False, Misleading, or Deceptive Acts in Promoting or Marketing Professional Services" [1.400.090]. (Issued June 2014. Effective December 15, 2014.)
- "Removing Client Files or Proprietary Information From a Firm" [1.400.210]. (Revised June 2014. Effective December 15, 2014.)
- "Use of Confidential Information From Nonclient Sources" [1.400.240]. (Revised June 2014. Effective December 15, 2014.)
- "Unpaid Fees" [1.500.008]. (Issued June 2014. Effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.510.005] of the "Contingent Fees Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.520.005] of the "Commissions and Referral Fees Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)

- "Billing for a Subcontractor's Services" [1.520.070]. (Revised June 2014. Effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.600.005] of the "Advertising and Other Forms of Solicitation Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "Use of AICPA-Awarded Designation" [1.600.030] (Revised June 2014. Effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.700.005] of the "Confidential Client Information Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "Disclosing Client Information in Director Positions" [1.700.080]. (Revised June 2014. Effective December 15, 2014.)
- "Disclosing Confidential Client Information as a Result of a Subpoena or Summons" [1.700.100]. (Issued June 2014. Effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.800.005] of the "Form of Organization and Name Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "Attest Engagement Performed With a Former Partner" [1.810.040]. (Revised June 2014. Effective December 15, 2014.)
- "Members in Business—Introduction" [2.000.01]. (Issued June 2014. Effective December 15, 2014.)
- "Members in Business—Ethical Conflicts" [2.000.020]. (Issued June 2014. Effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Business and Ethical Conflicts" interpretation [2.100.005] of the "Integrity and Objectivity Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Business and Ethical Conflicts" interpretation [2.300.005] of the "General Standards Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Business and Ethical Conflicts" interpretation [2.310.005] of the "Compliance with Standards Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Business and Ethical Conflicts" interpretation [2.320.005] of the "Accounting Standards Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "Application of the Conceptual Framework for Members in Business and Ethical Conflicts" interpretation [2.400.005] of the "Acts Discreditable Rule." (Issued June 2014. Paragraph .03 is effective December 15, 2014.)
- "Other Members—Introduction" [3.000.01]. (Issued June 2014. Effective December 15, 2014.)

- "Other Members—Applicability" [3.000.030]. (Issued June 2014. Effective December 15, 2014.)
- "False, Misleading, or Deceptive Acts in Promoting or Marketing Professional Services" [3.400.090]. (Issued June 2014. Effective December 15, 2014.)
- "Those charged with governance" under "Definitions" [0.400.48]. (Issued April 2014. Effective April 30, 2014.)
- "Cumulative Effect on Independence When Providing Multiple Nonattest Services" [1.295.020]. (Issued October 2013. Effective for engagements covering periods beginning on or after December 15, 2014.)
- "Covered member" under "Definitions" [0.400.12]. (Revised March 2013, revisions effective for engagements covering periods beginning on or after December 15, 2014.)
- "Partner equivalent" under "Definitions" [0.400.38]. (Issued March 2013, revisions effective for engagements covering periods beginning on or after December 15, 2014.)
- "Conceptual Framework for Independence" [1.210.010.14b]. (Revised March 2013, revisions effective for engagements covering periods beginning on or after December 15, 2014.)
- "Close Relatives" [1.270.100]. (Revised March 2013, revisions effective for engagements covering periods beginning on or after December 15, 2014.)
- "Scope and Applicability of Nonattest Services" [1.295.010.06]. (Revised March 2013, revisions effective for engagements covering periods beginning on or after December 15, 2014.)
- "Agreed-Upon Procedure Engagements Performed in Accordance With SSAEs" [1.297.020.04]. (Revised March 2013, revisions effective for engagements covering periods beginning on or after December 15, 2014.)

### **Effective Date**

.02 Paragraph .01, excluding the bulleted text, is effective December 15, 2014.

## **0.600.020 Pending Interpretations and Other Guidance**

.01 Periodically, new or revised authoritative ethics *interpretations* and other guidance are issued. This section lists the titles and citations of any pending new or revised *interpretations* or other guidance until they are effective and notes whether early application is permitted or encouraged. Once the *interpretation* or other guidance becomes effective, it will appear under the "New and Revised Interpretation and Other Guidance" section of the preface [0.600.010]:

- "Application of AICPA Code" [0.200.020]. (Revised January 2015. Effective March 31, 2016, early implementation allowed.)
- "Breach of an Independence Interpretation" [1.298]. (Added January 2015. Effective March 31, 2016, early implementation allowed.)

- "Breach of an Independence Interpretation" [1.298.010]. (Added January 2015. Effective March 31, 2016, early implementation allowed.)
- "Conceptual Framework for Members in Public Practice" [1.000.010]. (Issued June 2014. Effective December 15, 2015. Early implementation is allowed provided the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.100.005] of the "Integrity and Objectivity Rule" (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.300.005] of the "General Standards Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.310.005] of the "Compliance with Standards Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.320.005] of the "Accounting Standards Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.400.005] of the "Acts Discreditable Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.510.005] of the "Contingent Fees Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.520.005] of the "Commissions and Referral Fees Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.600.005] of the "Advertising and Other Forms of Solicitation Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015 and early implementation is allowed provided the member has implemented the revised code.)

- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.700.005] of the "Confidential Client Information Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts" interpretation [1.800.005] of the "Form of Organization and Name Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code.)
- "Conceptual Framework for Members in Business" [2.000.010]. (Issued June 2014. Effective December 15, 2015. Early implementation is allowed provided the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Business and Ethical Conflicts" interpretation [2.100.005] of the "Integrity and Objectivity Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed if the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Business and Ethical Conflicts" interpretation [2.300.005] of the "General Standards Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Business and Ethical Conflicts" interpretation [2.310.005] of the "Compliance with Standards Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Business and Ethical Conflicts" interpretation [2.320.005] of the "Accounting Standards Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code.)
- "Application of the Conceptual Framework for Members in Business and Ethical Conflicts" interpretation [2.400.005] of the "Acts Discreditable Rule." (Issued June 2014. Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code.)

### ***Effective Date***

.02 Paragraph .01, excluding the bulleted text, is effective December 15, 2014.

## **0.700 Deleted Interpretations and Other Guidance**

.01 The following interpretations and other guidance were deleted from the code during the 10 years prior to the 2014 edition:

- Definition of *holding out* (ET sec. 92 par. .12) (Deleted March 2013, effective May 31, 2013)
- Ethics Ruling No. 65, "Use of the CPA Designation by Member Not in Public Practice" (ET sec. 191 par. .130) (Deleted March 2013, effective May 31, 2013)
- Ethics Ruling No. 38, "CPA Title, Controller of Bank" (ET sec. 591 par. .075–.076) (Deleted March 2013, effective May 31, 2013)
- Ethics Ruling No. 78, "Letterhead: Lawyer-CPA" (ET sec. 591 par. .155–.156) (Deleted March 2013, effective May 31, 2013)
- Ethics Ruling No. 134, "Association of Accountants Not Partners" (ET sec. 591 par. .267–.268) (Deleted August 2012)
- Ethics Ruling No. 74, "Audits, Reviews, or Compilations and a Lack of Independence" (ET sec. 191 par. .148–.149) (Deleted April 2012).
- Ethics Ruling No. 135, "Association of Firms Not Partners" (ET sec. 591 par. .269–.270) (Deleted April 2012).
- Interpretation No. 101-8, "Effect on Independence of Financial Interests in Nonclients Having Investor or Investee Relationships With a Covered Member's Client" (ET sec. 101 par. .10) (Deleted November 2011. **Reestablished and effective October 31, 2012 until the earlier of January 1, 2014, or adoption of Interpretation 101-18).**
- Ethics Ruling No. 9, "Member as Representative of Creditor's Committee" (ET sec. 191 par. .017–.018) (Deleted November 2011)
- Ethics Ruling No. 10, "Member as Legislator" (ET sec. 191 par. .019–.020) (Deleted November 2011)
- Ethics Ruling No. 12, "Member as Trustee of Charitable Foundation" (ET sec. 191 par. .023–.024) (Deleted November 2011)
- Ethics Ruling No. 16, "Member on Board of Directors of Nonprofit Social Club" (ET sec. 191 par. .031–.032) (Deleted November 2011)
- Ethics Ruling No. 19, "Member on Deferred Compensation Committee" (ET sec. 191 par. .037–.038) (Deleted November 2011)
- Ethics Ruling No. 21, "Member as Director and Auditor of an Entity's Profit Sharing and Retirement Trust" (ET sec. 191 par. .041–.042) (Deleted November 2011. **Reestablished and effective October 31, 2012 until the earlier of January 1, 2014, or adoption of Interpretation 101-18)**
- Ethics Ruling No. 29, "Member as Bondholder" (ET sec. 191 par. .057–.058) (Deleted November 2011)
- Ethics Ruling No. 38, "Member as Co-Fiduciary With Client Bank" (ET sec. 191 par. .075–.076) (Deleted November 2011. **Reestablished and effective October 31, 2012 until the earlier of January 1, 2014, or adoption of Interpretation 101-18)**
- Ethics Ruling No. 48, "Faculty Member as Auditor of a Student Fund" (ET sec. 191 par. .095–.096) (Deleted November 2011)
- Ethics Ruling No. 60, "Employee Benefit Plans—Member's Relationships With Participating Employer," (ET sec. 191 par. .119–.120) (Deleted November 2011. **Reestablished and effective Oc-**

***tober 31, 2012 until the earlier of January 1, 2014, or adoption of Interpretation 101-18)***

- Ethics Ruling No. 69, "Investment With a General Partner" (ET sec. 191 par. .138–.139) (Deleted November 2011. ***Reestablished and effective October 31, 2012 until the earlier of January 1, 2014, or adoption of Interpretation 101-18)***)
- Ethics Ruling No. 81, "Member's Investment in a Limited Partnership" (ET sec. 191 par. .162–.163) (Deleted November 2011. ***Reestablished and effective October 31, 2012 until the earlier of January 1, 2014, or adoption of Interpretation 101-18)***)
- Ethics Ruling No. 98, "Member's Loan From a Nonclient Subsidiary or Parent of an Attest Client" (ET sec. 191 par. .196–.197) (Deleted November 2011. ***Reestablished and effective October 31, 2012 until the earlier of January 1, 2014, or adoption of Interpretation 101-18)***)
- Ethics Ruling No. 103, "Attest Report on Internal Controls" (ET sec. 191 par. .206–.207) (Deleted November 2011)
- Ethics Ruling No. 106, "Member Has Significant Influence Over an Entity That Has Significant Influence Over a Client" (ET sec. 191 par. .212–.213) (Deleted November 2011. ***Reestablished and effective October 31, 2012 until the earlier of January 1, 2014, or adoption of Interpretation 101-18)***)
- Ethics Ruling No. 111, "Employee Benefit Plan Sponsored by Client" (ET sec. 191 par. .222–.223) (Deleted November 2011. ***Reestablished and effective October 31, 2012 until the earlier of January 1, 2014, or adoption of Interpretation 101-18)***)
- Ethics Ruling No. 11, "Applicability of Rule 203 to Members Performing Litigation Support Services" (ET sec. 291 par. .021–.022) (Deleted November 2011)
- Ethics Ruling No. 2, "Fees: Collection of Notes Issued in Payment" (ET sec. 591 par. .003–.004) (Deleted November 2011)
- Ethics Ruling No. 33, "Course Instructor" (ET sec. 591 par. .065–.066) (Deleted November 2011)
- Ethics Ruling No. 108, "Member Interviewed by the Press" (ET sec. 591 par. .215–.216) (Deleted November 2011)
- Ethics Ruling No. 117, "Consumer Credit Company Director" (ET sec. 591 par. .233–.234) (Deleted November 2011)
- Ethics Ruling No. 140, "Political Election" (ET sec. 591 par. .279–.280) (Deleted November 2011)
- Ethics Ruling No. 144, "Title: Partnership Roster" (ET sec. 591 par. .287–.288) (Deleted November 2011)
- Ethics Ruling No. 176, "Member's Association With Newsletters and Publications" (ET sec. 591 par. .351–.352) (Deleted November 2011)
- Ethics Ruling No. 177, "Data Processing: Billing Services" (ET sec. 591 par. .353–.354) (Deleted November 2011)
- Ethics Ruling No. 179, "Practice of Public Accounting Under Name of Association or Group" (ET sec. 591 par. .357–.358) (Deleted November 2011)

- Ethics Ruling No. 101, "Client advocacy and Expert Witness Services" (ET sec. 191 par. .202–.203) (Deleted July 2007)
- Ethics Ruling No. 182, "Termination of Engagement Prior to Completion" (ET sec. 591 par. .363–.364) (Deleted April 2006).
- Ethics Ruling No. 1, "Acceptance of a Gift" (ET sec. 191 par. .001–.002) (Deleted January 2006).
- Ethics Ruling No. 35, "Stockholder in Mutual Funds" (ET sec. 191 par. .069–.070) (Deleted December 2005).
- Ethics Ruling No. 36, "Participant in Investment Club" (ET sec. 191 par. .071–.072) (Deleted December 2005).
- Ethics Ruling No. 79, "Member's Investment in a Partnership That Invests in Client" (ET sec. 191 par. .158–.159) (Deleted December 2005).
- Ethics Ruling No. 109, "Member's Investment in Financial Services Products that Invest in Clients" (ET sec. 191 par. .218–.219) (Deleted December 2005).
- Ethics Ruling No. 66, "Member's Retirement or Savings Plan Has Financial Interest in Client" (ET sec. 191 par. .132–.133) (Deleted December 2005).
- Ethics Ruling No. 68, "Blind Trust" (ET sec. 191 par. .136–.137) (Deleted December 2005).

The content of these deleted standards is available in a nonauthoritative document at <http://aicpa.org/InterestAreas/ProfessionalEthics/Community/DownloadableDocuments/Deletions.pdf>.

## ET Part 1

***Members in Public Practice***

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## 1.000 Introduction

.01 Part 1 of the Code of Professional Conduct (the code) applies to *members in public practice*. Accordingly, when the term *member* is used in part 1 of the code, the requirements apply only to *members in public practice*. When a *member in public practice* is also a *member in business* (for example, serves as a member of an entity's board of directors), the *member* should also consult part 2 of the code, which applies to a *member in business*.

.02 Government auditors within a government audit organization who audit federal, state, or local governments or component units thereof, that are structurally located within the government audit organization, are considered in *public practice* with respect to those entities provided the head of the audit organization meets one of the organizational structures described in paragraph .07b(i–iii) of the "Client" definition [0.400.07]. [No prior reference: new content]

### **Effective Date**

.03 Effective December 15, 2014.

## 1.000.010 Conceptual Framework for Members in Public Practice

### **Introduction**

.01 *Members* may encounter various relationships or circumstances that create *threats* to the *member's* compliance with the rules. The rules and *interpretations* seek to address many situations; however, they cannot address all relationships or circumstances that may arise. Thus, in the absence of an *interpretation* that addresses a particular relationship or circumstance, a *member* should evaluate whether that relationship or circumstance would lead a reasonable and informed third party who is aware of the relevant information to conclude that there is a *threat* to the *member's* compliance with the rules that is not at an *acceptable level*. When making that evaluation, the *member* should apply the conceptual framework approach as outlined in this interpretation.

.02 The code specifies that in some circumstances no *safeguards* can reduce a *threat* to an *acceptable level*. For example, the code specifies that a *member* may not subordinate the *member's* professional judgment to others without violating the "Integrity and Objectivity Rule" [1.100.001]. A *member* may not use the conceptual framework to overcome this prohibition or any other prohibition or requirement in the code.

.03 The "Conceptual Framework for Independence" interpretation [1.210.010] of the "Independence Rule" [1.200.001] provides authoritative guidance that *members* should use when making decisions on *independence* matters that are not explicitly addressed by the "Independence Rule" and its *interpretations*.

### **Definitions Used in Applying the Conceptual Framework**

.04 **Acceptable level.** A level at which a reasonable and informed third party who is aware of the relevant information would be expected to conclude that a *member's* compliance with the rules is not compromised.

.05 **Safeguards.** Actions or other measures that may eliminate a *threat* or reduce a *threat* to an *acceptable level*.

.06 **Threats.** Relationships or circumstances that could compromise a *member's* compliance with the rules.

### Conceptual Framework Approach

.07 Under the conceptual framework approach, *members* should identify *threats* to compliance with the rules and evaluate the significance of those threats. *Members* should evaluate identified *threats* both individually and in the aggregate because *threats* can have a cumulative effect on a *member's* compliance with the rules. *Members* should perform three main steps in applying the conceptual framework approach:

- a. *Identify threats.* The relationships or circumstances that a *member* encounters in various engagements and work assignments will often create different *threats* to complying with the rules. When a *member* encounters a relationship or circumstance that is not specifically addressed by a rule or an *interpretation*, under this approach, the *member* should determine whether the relationship or circumstance creates one or more *threats*, such as those identified in paragraphs .10–.16 that follow. The existence of a *threat* does not mean that the *member* is in violation of the rules; however, the *member* should evaluate the significance of the *threat*.
- b. *Evaluate the significance of a threat.* In evaluating the significance of an identified *threat*, the *member* should determine whether a *threat* is at an *acceptable level*. A *threat* is at an *acceptable level* when a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the *threat* would not compromise the *member's* compliance with the rules. *Members* should consider both qualitative and quantitative factors when evaluating the significance of a *threat*, including the extent to which existing *safeguards* already reduce the *threat* to an *acceptable level*. If the *member* evaluates the *threat* and concludes that a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the *threat* does not compromise a *member's* compliance with the rules, the *threat* is at an *acceptable level*, and the *member* is not required to evaluate the *threat* any further under this conceptual framework approach.
- c. *Identify and apply safeguards.* If, in evaluating the significance of an identified *threat*, the *member* concludes that the *threat* is not at an *acceptable level*, the *member* should apply *safeguards* to eliminate the *threat* or reduce it to an *acceptable level*. The *member* should apply judgment in determining the nature of the *safeguards* to be applied because the effectiveness of *safeguards* will vary, depending on the circumstances. When identifying appropriate *safeguards* to apply, one *safeguard* may eliminate or reduce multiple *threats*. In some cases, the *member* should apply multiple *safeguards* to eliminate or reduce one *threat* to an *acceptable level*. In other cases, an identified *threat* may be so significant that no *safeguards* will eliminate the *threat* or reduce it to an *acceptable level*, or the *member* will be unable to implement effective *safeguards*. Under such circumstances, providing the specific *professional services* would compromise the *member's* compliance with the rules, and the *member* should determine whether to decline or discontinue the *professional services* or resign from the engagement.

## Threats

.08 Many *threats* fall into one or more of the following seven broad categories: adverse interest, advocacy, familiarity, management participation, self-interest, self-review, and undue influence.

.09 Examples of *threats* associated with a specific relationship or circumstance are identified in the *interpretations* of the code. Paragraphs .10–.16 of this section define and provide examples, which are not all inclusive, of each of these *threat* categories.

**.10 Adverse interest threat.** The *threat* that a *member* will not act with objectivity because the *member's* interests are opposed to the *client's* interests. Examples of adverse interest *threats* include the following:

- a. The *client* has expressed an intention to commence litigation against the *member*.
- b. A *client* or officer, director, or significant shareholder of the *client* participates in litigation against the *firm*.
- c. A subrogee asserts a claim against the *firm* for recovery of insurance payments made to the *client*.
- d. A class action lawsuit is filed against the *client* and its officers and directors and the *firm* and its professional accountants.

**.11 Advocacy threat.** The *threat* that a *member* will promote a *client's* interests or position to the point that his or her objectivity or *independence* is compromised. Examples of advocacy *threats* include the following:

- a. A *member* provides forensic accounting services to a *client* in litigation or a dispute with third parties.
- b. A *firm* acts as an investment adviser for an officer, a director, or a 10 percent shareholder of a *client*.
- c. A *firm* underwrites or promotes a *client's* shares.
- d. A *firm* acts as a registered agent for a *client*.
- e. A *member* endorses a *client's* services or products.

**.12 Familiarity threat.** The *threat* that, due to a long or close relationship with a *client*, a *member* will become too sympathetic to the *client's* interests or too accepting of the *client's* work or product. Examples of familiarity *threats* include the following:

- a. A *member's* immediate family or close relative is employed by the *client*.
- b. A *member's* close friend is employed by the *client*.
- c. A former *partner* or professional employee joins the *client* in a *key position* and has knowledge of the *firm's* policies and practices for the *professional services* engagement.
- d. Senior personnel have a long association with a *client*.
- e. A *member* has a significant close business relationship with an officer, a director, or a 10 percent shareholder of a *client*.

**.13 Management participation threat.** The *threat* that a *member* will take on the role of *client* management or otherwise assume management responsibilities, such may occur during an engagement to provide nonattest services.

**.14 Self-interest threat.** The *threat* that a *member* could benefit, financially or otherwise, from an interest in, or relationship with, a *client* or persons associated with the *client*. Examples of self-interest *threats* include the following:

- a. The *member* has a *financial interest* in a *client*, and the outcome of a *professional services* engagement may affect the fair value of that *financial interest*.
- b. The *member's* spouse enters into employment negotiations with the *client*.
- c. A *firm* enters into a contingent fee arrangement for a tax refund claim that is not a predetermined fee.
- d. Excessive reliance exists on revenue from a single *client*.

**.15 Self-review threat.** The *threat* that a *member* will not appropriately evaluate the results of a previous judgment made or service performed or supervised by the *member* or an individual in the *member's firm* and that the *member* will rely on that service in forming a judgment as part of another service. Examples of self-review *threats* include the following:

- a. The *member* relies on the work product of the *member's firm*.
- b. The *member* performs bookkeeping services for a *client*.
- c. A *partner* in the *member's office* was associated with the *client* as an employee, an officer, a director, or a contractor.

**.16 Undue influence threat.** The *threat* that a *member* will subordinate his or her judgment to an individual associated with a *client* or any relevant third party due to that individual's reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the *member*. Examples of undue influence *threats* include the following:

- a. The *firm* is threatened with dismissal from a *client* engagement.
- b. The *client* indicates that it will not award additional engagements to the *firm* if the *firm* continues to disagree with the *client* on an accounting or tax matter.
- c. An individual associated with a *client* or any relevant third party threatens to withdraw or terminate a *professional service* unless the *member* reaches certain judgments or conclusions.

## Safeguards

**.17 Safeguards** may partially or completely eliminate a *threat* or diminish the potential influence of a *threat*. The nature and extent of the *safeguards* applied will depend on many factors. To be effective, *safeguards* should eliminate the *threat* or reduce it to an *acceptable level*.

**.18 Safeguards** that may eliminate a *threat* or reduce it to an *acceptable level* fall into three broad categories:

- a. *Safeguards* created by the profession, legislation, or regulation.
- b. *Safeguards* implemented by the *client*. It is not possible to rely solely on *safeguards* implemented by the *client* to eliminate or reduce significant *threats* to an *acceptable level*.
- c. *Safeguards* implemented by the *firm*, including policies and procedures to implement professional and regulatory requirements.

**.19** The effectiveness of a *safeguard* depends on many factors, including those listed here:

- a. The facts and circumstances specific to a particular situation
- b. The proper identification of *threats*
- c. Whether the *safeguard* is suitably designed to meet its objectives
- d. The party(ies) who will be subject to the *safeguard*
- e. How the *safeguard* is applied
- f. The consistency with which the *safeguard* is applied
- g. Who applies the *safeguard*
- h. How the *safeguard* interacts with a *safeguard* from another category
- i. Whether the *client* is a *public interest entity*

**.20** Examples of *safeguards* within each category are presented in the following paragraphs. Because these are only examples and are not intended to be all inclusive, it is possible that *threats* may be sufficiently mitigated through the application of other *safeguards* not specifically identified herein.

**.21** The following are examples of *safeguards* created by the profession, legislation, or regulation:

- a. Education and training requirements on *independence* and ethics rules
- b. Continuing education requirements on *independence* and ethics
- c. Professional standards and the threat of discipline
- d. External review of a *firm's* quality control system
- e. Legislation establishing prohibitions and requirements for a *firm* or a *firm's* professional employees
- f. Competency and experience requirements for professional licensure
- g. Professional resources, such as hotlines, for consultation on ethical issues

**.22** Examples of *safeguards* implemented by the *client* that would operate in combination with other *safeguards* are as follows:

- a. The *client* has personnel with suitable skill, knowledge, or experience who make managerial decisions about the delivery of *professional services* and makes use of third-party resources for consultation as needed.
- b. The tone at the top emphasizes the *client's* commitment to fair financial reporting and compliance with the applicable laws, rules, regulations, and corporate governance policies.
- c. Policies and procedures are in place to achieve fair financial reporting and compliance with the applicable laws, rules, regulations, and corporate governance policies.
- d. Policies and procedures are in place to address ethical conduct.
- e. A governance structure, such as an active audit committee, is in place to ensure appropriate decision making, oversight, and communications regarding a *firm's* services.
- f. Policies are in place that bar the entity from hiring a *firm* to provide services that do not serve the public interest or that would cause the *firm's independence* or objectivity to be considered *impaired*.

**.23** The following are examples of *safeguards* implemented by the *firm*:

- a. *Firm* leadership that stresses the importance of complying with the rules and the expectation that engagement teams will act in the public interest.
- b. Policies and procedures that are designed to implement and monitor engagement quality control.
- c. Documented policies regarding the identification of *threats* to compliance with the rules, the evaluation of the significance of those *threats*, and the identification and application of *safeguards* that can eliminate identified *threats* or reduce them to an *acceptable level*.
- d. Internal policies and procedures that are designed to monitor compliance with the *firm's* policies and procedures.
- e. Policies and procedures that are designed to identify interests or relationships between the *firm* or its *partners* and professional staff and the *firm's clients*.
- f. The use of different *partners*, *partner equivalents*, and engagement teams from different offices or that report to different supervisors.
- g. Training on, and timely communication of, a *firm's* policies and procedures and any changes to them for all *partners* and professional staff.
- h. Policies and procedures that are designed to monitor the *firm's*, *partner's*, or *partner equivalent's* reliance on revenue from a single *client* and that, if necessary, trigger action to address excessive reliance.
- i. Designation of someone from senior management as the person responsible for overseeing the adequate functioning of the *firm's* quality control system.
- j. A means for informing *partners* and professional staff of *attest clients* and related entities from which they must be independent.
- k. A disciplinary mechanism that is designed to promote compliance with policies and procedures.
- l. Policies and procedures that are designed to empower staff to communicate to senior members of the *firm* any engagement issues that concern them without fear of retribution.
- m. Policies and procedures relating to *independence* and ethics communications with audit committees or others charged with *client* governance.
- n. Discussion of *independence* and ethics issues with the audit committee or others responsible for the *client's* governance.
- o. Disclosures to the audit committee or others responsible for the *client's* governance regarding the nature of the services that are or will be provided and the extent of the fees charged or to be charged.
- p. The involvement of another professional accountant who (a) reviews the work that is done for a *client* or (b) otherwise advises the engagement team. This individual could be someone from outside the *firm* or someone from within the *firm* who is not otherwise associated with the engagement.
- q. Consultation on engagement issues with an interested third party, such as a committee of independent directors, a professional regulatory body, or another professional accountant.

- r. Rotation of senior personnel who are part of the engagement team.
- s. Policies and procedures that are designed to ensure that members of the engagement team do not make or assume responsibility for management decisions for the *client*.
- t. The involvement of another *firm* to perform part of the engagement.
- u. Having another *firm* to reperform a nonattest service to the extent necessary for it to take responsibility for that service.
- v. The removal of an individual from an *attest engagement team* when that individual's *financial interests* or relationships pose a *threat to independence* or objectivity.
- w. A consultation function that is staffed with experts in accounting, auditing, *independence*, ethics, and reporting matters who can help engagement teams
  - i. assess issues when guidance is unclear or when the issues are highly technical or require a great deal of judgment; and
  - ii. resist undue pressure from a *client* when the engagement team disagrees with the *client* about such issues.
- x. *Client* acceptance and continuation policies that are designed to prevent association with *clients* that pose a *threat* that is not at an *acceptable level* to the *member's* compliance with the rules.
- y. Policies that preclude audit *partners* or *partner equivalents* from being directly compensated for selling nonattest services to the *attest client*.
- z. Policies and procedures addressing ethical conduct and compliance with laws and regulations. [No prior reference: new content]

### **Effective Date**

.24 Effective December 15, 2015. Early implementation is allowed provided the member has implemented the revised code.

### **1.000.020 Ethical Conflicts**

.01 An ethical conflict arises when a *member* encounters one or both of the following:

- a. Obstacles to following an appropriate course of action due to internal or external pressures
- b. Conflicts in applying relevant professional standards or legal standards

For example, a *member* suspects a fraud may have occurred, but reporting the suspected fraud would violate the *member's* responsibility to maintain *client* confidentiality.

.02 Once an ethical conflict is encountered, a *member* may be required to take steps to best achieve compliance with the rules and law. In weighing alternative courses of action, the *member* should consider factors such as the following:

- a. Relevant facts and circumstances, including applicable rules, laws, or regulations
- b. Ethical issues involved

c. Established internal procedures

**.03** The *member* should also be prepared to justify any departures that the *member* believes were appropriate in applying the relevant rules and law. If the *member* was unable to resolve the conflict in a way that permitted compliance with the applicable rules and law, the *member* may have to address the consequences of any violations.

**.04** Before pursuing a course of action, the *member* should consider consulting with appropriate persons within the *firm* or the organization that employs the *member*.

**.05** If a *member* decides not to consult with appropriate persons within the *firm* or the organization that employs the *member* and the conflict remains unresolved after pursuing the selected course of action, the *member* should consider either consulting with other individuals for help in reaching a resolution or obtaining advice from an appropriate professional body or legal counsel. The *member* also should consider documenting the substance of the issue, the parties with whom the issue was discussed, details of any discussions held, and any decisions made concerning the issue.

**.06** If the ethical conflict remains unresolved, the *member* will in all likelihood be in violation of one or more rules if he or she remains associated with the matter creating the conflict. Accordingly, the *member* should consider his or her continuing relationship with the engagement team, specific assignment, *client*, *firm*, or employer. [No prior reference: new content.]

### **Effective Date**

**.07** Effective December 15, 2014.

## **1.100 Integrity and Objectivity**

### **1.100.001 Integrity and Objectivity Rule**

**.01** In the performance of any *professional service*, a *member* shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others. [Prior reference: paragraph .01 of ET section 102]

### **Interpretations Under the Integrity and Objectivity Rule**

#### **1.100.005 Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts**

**.01** In the absence of an *interpretation* of the "Integrity and Objectivity Rule" [1.100.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Public Practice" [1.000.010].

**.02** A *member* would be considered in violation of the "Integrity and Objectivity Rule" [1.100.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

**.03** A *member* should consider the guidance in "Ethical Conflicts" [1.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such

obstacles may be due to internal or external pressures or to conflicts in applying relevant professional or legal standards, or both. [No prior reference: new content]

### **Effective Date**

.04 Paragraphs .01 and .02 are effective December 15, 2015 and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

## **1.110 Conflicts of Interest**

### **1.110.010 Conflicts of Interest for Members in Public Practice**

.01 A *member* or his or her *firm* may be faced with a conflict of interest when performing a *professional service*. In determining whether a *professional service*, relationship or matter would result in a conflict of interest, a *member* should use professional judgment, taking into account whether a reasonable and informed third party who is aware of the relevant information would conclude that a conflict of interest exists.

.02 A conflict of interest creates adverse interest and self-interest *threats* to the *member's* compliance with the "Integrity and Objectivity Rule" [1.100.001]. For example, *threats* may be created when

- a. the *member* or the *member's firm* provides a *professional service* related to a particular matter involving two or more *clients* whose interests with respect to that matter are in conflict, or
- b. the interests of the *member* or the *member's firm* with respect to a particular matter and the interests of the *client* for whom the *member* or the *member's firm* provides a *professional service* related to that matter are in conflict.

.03 Certain professional engagements, such as audits, reviews and other attest services require *independence*. *Independence* impairments under the "Independence Rule" [1.200.001], its *interpretations*, and rulings cannot be eliminated by the *safeguards* provided in this interpretation or by disclosure and consent.

.04 The following are examples of situations in which conflicts of interest may arise:

- a. Providing corporate finance services to a *client* seeking to acquire an audit *client* of the *firm*, when the *firm* has obtained confidential information during the course of the audit that may be relevant to the transaction
- b. Advising two *clients* at the same time who are competing to acquire the same company when the advice might be relevant to the parties' competitive positions
- c. Providing services to both a vendor and a purchaser who are *clients* of the *firm* in relation to the same transaction
- d. Preparing valuations of assets for two *clients* who are in an adversarial position with respect to the same assets
- e. Representing two *clients* at the same time regarding the same matter who are in a legal dispute with each other, such as during divorce proceedings or the dissolution of a partnership

- f. Providing a report for a licensor on royalties due under a license agreement while at the same time advising the licensee of the correctness of the amounts payable under the same license agreement
- g. Advising a *client* to invest in a business in which, for example, the *immediate family* member of the *member* has a *financial interest* in the business
- h. Providing strategic advice to a *client* on its competitive position while having a joint venture or similar interest with a competitor of the *client*
- i. Advising a *client* on the acquisition of a business which the *firm* is also interested in acquiring
- j. Advising a *client* on the purchase of a product or service while having a royalty or commission agreement with one of the potential vendors of that product or service
- k. Providing forensic investigation services to a *client* for the purpose of evaluating or supporting contemplated litigation against another *client* of the *firm*
- l. Providing tax or personal financial planning services for several members of a family whom the *member* knows to have opposing interests
- m. Referring a personal financial planning or tax *client* to an insurance broker or other service provider, which refers *clients* to the *member* under an exclusive arrangement

### **Identification of a Conflict of Interest**

**.05** Before accepting a new *client* relationship, engagement, or business relationship, a *member* should take reasonable steps to identify circumstances that might create a conflict of interest including identification of

- a. the nature of the relevant interests and relationships between the parties involved and
- b. the nature of the service and its implication for relevant parties.

**.06** The nature of the relevant interests and relationships and the services may change during the course of the engagement. This is particularly true when a *member* is asked to conduct an engagement for a *client* in a situation that may become adversarial with respect to another *client* or the *member* or *member's firm*, even though the parties who engage the *member* may not initially be involved in a dispute. A *member* should remain alert to such changes for the purpose of identifying circumstances that might create a conflict of interest.

**.07** For the purpose of identifying interests and relationships that might create a conflict of interest, having an effective conflict identification process assists a *member* in identifying actual or potential conflicts of interest that may create significant *threats* to compliance with the "Integrity and Objectivity Rule" [1.100.001] prior to determining whether to accept an engagement and throughout an engagement. This includes matters identified by external parties, for example *clients* or potential *clients*. The earlier an actual or potential conflict of interest is identified, the greater the likelihood of a *member* being able to apply *safeguards* to eliminate or reduce significant *threats* to an *acceptable level*. The process to identify actual or potential conflicts of interest will depend on such factors as

- a. the nature of the *professional services* provided,

- b. the size of the *firm*,
- c. the size and nature of the *client* base, and
- d. the structure of the *firm*, for example the number and geographic location of offices.

.08 If the *firm* is a member of a *network*, the *member* is not required to take specific steps to identify conflicts of interest of other *network firms*; however, if the *member* knows or has reason to believe that such conflicts of interest may exist or might arise due to interests and relationships of a *network firm*, the *member* should evaluate the significance of the *threat* created by such conflicts of interest as described below.

### **Evaluation of a Conflict of Interest**

.09 When an actual conflict of interest has been identified, the *member* should evaluate the significance of the *threat* created by the conflict of interest to determine if the *threat* is at an *acceptable level*. Members should consider both qualitative and quantitative factors when evaluating the significance of the *threat*, including the extent to which existing *safeguards* already reduce the *threat* to an *acceptable level*. In evaluating the significance of an identified *threat*, *members* should consider both of the following:

- a. The significance of relevant interests or relationships.
- b. The significance of the *threats* created by performing the *professional service* or services. In general, the more direct the connection between the *professional service* and the matter on which the parties' interests are in conflict, the more significant the *threat* to compliance with the rule will be.

.10 If the *member* concludes that the *threat* is not at an *acceptable level*, the *member* should apply *safeguards* to eliminate the *threat* or reduce it to an *acceptable level*. Examples of *safeguards* include the following:

- a. Implementing mechanisms to prevent unauthorized disclosure of confidential information when performing *professional services* related to a particular matter for two or more *clients* whose interests with respect to that matter are in conflict. This could include
  - i. using separate engagement teams who are provided with clear policies and procedures on maintaining confidentiality;
  - ii. creating separate areas of practice for specialty functions within the *firm*, which may act as a barrier to the passing of *confidential client information* from one practice area to another within a *firm*;
  - iii. establishing policies and procedures to limit access to *client* files, the use of confidentiality agreements signed by employees and *partners* of the *firm* and the physical and electronic separation of confidential information.
- b. Regularly reviewing the application of *safeguards* by a senior individual not involved with the *client* engagement or engagements.
- c. Having a member of the *firm* who is not involved in providing the service or otherwise affected by the conflict, review the work performed to assess whether the key judgments and conclusions are appropriate.
- d. Consulting with third parties, such as a professional body, legal counsel, or another professional accountant.

.11 In cases where an identified *threat* may be so significant that no *safeguards* will eliminate the *threat* or reduce it to an *acceptable level*, or the *member* is unable to implement effective *safeguards*, the *member* should (a) decline to perform or discontinue the *professional services* that would result in the conflict of interest; or (b) terminate the relevant relationships or dispose of the relevant interests to eliminate the *threat* or reduce it to an *acceptable level*.

### **Disclosure of a Conflict of Interest and Consent**

.12 When a conflict of interest exists, the *member* should disclose the nature of the conflict of interest to *clients* and other appropriate parties affected by the conflict and obtain their consent to perform the *professional services*. The *member* should disclose the conflict of interest and obtain consent even if the *member* concludes that *threats* are at an *acceptable level*.

.13 Disclosure and consent may take different forms. The following are examples:

- a. General disclosure to *clients* of circumstances in which the *member*, in keeping with common commercial practice, does not provide services exclusively for any one *client* (for example, in a particular service in a particular market sector) in order for the *client* to provide general consent accordingly. Such disclosure might be made in a *member's* standard terms and conditions for the engagement.
- b. Specific disclosure to affected *clients* of the circumstances of the particular conflict including an explanation of the situation and any planned safeguards, sufficient to enable the *client* to make an informed decision with respect to the matter and to provide specific consent.

.14 The *member* should determine whether the nature and significance of the conflict of interest is such that specific disclosure and specific consent are necessary, as opposed to general disclosure and general consent. For this purpose, the *member* should exercise professional judgment in evaluating the circumstances that create a conflict of interest, including the parties that might be affected, the nature of the issues that might arise and the potential for the particular matter to develop in an unexpected manner.

.15 When a *member* has requested specific consent from a *client* and that consent has been refused by the *client*, the *member* should (a) decline to perform or discontinue *professional services* that would result in the conflict of interest; or (b) terminate the relevant relationships or dispose of the relevant interests to eliminate the *threat* or reduce it to an *acceptable level*, such that consent can be obtained, after applying any additional *safeguards*, if necessary.

.16 The *member* is encouraged to document the nature of the circumstances giving rise to the conflict of interest, the *safeguards* applied to eliminate or reduce the *threats* to an *acceptable level*, and the consent obtained.

.17 When addressing conflicts of interest, including making disclosures and seeking guidance of third parties, a *member* should remain alert to the requirements of the "Confidential Client Information Rule" [1.700.001] and the "Confidential Information Obtained From Employment or Volunteer Activities" interpretation [1.400.070] of the "Acts Discreditable Rule" [1.400.001]. In addition, federal, state, or local statutes, or regulations concerning confidentiality of *client* information may be more restrictive than the requirements contained in the Code of Professional Conduct.

.18 When practicing before the IRS or other taxing authorities, *members* should ensure compliance with any requirements that are more restrictive. For example, Treasury Department Circular No. 230, *Regulations Governing Practice before the Internal Revenue Service*, provides more restrictive requirements concerning written consent by the *client* when a conflict of interest exists.

[See Revision History Table.]

A nonauthoritative question and answer regarding independent contractors retained by the firm who are simultaneously employed or associated with an attest client is available in the FAQ at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf).

### 1.110.020 Director Positions

.01 When a *member* serves as a director of an entity, such as a bank, the *member's* fiduciary responsibilities to the entity may create *threats* to the *member's* compliance with the "Integrity and Objectivity Rule" [1.100.001] and the "Confidential Client Information Rule" [1.700.001]. For example, an adverse interest *threat* to the *member's* objectivity may exist if the *member's clients* are customers of the entity or likely to engage in significant transactions with the entity. A *member's* general knowledge and experience may be very helpful to an entity in formulating policies and making business decisions. Nevertheless, if the *member's clients* are likely to engage in significant transactions with the entity, it would be more appropriate for the *member* to serve as a consultant to the board. Under such an arrangement, the *member* could limit activities to those that do not *threaten* the *member's* compliance with these rules. If, however, the *member* serves as a board member, the *member* should evaluate the significance of any *threats* and apply *safeguards*, when necessary, to eliminate or reduce the *threats* to an *acceptable level*.

.02 Refer to the "Disclosing Client Information in Director Positions" interpretation [1.700.080] of the "Confidential Client Information Rule" [1.700.001] for additional guidance. [Prior reference: paragraphs .170–.171 of ET section 191]

#### **Effective Date**

.03 This revised interpretation is effective December 15, 2014.

## 1.120 Gifts and Entertainment

### 1.120.010 Offering or Accepting Gifts or Entertainment

.01 For purposes of this interpretation, a client includes the *client*, an individual in a *key position* with the *client*, or an individual owning 10 percent or more of the *client's* outstanding equity securities or other ownership interests.

.02 When a *member* offers to a client or accepts gifts or entertainment from a client, self-interest, familiarity, or undue influence *threats* to the *member's* compliance with the "Integrity and Objectivity Rule" [1.100.001] may exist.

.03 *Threats* to compliance with the "Integrity and Objectivity Rule" [1.100.001] would not be at an *acceptable level* and could not be reduced to

an *acceptable level* by the application of *safeguards* and the *member* would be presumed to lack integrity in violation of the "Integrity and Objectivity Rule" in the following circumstances:

- a. The *member* offers to a client or accepts gifts or entertainment from a client that violate the member's or client's policies or applicable laws, rules, and regulations; and
- b. The *member* knows of the violation or demonstrates recklessness in not knowing.

**.04** A *member* should evaluate the significance of any *threats* to determine if they are at an *acceptable level*. *Threats* are at an *acceptable level* when gifts or entertainment are reasonable in the circumstances. The *member* should exercise judgment in determining whether gifts or entertainment would be considered reasonable in the circumstances. The following are examples of relevant facts and circumstances:

- a. The nature of the gift or entertainment
- b. The occasion giving rise to the gift or entertainment
- c. The cost or value of the gift or entertainment
- d. The nature, frequency, and value of other gifts and entertainment offered or accepted
- e. Whether the entertainment was associated with the active conduct of business directly before, during, or after the entertainment
- f. Whether other clients also participated in the entertainment
- g. The individuals from the client and *member's firm* who participated in the entertainment

**.05** *Threats* to compliance with the "Integrity and Objectivity Rule" [1.100.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* through the application of *safeguards* if a *member* offers to a client or accepts gifts or entertainment from a client that is not reasonable in the circumstances. The *member* would be presumed to lack objectivity in violation of the "Integrity and Objectivity Rule" under these circumstances.

**.06** Refer to the "Offering or Accepting Gifts or Entertainment" interpretation [1.285.010] of the "Independence Rule" [1.200.001] for additional guidance. [Prior reference: paragraphs .226–.227 of ET section 191]

A nonauthoritative basis-for-conclusions document summarizing considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Gifts\\_Basis\\_Document.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Gifts_Basis_Document.pdf).

A nonauthoritative question and answer regarding campaign contributions is available at the following address. The subject is member contributions made to the campaign of an individual who holds a key position with or has a financial interest in an attest client. [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf).

## 1.130 Preparing and Reporting Information

### 1.130.010 *Knowing Misrepresentations in the Preparation of Financial Statements or Records*

**.01** *Threats* to compliance with the "Integrity and Objectivity Rule" [1.100.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* and the *member* would be considered to have knowingly misrepresented facts in violation of the "Integrity and Objectivity Rule," if the *member*

- a. makes, or permits or directs another to make, materially false and misleading entries in an entity's *financial statements* or records;
- b. fails to correct an entity's *financial statements* or records that are materially false and misleading when the *member* has the authority to record the entries; or
- c. signs, or permits or directs another to sign, a document containing materially false and misleading information. [Prior reference: paragraph .02 of ET section 102]

### 1.130.020 *Subordination of Judgment*

**.01** The "Integrity and Objectivity Rule" [1.100.001] prohibits a *member* from knowingly misrepresenting facts or subordinating his or her judgment when performing *professional services* for a *client*, for an employer, or on a volunteer basis. This interpretation addresses differences of opinion between a *member* and his or her supervisor or any other person within the *member's* organization.

**.02** Self-interest, familiarity, and undue influence *threats* to the *member's* compliance with the "Integrity and Objectivity Rule" [1.100.001] may exist when a *member* and his or her supervisor or any other person within the *member's* organization have a difference of opinion relating to the application of accounting principles; auditing standards; or other relevant professional standards, including standards applicable to tax and consulting services or applicable laws or regulations.

**.03** A *member* should evaluate the significance of any *threats* to determine if they are at an *acceptable level*. *Threats* are at an *acceptable level* if the *member* concludes that the position taken does not result in a material misrepresentation of fact or a violation of applicable laws or regulations. If *threats* are not at an *acceptable level*, the *member* should apply the *safeguards* in paragraphs .06–.08 to eliminate or reduce the *threat(s)* to an *acceptable level* so that the *member* does not subordinate his or her judgment.

**.04** In evaluating the significance of any identified *threats*, the *member* should determine, after appropriate research or consultation, whether the result of the position taken by the supervisor or other person

- a. fails to comply with professional standards, when applicable;
- b. creates a material misrepresentation of fact; or
- c. may violate applicable laws or regulations.

**.05** If the *member* concludes that *threats* are at an *acceptable level* the *member* should discuss his or her conclusions with the person taking the position. No further action would be needed under this interpretation.

**.06** If the *member* concludes that the position results in a material misrepresentation of fact or a violation of applicable laws or regulations, then *threats* would not be at an *acceptable level*. In such circumstances, the *member* should discuss his or her concerns with the supervisor.

**.07** If the difference of opinion is not resolved after discussing the concerns with the supervisor, the *member* should discuss his or her concerns with the appropriate higher level(s) of management within the *member's* organization (for example, the supervisor's immediate superior, senior management, and *those charged with governance*).

**.08** If after discussing the concerns with the supervisor and appropriate higher level(s) of management within the *member's* organization, the *member* concludes that appropriate action was not taken, then the *member* should consider, in no specific order, the following *safeguards* to ensure that *threats* to the *member's* compliance with the "Integrity and Objectivity Rule" [1.100.001] are eliminated or reduced to an *acceptable level*:

- a. Determine whether the organization's internal policies and procedures have any additional requirements for reporting differences of opinion.
- b. Determine whether he or she is responsible for communicating to third parties, such as regulatory authorities or the organization's (former organization's) external accountant. In considering such communications, the *member* should be cognizant of his or her obligations under the "Confidential Information Obtained From Employment or Volunteer Activities" interpretation [1.400.070] of the "Acts Discreditable Rule" [1.400.001].
- c. Consult with his or her legal counsel regarding his or her responsibilities.
- d. Document his or her understanding of the facts, the accounting principles, auditing standards, or other relevant professional standards involved or applicable laws or regulations and the conversations and parties with whom these matters were discussed.

**.09** If the *member* concludes that no *safeguards* can eliminate or reduce the *threats* to an *acceptable level* or if the *member* concludes that appropriate action was not taken, then he or she should consider the continuing relationship with the *member's* organization and take appropriate steps to eliminate his or her exposure to subordination of judgment.

**.10** Nothing in this interpretation precludes a *member* from resigning from the organization at any time. However, resignation may not relieve the *member* of responsibilities in the situation, including any responsibility to disclose concerns to third parties, such as regulatory authorities or the employer's (former employer's) external accountant.

**.11** A *member* should use professional judgment and apply similar *safeguards*, as appropriate, to other situations involving a difference of opinion as described in this interpretation so that the *member* does not subordinate his or her judgment. [Prior reference: paragraph .05 of ET section 102]

## 1.140 Client Advocacy

### 1.140.010 Client Advocacy

**.01** An advocacy *threat* to compliance with the "Integrity and Objectivity Rule" [1.100.001] may exist when a *member* or the *member's firm* is engaged to perform nonattest services, such as tax and consulting services, that involve acting as an advocate for the *client* or to support a *client's* position on accounting or financial reporting issues either within the *firm* or outside the *firm* with standard setters, regulators, or others.

**.02** The code governs these types of *professional services*, and the *member* shall perform such services in compliance with the "General Standards Rule" [1.300.001], the "Compliance With Standards Rule" [1.310.001], the "Accounting Principles Rule" [1.320.001], and any *interpretations* thereof. The *member* shall also comply with the "Integrity and Objectivity Rule" [1.100.001] that requires maintaining objectivity and integrity and prohibits subordinating one's judgment to others.

**.03** Some *professional services* involving *client* advocacy may stretch the bounds of performance standards, go beyond sound and reasonable professional practice, or compromise credibility, thereby creating *threats* to the *member's* compliance with the rules and damaging the reputation of the *member* and the *member's firm*. If such circumstances exist, the *member* and *member's firm* should determine whether it is appropriate to perform the *professional services*.

**.04** When performing *professional services* requiring *independence*, a *member* shall also comply with the "Independence Rule" [1.200.001]. [Prior reference: paragraph .07 of ET section 102]

## 1.150 Use of a Third-Party Service Provider

### 1.150.040 Use of a Third-Party Service Provider

**.01** When a *member* uses a *third-party service provider* to assist the *member* in providing *professional services*, *threats* to compliance with the "Integrity and Objectivity Rule" [1.100.001] may exist.

**.02** *Clients* might not have an expectation that a *member* would use a *third-party service provider* to assist the *member* in providing the *professional services*. Therefore, before disclosing *confidential client information* to a *third-party service provider*, the *member* should inform the *client*, preferably in writing, that the *member* may use a *third-party service provider*. If the *client* objects to the *member's* use of a *third-party service provider*, the *member* either should not use the *third-party service provider* to perform the *professional services* or should decline to perform the engagement.

**.03** A *member* is not required to inform the *client* when he or she uses a *third-party service provider* to provide administrative support services to the *member* (for example, record storage, software application hosting, or authorized e-file tax transmittal services).

**.04** Refer to the "Use of a Third-Party Service Provider" interpretation [1.300.040] of the "General Standards Rule" [1.300.001] and the "Disclosing Information to a Third-Party Service Provider" interpretation [1.700.040] of the "Confidential Client Information Rule" [1.700.001] for additional guidance. [Prior reference: paragraphs .224–.225 of ET section 191]

A nonauthoritative basis for conclusions document that summarizes considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsOutsourcing.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsOutsourcing.pdf).

In addition, nonauthoritative sample client disclosure language a member could use to fulfill the requirement discussed in this interpretation is also available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Sample\\_Disclosure\\_Notification.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Sample_Disclosure_Notification.pdf).

## 1.200 Independence

### 1.200.001 Independence Rule

.01 A *member* in public practice shall be independent in the performance of *professional services* as required by standards promulgated by bodies designated by *Council*. [Prior reference: paragraph .01 of ET section 101]

### Interpretations Under the Independence Rule

#### 1.200.005 Application of the Conceptual Framework for Independence and Ethical Conflicts

.01 In the absence of an *interpretation* of the "Independence Rule" [1.200.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Independence" interpretation [1.210.010].

.02 A *member* would be considered in violation of the "Independence Rule" [1.200.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*. [Prior reference: "Other Considerations" section of paragraph .02 of ET section 101]

.03 A *member* should consider the guidance in "Ethical Conflicts" [1.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional or legal standards, or both. [No prior reference: new content]

#### Effective Date

.04 Paragraph .03 is effective December 15, 2014.

## 1.210 Conceptual Framework Approach

### 1.210.010 Conceptual Framework for Independence

#### Introduction

.01 It is impossible to enumerate all relationships or circumstances in which the appearance of *independence* might be questioned. Thus, in the

absence of an *independence interpretation* that addresses a particular relationship or circumstance, a *member* should evaluate whether that relationship or circumstance would lead a reasonable and informed third party who is aware of the relevant information to conclude that there is a *threat* to either the *member's* or *firm's independence*, or both, that is not at an *acceptable level*. When making that evaluation, a *member* should apply the conceptual framework approach as outlined in this interpretation to analyze *independence* matters. A *member* may also wish to consider the conceptual framework approach described in this interpretation to gain a better understanding of the conclusions reached in other *interpretations* in ET section 1.200, "Independence." [Prior reference: "Other Considerations" section of paragraph .02 of ET section 101]

**.02** The code specifies that in some circumstances no *safeguards* can reduce an *independence threat* to an *acceptable level*. For example, the code specifies that a *covered member* may not own even an immaterial *direct financial interest* in an *attest client* because there is no *safeguard* to reduce the self-interest *threat* to an *acceptable level*. A *member* may not use the conceptual framework to overcome this prohibition or any other prohibition or requirement in an *independence interpretation*.

### **Definitions Used in Applying the Conceptual Framework for Independence**

**.03 Acceptable level.** A level at which a reasonable and informed third party who is aware of the relevant information would be expected to conclude that a *member's independence* is not *impaired*.

**.04 Impair(ed).** In connection with *independence*, to effectively extinguish *independence*. When a *member's independence* is *impaired*, the *member* is not independent.

**.05 Safeguards.** Actions or other measures that may eliminate a *threat* or reduce a *threat* to an *acceptable level*.

**.06 Threats.** Relationships or circumstances that could *impair independence*.

### **Conceptual Framework Approach**

**.07** The conceptual framework approach entails identifying *threats* and evaluating the *threat* that the *member* would not be independent or would be perceived by a reasonable and informed third party who is aware of the relevant information as not being independent. The *member* must eliminate or reduce that *threat* to an *acceptable level* to conclude that the *member* is independent. *Threats* are at an *acceptable level* either because of the types of *threats* and their potential effect or because *safeguards* have eliminated or reduced the *threat*, so that a reasonable and informed third party who is aware of the relevant information would perceive that the *member's* professional judgment is not compromised.

**.08** Refer to paragraph .07 of the "Conceptual Framework for Members in Public Practice" [1.000.010.07] for a detailed description of the conceptual framework approach. [Prior reference: ET section 100-1]

### **Documentation**

**.09** When the *member* applies *safeguards* to eliminate or reduce significant *threats* to an *acceptable level*, as described in paragraph .07c of the "Conceptual Framework for Members in Public Practice" [1.000.010.07], the *member* should document the identified *threats* and *safeguards* applied. Failure to

prepare the required documentation would be considered a violation of the "Compliance With Standards Rule" [1.310.001] rather than the "Independence Rule" [1.200.001] if the *member* can demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*. [Prior reference: "Other Considerations" section of paragraph .02 of ET section 101]

### **Threats**

**.10** Many different relationships or circumstances (or combinations of relationships or circumstances) can create *threats* to compliance with the "Independence Rule" [1.200.001]. It is impossible to identify every relationship or circumstance that creates a *threat*. Many *threats* fall into one or more of the following seven broad categories: adverse interest, advocacy, familiarity, management participation, self-interest, self-review, and undue influence.

**.11** Examples of *threats* associated with a specific relationship or circumstance are identified in the *interpretations* of the code. Paragraphs .12–.18 in this section define and provide examples, which are not all inclusive, of each of these *threat* categories. In certain circumstances, the code specifies that because of the type of *threat* and its potential effect, either no *safeguards* can eliminate or reduce the *threat* to an *acceptable level*, or a *member* would need to apply specific *safeguards* to eliminate or reduce an *independence threat* to an *acceptable level*. When *independence interpretations* in the code address one of these examples, a specific reference to the *independence interpretation* is provided in brackets after that example. If an example does not contain a specific reference to an *independence interpretation*, a *member* should use this "Conceptual Framework for Independence" interpretation to evaluate whether a *threat* is significant.

**.12** *Adverse interest threat*. The *threat* that a *member* will not act with objectivity because the *member's* interests are in opposition to the interests of an *attest client*. An example is either the *attest client* or the *member* commencing litigation against the other or expressing the intent to commence litigation. [1.290.010]

**.13** *Advocacy threat*. The *threat* that a *member* will promote an *attest client's* interests or position to the point that his or her *independence* is compromised. Examples of *advocacy threats* include the following:

- a. A *member* promotes the *attest client's* securities as part of an initial public offering. [1.295.130]
- b. A *member* provides expert witness services to an *attest client*. [1.295.140]
- c. A *member* represents an *attest client* in U.S. tax court or other public forum. [1.295.160]

**.14** *Familiarity threat*. The *threat* that, because of a long or close relationship with an *attest client*, a *member* will become too sympathetic to the *attest client's* interests or too accepting of the *attest client's* work or product. Examples of *familiarity threats* include the following:

- a. A member of the *attest engagement team* has an *immediate family member* or *close relative* in a *key position* at the *attest client*, such as the *attest client's* CEO. [1.270.020 and 1.270.100]
- b. A *partner* or *partner equivalent* of the *firm* has been a member of the *attest engagement team* for a prolonged period.
- c. A member of the *firm* has recently been a director or an officer of the *attest client*. [1.277.010]

- d. A member of the *attest engagement team* has a close friend who is in a *key position* at the *attest client*.

**.15 Management participation threat.** The *threat* that a *member* will take on the role of *attest client* management or otherwise assume management responsibilities for an *attest client*. Examples of management participation *threats* include the following:

- a. A *member* serves as an officer or a director of the *attest client*. [1.275.005]
- b. A *member* accepts responsibility for designing, implementing, or maintaining internal controls for the *attest client*. [1.295.030]
- c. A *member* hires, supervises, or terminates the *attest client's* employees. [1.295.135]

**.16 Self-interest threat.** The *threat* that a *member* could benefit, financially or otherwise, from an interest in, or relationship with, an *attest client* or persons associated with the *attest client*. Examples of self-interest *threats* include the following:

- a. A *member* has a *direct financial interest* or material *indirect financial interest* in the *attest client*. [1.240.010]
- b. A *member* has a *loan* from the *attest client*, an officer or a director of the *attest client*, or an individual who owns 10 percent or more of the *attest client's* outstanding equity securities. [1.260.010]
- c. A *member* or his or her *firm* relies excessively on revenue from a single *attest client*.
- d. A *member* or *member's firm* has a material joint venture or other material joint business arrangement with the *attest client*. [1.265]

**.17 Self-review threat.** The *threat* that a *member* will not appropriately evaluate the results of a previous judgment made, or service performed or supervised by the *member* or an individual in the *member's firm* and that the *member* will rely on that service in forming a judgment as part of an *attest engagement*. Certain self-review *threats*, such as preparing source documents used to generate the *attest client's financial statements* [1.295.120], pose such a significant self-review *threat* that no *safeguards* can eliminate or reduce the *threats* to an *acceptable level*.

**.18 Undue influence threat.** The *threat* that a *member* will subordinate his or her judgment to that of an individual associated with an *attest client* or any relevant third party due to that individual's reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the *member*. Examples of undue influence *threats* include the following:

- a. Management threatens to replace the *member* or *member's firm* over a disagreement on the application of an accounting principle.
- b. Management pressures the *member* to reduce necessary audit procedures in order to reduce audit fees.
- c. The *member* receives a gift from the *attest client*, its management, or its significant shareholders. [1.285.010]

## Safeguards

**.19 Safeguards** may partially or completely eliminate a *threat* or diminish the potential influence of a *threat*. The nature and extent of the *safeguards* applied will depend on many factors, including the size of the *firm* and whether the *attest client* is a *public interest entity*. To be effective, *safeguards* should eliminate the *threat* or reduce it to an *acceptable level*.

**.20** The following are three broad categories of *safeguards*:

- a. *Safeguards* created by the profession, legislation, or regulation.
- b. *Safeguards* implemented by the *attest client*. It is not possible to rely solely on *safeguards* implemented by the *attest client* to eliminate or reduce significant *threats* to an *acceptable level*.
- c. *Safeguards* implemented by the *firm*, including policies and procedures to implement professional and regulatory requirements.

**.21** The effectiveness of a *safeguard* depends on many factors, including those listed here:

- a. The facts and circumstances specific to a particular situation
- b. The proper identification of *threats*
- c. Whether the *safeguard* is suitably designed to meet its objectives
- d. The party(ies) that will be subject to the *safeguard*
- e. How the *safeguard* is applied
- f. The consistency with which the *safeguard* is applied
- g. Who applies the *safeguard*
- h. How the *safeguard* interacts with a *safeguard* from another category
- i. Whether the *attest client* is a *public interest entity*

**.22** Examples of various *safeguards* within each category are presented in paragraphs .21–.23 of the "Conceptual Framework for Members in Public Practice" [1.000.010]. The examples presented in these paragraphs are not intended to be all inclusive. In addition, *threats* may be sufficiently mitigated through the application of other *safeguards* not specifically identified in these paragraphs. [Prior reference: ET section 100-1]

### **Effective Date**

**.23** The addition of *partner equivalents* to paragraph .14b is effective for engagements covering periods beginning on or after December 15, 2014.

## **1.220 Accounting Firms**

A nonauthoritative question and answer regarding letter of intent to purchase practice is available in the Ethics FAQ at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf).

### **1.220.010 Network and Network Firms**

#### **General**

**.01** To enhance their capabilities to provide *professional services*, *firms* frequently join larger groups, which typically are membership associations that are separate legal entities and otherwise unrelated to their members. The associations facilitate their members' use of association services and resources. They do not themselves typically engage in *public practice* or provide *professional services* to their members' *clients* or other third parties.

**.02** *Firms* and other entities in the association cooperate with the *firms* and other entities that are members of the association to enhance their capabilities to provide *professional services*. For example, a *firm* may become a member of an association in order to refer work to, or receive referrals from, other association members. That characteristic alone would not be sufficient for the association to constitute a *network* or for the *firm* to be considered a *network firm*.

**.03** However, an association would be considered a *network* if, in addition to cooperation among member *firms* and other entities to enhance their capabilities to provide *professional services*, member *firms* and other entities share one or more additional characteristics described in paragraphs .07–.18 of this section. If an association is considered a *network* and an entity is considered a *network firm* the classification should be applied consistently by all members of the association. When determining if one or more additional characteristics exist, *members* should give due consideration to what a reasonable and informed third party who is aware of the relevant information would be expected to conclude.

**.04** A *network firm* is required to comply with the "Independence Rule" [1.200.001] with respect to the *financial statement* audit and review *clients* of the other *network firms* if the use of the audit or review report for the *client* is not restricted, as defined by professional standards. For all other *attest clients*, the *covered member* should consider any *threats* that the *covered member* knows or has reason to believe may be created by another *network firm's* interests and relationships. If those *threats* are not at an *acceptable level*, the *covered member* should apply *safeguards* to eliminate the *threats* or reduce them to an *acceptable level*. If *safeguards* cannot be applied to eliminate or reduce the *threats* to an *acceptable level*, *independence* will be *impaired*. Entities within the *network* that meet the definition of a *network firm* are subject to the "Independence Rule."

**.05** The determination that a *firm* or other entity or an association of *firms* or other entities meets the definition of a *network firm* and *network* is solely for purposes of this interpretation and may not be used or relied upon in any other context. In particular, determining whether a *firm* or other entity is a *network firm* or whether an association of *firms* or other entities is a *network* for purposes of defining legal responsibilities from one *firm* to the other or to third parties is beyond the scope of this interpretation.

### **Characteristics of a Network**

**.06** When an association is formed for the purpose of cooperating to enhance the *firms'* capabilities to provide *professional services*, and one of the characteristics described in paragraphs .07–.18 of this section also applies, the association is considered to be a *network*.

**.07** *Sharing a common brand name*. This characteristic exists when the association's members or entities *controlled* by the association's members share the use of a common brand name or share common initials as part of the *firm* name.

**.08** A *firm* that does not use a common brand name as part of its *firm* name but makes reference in its stationery or promotional materials to being a member of an association of *firms* should carefully consider how it describes that membership and take steps to avoid the perception that it belongs to a *network*. The *firm* may wish to avoid such perception by clearly describing the nature of its membership in the association (for example, by stating on its stationery or promotional material that it is "an independently owned and operated member firm of XYZ Association").

**.09 *Sharing common control.*** This characteristic exists when entities within the association are under common *control* with other firms in the association through ownership, management, or other means (for example, by contract). However, compliance with association requirements as a condition of membership does not indicate that members are under common *control*; rather, it reflects the type of cooperation that is expected when an entity joins the association.

**.10 *Sharing profits or costs.*** This characteristic exists when entities within the association share profits or costs. Following are examples of profit and cost sharing that would not create a *network*:

- a. Sharing immaterial costs
- b. Sharing costs related to operating the association
- c. Sharing costs related to the development of audit methodologies, manuals, and training courses
- d. Arrangements between a *firm* and an otherwise unrelated entity to jointly provide a service or develop a product

**.11 *Sharing a common business strategy.*** This characteristic exists when entities within the association share a common business strategy. Sharing a common business strategy involves ongoing collaboration among the *firms* whereby the *firms* are responsible for implementing the association's strategy and held accountable for performance pursuant to that strategy. An entity's ability to pursue an alternative strategy may be limited by the common business strategy because, as a member, it must act in accordance with the common business strategy and, therefore, in the best interest of the association.

**.12** An entity is not considered to be a *network firm* merely because it cooperates with another entity solely to market *professional services* or responds jointly to a request for a proposal for the provision of a *professional service*.

**.13 *Sharing significant professional resources.*** This characteristic exists when entities within the association share a significant part of professional resources. *Members* should consider both qualitative and quantitative factors in determining whether the shared professional resources are significant.

**.14** Examples of professional resources include the following:

- a. Common systems that enable *firms* to exchange information, such as *client* data, billing, and time records
- b. *Partners* and staff
- c. Technical departments to consult on technical or industry-specific issues, transactions, or events for assurance engagements
- d. Audit methodology or audit manuals
- e. Training courses and facilities

**.15** When shared professional resources involve the exchange of *client* information or personnel, such as when staff are drawn from a shared pool or a common technical department is created within the association to provide participating *firms* with technical advice that the *firms* are required to follow, a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the shared professional resources are significant.

**.16** When the entities within the association do not share a significant amount of human resources (for example, a *firm* occasionally uses personnel of another member *firm* to assist with an engagement, such as observing a *client's* physical inventory count) or significant *client* information (for example,

*client* data, billing, and time records) and have the ability to make independent decisions regarding technical matters, audit methodology, training, and the like, the entities are not considered to be sharing a significant part of professional resources.

**.17** When the shared professional resources are limited to a common audit methodology, audit manuals, training courses, or facilities and do not include a significant amount of human resources or *clients* or markets, the shared professional resources are not considered significant.

**.18** *Sharing common quality control policies and procedures.* This characteristic exists when entities within the association are required to follow common quality control policies and procedures that the association monitors. Monitoring is the ongoing consideration and evaluation of the *firms'* systems of quality control, which enables the association to obtain reasonable assurance that the *firms'* systems of quality control are designed appropriately and operating effectively.

**.19** Refer to paragraph .03*d* of the "Application of the AICPA Code" [0.200.020] for additional guidance. [Prior reference: paragraph .19 of ET section 101]

Nonauthoritative implementation guidance can be found at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-Division-Network-Firm-Implementation-Guidance.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-Division-Network-Firm-Implementation-Guidance.pdf).

Nonauthoritative frequently asked questions (FAQ) and case studies can be found at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NetworkFirmFAQandCaseStudies.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NetworkFirmFAQandCaseStudies.pdf)

### **1.220.020 Alternative Practice Structures**

**.01** *Members* practicing public accounting in nontraditional practice structures (alternative practice structures [APS]) should apply this interpretation to determine whether they are in compliance with the "Independence Rule" [1.200.001].

**.02** All such structures must be organized in a form that complies with applicable laws, rules, and regulations, the "Form of Organization and Name Rule" [1.800.001] and the related "Alternative Practice Structures" interpretation [1.810.050] of the "Form of Organization and Name Rule."

**.03** For example, in an APS, a substantial piece of the nonattest portion of a *member's* practice may be conducted under public or private ownership, and the attest portion of the practice may be conducted through a separate *firm* that the *member* owns and *controls*.

#### **Terminology**

**.04** The following terms are defined solely for the purpose of applying this interpretation:

- a.* APS is a form of organization in which a *firm* that provides attest services is closely aligned with another public or private organization that performs other *professional services*.
- b.* A covered member includes both employed and leased individuals who meet the definition of a *covered member*.

- c. The term direct superiors includes those persons so closely associated with a *partner* or *manager* who is a covered member that such persons can directly control the *partner's* or *manager's* activities. 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. An example is 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 so closely aligned through direct reporting relationships that their interests seem to be inseparable.
- d. Indirect superiors are not connected with *partners* and *managers* who are covered members through direct reporting relationships; rather, they are one or more levels above direct superiors of covered members (that is, there always is a level in between). Generally, this starts with persons in an organization structure to whom direct superiors report and go up the line from there. Indirect superiors also include the *immediate family* of indirect superiors.
- e. Other public company entities include the public company and all entities consolidated in the public company *financial statements* that are not subject to the "Independence Rule" [1.200.001] and its *interpretations* in their entirety.
- f. Significant influence is having the ability to exercise significant influence over the financial, operating, or accounting policies of the entity by, for example
  - i. being connected with the entity as a promoter, an underwriter, a voting trustee, a general partner, or a director;
  - ii. being in a policy-making position, such as chief executive officer, chief operating officer, chief financial officer, or chief accounting officer; or
  - iii. meeting the criteria in Financial Accounting Standards Board (FASB) *Accounting Standards Codification (ASC)* 323-10-15 to determine the ability of an investor to exercise such influence with respect to an entity.

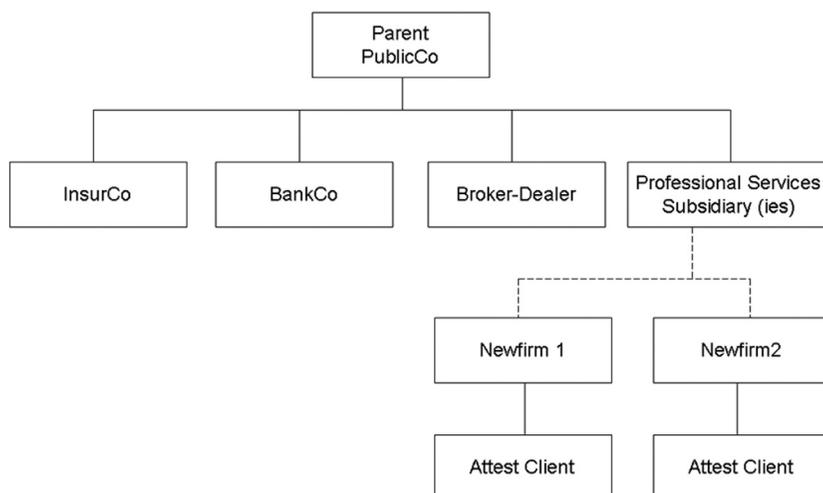
### **APS Model**

.05 The APS described in paragraphs .06–.07 in this section and the related chart provides an example of a structure in use at the time that this interpretation was developed. Many of the references in this interpretation are to the example, but *members* should apply the concepts in spirit and substance to variations of the example structure as they develop.

.06 The example APS in this interpretation is one in which 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, an insurance company, or a broker-dealer. It also has one or more professional service subsidiaries (PSS) or divisions that offer nonattest services (for example, tax, personal financial planning, and management consulting) to *clients*. 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, in-

cluding the former owners of Oldfirm, own a majority of Newfirm (with regard to voting and financial interests). Attest services are performed by Newfirm and 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.

**.07** The chief executive of the local office of the PSS where the *partners* of Newfirm are employed would be a direct superior. The chief executive of the 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.



### Interpretation

**.08** The "Independence Rule" [1.200.001] and *interpretations* normally extend only to those persons and entities included in the definition of *covered members*. However, in an APS environment, the self-interest, management participation, self-review, advocacy, or undue influence *threats* to a covered member's compliance with the "Independence Rule" may not be at an *acceptable level* unless certain *safeguards* are implemented by other individuals or entities.

**.09** *Threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level*, could not be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired* when the following individuals or entities fail to apply the "Independence Rule" and *interpretations* with respect to *attest clients* of Newfirm:

- a. Covered members of Newfirm
- b. Direct superiors of any *partner* or *manager* who is a covered member of Newfirm and entities within the APS over which such individuals can exercise *significant influence*

**.10** In addition, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level*, could not be reduced to an

*acceptable level* by the application of *safeguards*, and *independence* would be *impaired* in the following circumstances:

- a. Indirect superiors and other public company entities have a material relationship with an *attest client* of Newfirm that is prohibited by the "Overview of Financial Interests" interpretation [1.240.010], the "Trustee or Executor" interpretation [1.245.010], the "Loans" interpretation [1.260.010], or the "Joint Closely Held Investments" interpretation [1.265.020] of the "Independence Rule" (for example, investments, *loans*, and so on). In making the test for materiality for financial relationships of an indirect superior, all the financial relationships with an *attest client* held by that 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 public company 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.
- b. Any other public company entity over which an indirect superior has direct responsibility has a financial relationship with an *attest client* during the *period of the professional engagement* that is material in relation to the other public company entity's *financial statements*.
- c. Financial relationships of indirect superiors or other public company entities allow such persons or entities to exercise significant influence over the *attest client* during the *period of the professional engagement*. In making the test for significant influence, financial relationships of all indirect superiors and other public company entities should be aggregated.
- d. Other public company entities or any of their employees are connected with an *attest client* of Newfirm as a promoter, an underwriter, a voting trustee, a director, or an officer during the *period of the professional engagement* or during the period covered by the *financial statements*.

.11 Indirect superiors and other public company entities may provide services to an *attest client* of Newfirm that would *impair independence* if performed by Newfirm, except as noted in paragraph .10d.

.12 When Newfirm and its *partners* and professional employees perform *attest engagements* for PublicCo or any of its subsidiaries or divisions, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* through the application of *safeguards*. Accordingly, *independence* would be *impaired*.

.13 If an *attest client* of Newfirm holds an investment in PublicCo that is material to the *attest client* or that allows the *attest client* to exercise significant influence over PublicCo during the *period of the professional engagement*, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* through the application of *safeguards*. Accordingly, *independence* would be *impaired*.

.14 When making referrals of services between Newfirm and any of the entities within PublicCo, a *member* should consider the provisions of the "Conflicts of Interest" interpretation [1.110.010] of the "Integrity and Objectivity Rule" [1.100.001] and the "Alternative Practice Structures" interpretation [1.810.050]

of the "Form of Organization and Name Rule" [1.800.001]. [Prior reference: paragraph .16 of ET section 101]

### **1.220.030 Use of a Nonindependent CPA Firm on an Engagement**

.01 If *partners* or professional employees from another *firm* that was not independent of an *attest client* participate on the *attest engagement team*, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* through the application of *safeguards*. Accordingly, the *firm's independence* would be *impaired*.

.02 However, the *firm* may use the work of such individuals in a manner similar to internal auditors, provided that the *firm* complies with AU-C section 610, *Using the Work of Internal Auditors* (AICPA, *Professional Standards*). [Prior reference: paragraphs .142–.143 of ET section 191]

## **1.224 Affiliates, Including Governmental Units**

### **1.224.010 Client Affiliates**

.01 *Financial interests* in, and other relationships with, *affiliates* of a *financial statement attest client* may create *threats* to a *member's* compliance with the "Independence Rule" [1.200.001].

.02 When a *client* is a *financial statement attest client*, *members* should apply the "Independence Rule" [1.200.001] and related *interpretations* applicable to the *financial statement attest client* to their *affiliates*, except in the following situations:

- a. A *covered member* may have a *loan* to or from an individual who is an officer, a director, or a 10 percent or more owner of an *affiliate* of a *financial statement attest client* during the *period of the professional engagement* unless the *covered member* knows or has reason to believe that the individual is in such a position with the *affiliate*. If the *covered member* knows or has reason to believe that the individual is an officer, a director, or a 10 percent or more owner of the *affiliate*, the *covered member* should evaluate the effect that the relationship would have on the *covered member's independence* by applying the "Conceptual Framework for Independence" [1.210.010].
- b. A *member* or the *member's firm* may provide prohibited nonattest services to entities described under items *c–j* of the definition of *affiliate* during the *period of the professional engagement* or during the period covered by the *financial statements*, provided that it is reasonable to conclude that the services do not create a self-review *threat* with respect to the *financial statement attest client* because the results of the nonattest services will not be subject to *financial statement attest* procedures. For any other *threats* that are created by the provision of the nonattest services that are not at an *acceptable level* (in particular, those relating to management participation), the *member* should apply *safeguards* to eliminate or reduce the *threats* to an *acceptable level*.
- c. A *firm* will only have to apply the "Subsequent Employment or Association With an Attest Client" interpretation [1.279.020] of the "Independence Rule" if the former employee, by virtue of his or her employment at an entity described under items *c–j* of the

definition of *affiliate*, is in a *key position* with respect to the *financial statement attest client*. Individuals in a position to influence the *attest engagement* and on the *attest engagement team* who are considering employment with an *affiliate* of a *financial statement attest client* will still need to report consideration of employment to an appropriate person in the *firm* and remove themselves from the *financial statement attest engagement*, even if the position with the *affiliate* is not a *key position*.

- d. A *covered member's immediate family members* and *close relatives* may be employed in a *key position* at an entity described under items c–j of the definition of *affiliate* during the *period of the professional engagement* or during the period covered by the *financial statements*, provided they are not in a *key position* with respect to the *financial statement attest client*.

**.03** A *member* must expend best efforts to obtain the information necessary to identify the *affiliates* of a *financial statement attest client*. If, after expending best efforts, a *member* is unable to obtain the information to determine which entities are *affiliates* of a *financial statement attest client*, *threats* would be at an *acceptable level* and *independence* would not be *impaired* if the *member* (a) discusses the matter, including the potential impact on *independence*, with those *charged with governance*; (b) documents the results of that discussion and the efforts taken to obtain the information; and (c) obtains written assurance from the *financial statement attest client* that it is unable to provide the *member* with the information necessary to identify the *affiliates* of the *financial statement attest client*.

**.04** This interpretation does not apply to a *financial statement attest client* that is covered by the "Entities Included in State and Local Government Financial Statements" interpretation [1.224.020] of the "Independence Rule" [1.200.001]. [Prior reference: paragraph .20 of ET section 101]

### **Acquisitions and Other Business Combinations That Involve a Financial Statement Attest Client**

**.05** The exception in paragraph .06 would apply when (1) a *financial statement attest client* is acquired during the *period of the professional engagement* by either a non-client or a nonattest client (acquirer), (2) the *attest engagement* covers only periods prior to the acquisition, and (3) the *member* or *member's firm* will not continue to provide *financial statement attest services* to the acquirer.

**.06** *Independence* will not be considered *impaired* with respect to the *financial statement attest client* because a *member* or *member's firm* has an interest in or relationship with the acquirer that may otherwise *impair independence* as a result of the requirements of this interpretation or the definition of "*attest client*" (as it relates to the entity or person that engages the *member* or *member's firm* to perform the *attest engagement*).

**.07** Notwithstanding paragraph .06, a *member* should give consideration to the requirements of the "Conflicts of Interest" interpretation [1.110.010], under the "Integrity and Objectivity Rule" [1.100.001], with regard to any relationships that the *member* knows or has reason to believe exist with the acquirer, the *financial statement attest client*, or the *firm*.

**.08** A *member* should refer to paragraph .03 of "Application of the AICPA Code" [0.200.020] for guidance on circumstances involving foreign network firms.

**Effective Date**

.09 Paragraphs .01–.04 are effective for engagements covering periods beginning on or after January 1, 2014. Early implementation is allowed.

[See Revision History Table.]

Nonauthoritative questions and answers regarding the application of the independence rules to affiliates of employee benefit plans are available at <http://aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/FAQsOnApplicationOfTheIndependenceRulesToAffiliatesOfEmployeeBenefitPlans.pdf>.

**1.224.020 Entities Included in State and Local Government Financial Statements**

.01 For purposes of this interpretation, a financial reporting entity's basic *financial statements* issued in conformity with generally accepted accounting principles (GAAP) include the following:

- a. The government-wide *financial statements* (consisting of the entity's governmental activities, business-type activities, and discretely presented component units)
- b. The fund *financial statements* (consisting of major funds, nonmajor governmental and enterprise funds, internal service funds, blended component units, and fiduciary funds)
- c. Other entities disclosed in the notes to the basic *financial statements*. Examples of other entities that should be disclosed include the following:
  - i. Related organizations
  - ii. Joint ventures
  - iii. Jointly governed organizations
  - iv. Component units of another government with characteristics of a joint venture or jointly governed organization

.02 Certain terminology used in this interpretation is specifically defined by the Governmental Accounting Standards Board (GASB).

.03 When a *covered member* audits the basic *financial statements* of a financial reporting entity or the *financial statements* of a major fund, a nonmajor fund, an internal service fund, a fiduciary fund, or a component unit of the financial reporting entity or other entity that should be disclosed in the notes to the basic *financial statements*, the *covered member* must be independent of the entity, fund, or component unit that the *covered member* is auditing, as discussed in this interpretation.

**Auditor of the Financial Reporting Entity**

.04 When a *covered member* audits the basic *financial statements* of the financial reporting entity, the *covered member* must also be independent of any major or nonmajor fund, internal service fund, fiduciary fund, or component unit or other entities disclosed in the basic *financial statements* unless the primary auditor explicitly states reliance on other auditors' reports.

**.05** *Independence* is not required with respect to an entity disclosed in the notes to the basic *financial statements* if the financial reporting entity is not financially accountable for the entity and the required disclosure does not include financial information. For example, a disclosure limited to the financial reporting entity's ability to appoint the governing board members would not require the *covered member* to be independent of that entity.

**.06** Regardless of the exceptions in paragraph .05, if a *covered member* or a *covered member's immediate family* holds a *key position* in any of the following entities during the *period of the professional engagement* or during the period covered by the *financial statements*, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* and the *covered member's independence* would be *impaired*:

- a. Major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity
- b. Other entity that should be disclosed in the notes to the basic *financial statements*

### **Auditor Does Not Audit the Primary Government**

**.07** When a *covered member* does not audit the primary government but audits the *financial statements* of the following entities, the *covered member* is not required to be independent of entities that the *covered member* does not audit:

- a. A major fund, a nonmajor fund, an internal service fund, a fiduciary fund, or a component unit of the financial reporting entity
- b. An entity that should be disclosed in the notes to the basic *financial statements* of the financial reporting entity

**.08** However, if a *covered member* or a *covered member's immediate family* holds a *key position* within the primary government during the *period of the professional engagement* or during the period covered by the *financial statements*, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, the *covered member's independence* would be *impaired*. For purposes of this interpretation, a *covered member* and the *covered member's immediate family* would not be considered employed by the primary government if the exceptions provided for in paragraph .07b of the "Client" definition [0.400.07] were met. [Prior reference: paragraph .12 of ET section 101]

## **1.226 Reissued Reports**

### **1.226.010 Consenting to the Use of a Previously Issued Report**

**.01** A *member* or *member's firm* who was in compliance with the "Independence Rule" [1.200.001] when initially issuing a report may reissue the previously issued report or consent to, or acknowledge the inclusion or incorporation by reference of, the report when the *member* or *member's firm's independence* is *impaired*, provided that the *member* or *member's firm* does not perform procedures that require updating the date or dual dating the report.

**.02** In order to consent to, or acknowledge the inclusion or incorporation by reference of, a previously issued report, the *member* or *member's firm* may perform procedures required by applicable professional standards when the *mem-*

*ber's or member's firm's independence is impaired.* Such procedures include making inquiries of successor auditors, reading the subsequent *financial statements*, or other procedures that the *member* believes are necessary to assess the effect of subsequently discovered facts on the *financial statements* covered by the previously issued report. [Prior reference: paragraphs .200–.201 of ET section 191]

## 1.228 Engagement Contractual Terms

### 1.228.010 Indemnification of a Covered Member

**.01** *Threats* to compliance with the "Independence Rule" [1.200.001] would be at an *acceptable level* and a *covered member's independence* would not be *impaired* if the *covered member* includes in engagement letters a clause that provides that its *attest client* would release, indemnify, defend, and hold the *covered member* (and the *covered member's partners*, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management. [Prior reference: paragraphs .188–.189 of ET section 191]

**.02** Refer to the "Indemnification and Limitation of Liability Provisions" interpretation [1.400.060] of the "Acts Discreditable Rule" [1.400.001].

### 1.228.020 Indemnification of an Attest Client

**.01** *Threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* if the *covered member* enters into an agreement providing, among other things, that the *covered member* indemnifies the *attest client* for damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or indirectly, to the *attest client's* acts. The *covered member's independence* would be *impaired* under these circumstances. [Prior reference: paragraphs .204–.205 of ET section 191]

### 1.228.030 Alternative Dispute Resolution

**.01** A *covered member* may include in an engagement letter a provision to use alternative dispute resolution (ADR) techniques to resolve disputes relating to past services (in lieu of litigation). *Threats* to compliance with the "Independence Rule" [1.200.001] would be at an *acceptable level* and *independence* would not be *impaired* because the *covered member* and *attest client* would not be in positions of material adverse interests due to threatened or actual litigation.

**.02** The *covered member* should exercise professional judgment when rendering current services, regardless of the existence of the provision. [Prior reference: paragraphs .190–.191 of ET section 191]

**.03** If ADR techniques are initiated to resolve a dispute with the *attest client*, *threats* to compliance with the "Independence Rule" [1.200.001] would be at an *acceptable level* when the ADR techniques are designed to facilitate negotiation, and the conduct of those negotiations does not place the *covered member* and the *attest client* in positions of material adverse interests. *Independence* would not be *impaired* under these circumstances. If, however, the ADR proceedings are sufficiently similar to litigation (as in the case of binding arbitration), an adverse interest *threat* may exist and place the *covered member* and the *attest client* in a position of material adverse interests. Under such circumstances, the *member* should apply the guidance under the "Actual or

Threatened Litigation" interpretation [1.290.010] of the "Independence Rule." [Prior reference: paragraphs .192–.193 of ET section 191]

## 1.230 Fees

A nonauthoritative question and answer regarding *pro bono* and below cost fees is available in the Ethics FAQ at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf).

### 1.230.010 Unpaid Fees

**.01** The existence of unpaid fees to a *covered member* for *professional services* previously rendered to an *attest client* may create self-interest, undue influence, or advocacy *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001].

**.02** *Threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* if a *covered member* has unpaid fees from an *attest client* for any previously rendered *professional service* provided more than one year prior to the date of the current-year report. Accordingly, *independence* would be *impaired*. Unpaid fees include fees that are unbilled or a note receivable arising from such fees.

**.03** This interpretation does not apply to fees outstanding from an *attest client* in bankruptcy. [Prior reference: paragraphs .103–.104 of ET section 191]

**.04** Refer to the "Fees and Other Types of Remuneration" topic [1.500] for additional guidance.

### 1.230.020 Fees and Other Types of Remuneration

**.01** See the "Fees and Other Types of Remuneration" topic [1.500] for guidance on contingent fees, commissions, and referral fees. [No prior reference: new content]

#### **Effective Date**

**.02** Effective December 15, 2014.

## 1.240 Financial Interests

### 1.240.010 Overview of Financial Interests

**.01** If a *covered member* had or was committed to acquire any material *indirect financial interest* in an *attest client* during the *period of the professional engagement*, the self-interest *threat* to the *covered member's* compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*. [Prior reference: paragraphs .02A(1) and .17 of ET section 101]

**.02** If a *covered member* had or was committed to acquire any material *indirect financial interest* in an *attest client* during the *period of the professional*

*engagement*, the self-interest *threat* to the *covered member's* compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*. [Prior reference: paragraphs .02A(1) and .17 of ET section 101]

.03 If a *partner* or professional employee of the *firm*, his or her *immediate family*, or any group of such persons acting together owned more than 5 percent of an *attest client's* outstanding equity securities or other ownership interests during the *period of the professional engagement*, the self-interest *threat* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*. [Prior reference: paragraph .02B of ET section 101]

.04 Refer to the "Joint Closely Held Investments" interpretation [1.265.020] for additional guidance.

## 1.240.020 Unsolicited Financial Interests

.01 When a *covered member* becomes aware that he or she will receive, or has received, an unsolicited *financial interest* in an *attest client* during the *period of the professional engagement*, such as through a gift or an inheritance, the self-interest *threat* would be at an *acceptable level* and *independence* would not be *impaired* if both of the following *safeguards* are met:

- a. The *covered member* disposes of the *financial interest* as soon as practicable but no later than 30 days after the *covered member* has knowledge of and obtains the right to dispose of the *financial interest*.
- b. During the period in which the *covered member* does not have the right to dispose of the *financial interest*, the *covered member* does not participate on the *attest engagement team*, and the *direct financial interest* or *indirect financial interest* is not material to the *covered member*. [Prior reference: paragraph .17 of ET section 101]

## 1.240.030 Mutual Funds

.01 A *covered member* who owns shares in a mutual fund has a *direct financial interest* in the mutual fund. However, whether the underlying investments in the mutual fund are considered to be the *covered member's direct financial interests* or *indirect financial interests* depends on the proportion of the mutual fund's outstanding shares that the *covered member* owns and whether the mutual fund is diversified.

.02 If a *covered member* owns 5 percent or less of the outstanding shares of a diversified mutual fund, the underlying investments would be considered immaterial *indirect financial interests*. Accordingly, the self-interest *threat* would be at an *acceptable level*, and *independence* would not be *impaired*. To determine if the mutual fund is diversified, the *covered member* should consider referring to (a) the mutual fund's prospectus for disclosure regarding fund management's determination regarding diversification and (b) Section 5(b)(1) of the Investment Company Act of 1940.

.03 If a *covered member* owns more than 5 percent of a diversified mutual fund's outstanding shares, or if a *covered member* owns a *financial interest* in a nondiversified mutual fund, the *covered member* should evaluate the mutual

fund's underlying investments to determine whether the *covered member* holds a material *indirect financial interest* in any of the underlying investments.

.04 The following example illustrates how to determine if the underlying investments are material to a *covered member's* net worth. If

- a nondiversified mutual fund owns shares in client company A,
- the mutual fund's net assets are \$10 million,
- the *covered member* owns 1 percent of the outstanding shares of the mutual fund, having a value of \$100,000, and
- the mutual fund has 10 percent of its assets invested in company A,

then the *covered member's indirect financial interest* in company A is \$10,000 (\$100,000 10%). The *covered member* would then compare the \$10,000 *indirect financial interest* with his or her net worth, including the net worth of his or her *immediate family*, to determine if the *indirect financial interest* in company A is material. [Prior reference: paragraph .17 of ET section 101]

### **1.240.040 Retirement, Savings, Compensation, or Similar Plans**

.01 Depending upon the facts and circumstances, *financial interests* held in a retirement, savings, compensation, or similar plan are either *direct financial interests* or *indirect financial interests*.

.02 Investments held by a retirement, savings, compensation, or similar plan sponsored by a *firm* are *direct financial interests* of the *firm*.

.03 If a *covered member* or his or her *immediate family* self-directs the investments in a retirement, savings, compensation, or similar plan or has the ability to supervise or participate in the plan's investment decisions, the *financial interests* held by the plan are *direct financial interests* of the *covered member*. For example,

- a. when a *covered member* or his or her *immediate family* member is a trustee of a retirement, savings, compensation, or similar plan or otherwise has the authority to supervise or participate in the plan's investment decisions (including through the selection of investment managers or pooled investment vehicles), the underlying investments are *direct financial interests* of the *covered member*.
- b. for self-directed or participant-directed plans (that is, the *covered member* or his or her *immediate family* member selects the underlying plan investments or selects from investment alternatives offered by the plan), the underlying investments are *direct financial interests* of the *covered member*.

.04 When the *covered member* or his or her *immediate family* do not participate in a self-directed or participant-directed plan and have no authority to supervise or participate in the plan's investment decisions, the underlying investments would be considered to be *indirect financial interests* of the *covered member*.

.05 *Financial interests* held by a defined benefit plan are not considered *financial interests* of the *covered member* unless the *covered member* or his or her *immediate family* member is a trustee of the plan or otherwise has the ability to supervise or participate in the plan's investment decisions.

.06 Allocated shares held in an employee stock ownership plan (ESOP) are considered *beneficially owned* by the *covered member*. Until the *covered member*

or his or her *immediate family* member has the right to dispose of the allocated shares of the ESOP, the beneficial ownership is considered an *indirect financial interest*. Once the participant has the right to dispose of the *financial interests*, the *financial interests* are *direct financial interests* of the *covered member*.

**.07** Rights to acquire equity interests, restricted stock awards, or other *share-based compensation arrangements* are considered the *direct financial interests* of the *covered member*, regardless of whether such *financial interests* are vested or exercisable.

**.08** See the "Plan Is an Attest Client or Is Sponsored by an Attest Client" interpretation [1.250.010] and the "Former Employment or Association With an Attest Client" interpretation [1.277.010] of the "Independence Rule" [1.200.001] and the interpretations of the "Family Relationships With Attest Clients" subtopic [1.270] under the "Independence Rule." [Prior reference: paragraph .17 of ET section 101]

### 1.240.050 Partnerships

**.01** When used in this interpretation, control includes situations in which the *covered member* has the ability to exercise such control, either individually or acting together with his or her *firm* or other *partners* or professional employees of his or her *firm*.

**.02** The ownership of a general or limited partnership interest is considered a *direct financial interest* in the partnership.

**.03** *General partner*. If the *covered member* is a general partner, the *financial interests* held by a partnership are a *covered member's direct financial interests* because the *covered member* is in a position to control the partnership or supervise or participate in the partnership's investment decisions.

**.04** *Limited partner*. If the *covered member* is a limited partner, the *financial interests* held by a limited partnership are a *covered member's indirect financial interests* as long as the *covered member* does not control the partnership or supervise or participate in the partnership's investment decisions. However, if the *covered member* has the ability to replace the general partner or has the authority to supervise or participate in the partnership's investment decisions, the partnership's *financial interests* would be the *covered member's direct financial interests*.

**.05** Refer to the "Client Affiliates" interpretation [1.224.010] [1.200.001] and the "Joint Closely Held Investments" interpretation [1.265.020] of the "Independence Rule" for additional guidance. [Prior reference: paragraph .17 of ET section 101]

### 1.240.060 Limited Liability Companies

**.01** When used in this interpretation, control includes situations in which the *covered member* has the ability to exercise such control, either individually or acting together with his or her *firm* or other *partners* or professional employees of his or her *firm*.

**.02** Ownership of an interest in a limited liability company (LLC) is a *direct financial interest* in the LLC.

**.03** In an LLC, managing members control the LLC and have the authority to supervise or participate in the LLC's investment decisions. Accordingly, if a *covered member* is a manager of the LLC, the *financial interests* of the LLC are the *covered member's direct financial interests*. When a *covered member* is not a managing member of the LLC, the *covered member* should review the LLC's

operating agreement to determine whether he or she can control the LLC or has the authority to supervise or participate in the LLC's investment decisions. In situations in which the *covered member* does not control the LLC and does not have the authority to supervise or participate in the LLC's investment decisions, the *financial interests* held by the LLC are the *covered member's indirect financial interests*. [Prior reference: paragraph .17 of ET section 101]

### **1.240.070 Section 529 Plans**

**.01** Section 529 plans are sponsored by states or higher education institutions and may be prepaid tuition plans or savings plans. An account owner establishes both types of plans for the benefit of a single beneficiary. The account owner may change the beneficiary at any time to another individual who is a relative of the previous beneficiary.

**.02** *Prepaid tuition plan.* A *covered member* who is the account owner of a Section 529 prepaid tuition plan is considered to have a *direct financial interest* in the plan. The account owner does not have any *financial interests* in the plan's underlying investments because the credits purchased represent an obligation of the state or educational institution to provide the education regardless of the plan's investment performance or the cost of the education at the future date.

**.03** *Savings plan.* A *covered member* who is the account owner of a Section 529 savings plan is considered to have a *direct financial interest* in both the plan and the plan's underlying investments because the account owner elects which sponsor's Section 529 savings plan to invest in, and prior to making the investment decision, the *covered member* has access to information about the plan's investment options or funds. However, if the Section 529 savings plan does not hold *financial interests* in an *attest client* at the time of the investment but the plan subsequently invests in that *attest client*, the financial interest *threat* would be at an *acceptable level* and *independence* would not be *impaired* if the *covered member* applies both of the following *safeguards*:

- a. The *covered member* transfers the account to another sponsor's Section 529 savings plan.
- b. The *covered member* transfers the account to another account owner who is not a *covered member*.

When the transfer of the account will result in a penalty or tax that is significant to the account, the *covered member* may continue to own the account until the account can be transferred without significant penalty or tax, provided that the *covered member* does not participate on the *attest engagement team* and is not an *individual in a position to influence the attest engagement*.

**.04** *Beneficiary of Section 529 account.* A *covered member* who is a beneficiary of a Section 529 account is not considered to have a *financial interest* in the plan or the plan's underlying investments because the *covered member* does not own the account or possess any of the underlying benefits of ownership. The beneficiary's only interest is to receive distributions from the account for qualified higher education expenses if and when they are authorized by the account owner.

**.05** *Government or governmental entity sponsors Section 529 plan.* Before becoming engaged to perform an *attest engagement* for a government or governmental entity that sponsors a Section 529 plan, *covered members* who are account owners of a Section 529 plan should consider the guidance in the "Entities Included in State and Local Government Financial Statements" interpretation [1.224.020]. [Prior reference: paragraph .17 of ET section 101]

## 1.245 Trusts and Estates

### 1.245.010 Trustee or Executor

.01 The designation of a *covered member* to serve as a trustee of a trust or an executor or administrator of an estate that held, or was committed to acquire, any *direct financial interest* or any material *indirect financial interest* in an *attest client* during the *period of the professional engagement* does not in itself create a self-interest *threat* to the *covered member's* compliance with the "Independence Rule" [1.200.001]. [Prior reference: paragraphs .021–.022 of ET section 191]

.02 However, when the *covered member* serves as the trustee or executor during the *period of the professional engagement*, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* if

- a. the *covered member* (individually or with others) has the authority to make investment decisions for the trust or estate,
- b. the trust or estate owned or was committed to acquire more than 10 percent of the *attest client's* outstanding equity securities or other ownership interests, or
- c. the value of the trust's or estate's holdings in the *attest client* exceeds 10 percent of the total assets of the trust or estate.

Accordingly, in these situations, *independence* would be *impaired*. [Prior reference: paragraph .02A(2) of ET section 101]

### 1.245.020 Trust Investments

.01 When used in this interpretation, control includes situations in which the *covered member* has the ability to exercise such control, either individually or acting together with his or her *firm* or other *partners* or professional employees of his or her *firm*.

.02 When a *covered member* is a grantor of a trust, including a blind trust, the trust and its underlying investments are considered to be the *covered member's direct financial interest* if any of the following rights or responsibilities exist:

- a. The *covered member* has the ability to amend or revoke the trust.
- b. The *covered member* has authority to control the trust.
- c. The *covered member* has ability to supervise or participate in the trust's investment decisions.
- d. The underlying trust investments will ultimately revert to the *covered member* as the grantor of the trust.

However, the trust and the trust's underlying investments are not considered to be *financial interests* of a *covered member* if the *covered member* is the grantor of the trust and the *covered member* does not have any of the rights or responsibilities in items a–d.

.03 When a *covered member* is only a beneficiary of a trust and does not have any of the rights or responsibilities noted in paragraph .02, the trust is considered to be the *direct financial interest* of the *covered member*, and the trust's underlying investments are considered to be *indirect financial interests* of the *covered member*. [Prior reference: paragraph .17 of ET section 101]

**Effective Date**

.04 This revised interpretation is effective December 15, 2014.

A nonauthoritative question and answer regarding the use of blind trusts is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf).

**1.250 Participation in Employee Benefit Plans****1.250.010 Plan Is an Attest Client or Is Sponsored by an Attest Client**

.01 When a *covered member* participates in an employee benefit plan that is an *attest client* or is sponsored by an *attest client*, during the *period of the professional engagement* or during the period covered by the *financial statements*, the self-interest *threat* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level*. *Independence* with respect to the employee benefit plan and the sponsor would be *impaired* except in the following specific situations:

- a. *Governmental organization*. When a *covered member* is an employee of a governmental organization that sponsors, cosponsors, or participates with other governmental organizations in a public employee retirement plan (the plan) and the *covered member* is required by law, rule, or regulation to audit the plan, *threats to independence* would be at an *acceptable level* if all of the following *safeguards* are met:
  - i. The *covered member* is required to participate in the plan as a condition of employment.
  - ii. The plan is offered to all employees in comparable employment positions.
  - iii. The *covered member* is not associated with the plan in any capacity prohibited by the "Simultaneous Employment or Association With an Attest Client" interpretation [1.275.005] of the "Independence Rule."
  - iv. The *covered member* has no influence or control over the investment strategy, benefits, or other management activities associated with the plan.
- b. *Former employment or association with the attest client*. The requirements of paragraph .04 of the "Former Employment or Association With an Attest Client" interpretation [1.277.010] must be met. [Prior reference: paragraphs .214–.215 of ET section 191]

.02 When an *immediate family member* participates as a result of his or her employment, in an employee benefit plan that is an *attest client* or is sponsored by an *attest client*, the requirements of the "Immediate Family Member Participation in an Employee Benefit Plan That Is an Attest Client or Is Sponsored by an Attest Client (Other Than Certain Share-Based Arrangements or Nonqualified Deferred Compensation Plans)" interpretation [1.270.030] of the "Independence Rule" [1.200.001] must be met. [Prior reference: paragraph .17 of ET section 101]

### **1.250.020 Former Partners and Professional Employees Participation in a Firm-Sponsored Plan**

.01 When *partners* and professional employees leave a *firm* and are subsequently employed by, or associated with, an *attest client* of the *firm* in a *key position*, the requirements of paragraph .02a–c of the "Subsequent Employment or Association With an Attest Client" interpretation [1.279.020] must be met to reduce the familiarity, self-interest, or management participation *threats* to an *acceptable level*. [Prior reference: paragraph .04 of ET section 101]

## **1.255 Depository, Brokerage, and Other Accounts**

### **1.255.010 Depository Accounts**

.01 If a *covered member* maintains checking, savings, certificates of deposit, money market, or other depository accounts (depository accounts) at a bank or similar depository institution that is an *attest client* during the *period of the professional engagement*, a self-interest *threat* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist. For specific guidance applicable to any other types of custodial accounts (for example, brokerage accounts), see the "Brokerage and Other Accounts" interpretation [1.255.020] of the "Independence Rule."

.02 When the *covered member* is a *firm*, the *threat* would be at an *acceptable level*, and *independence* would not be *impaired* if the *firm* concludes that the likelihood is remote that the bank or similar depository institution will experience financial difficulties.

.03 When the *covered member* is an individual, the *threat* would be at an *acceptable level*, and *independence* would not be *impaired* if

- a. the balance in the depository account(s) is fully insured by the appropriate state or federal government deposit insurance agencies or by any other insurer, or
- b. any uninsured amounts, in the aggregate, were not material to the *covered member's* net worth, or
- c. if uninsured amounts were considered material, any uninsured amounts, in the aggregate, are reduced to an immaterial amount no later than 30 days from the date that the uninsured amount becomes material to the *covered member's* net worth.

.04 Refer to the "Member of a Credit Union" interpretation [1.280.040] of the "Independence Rule" [1.200.001] for additional guidance. [Prior reference: paragraphs .140–.141 of ET section 191]

### **1.255.020 Brokerage and Other Accounts**

.01 If an *attest client* in the financial services industry, such as an insurance company, an investment adviser, a broker-dealer, a bank, or similar depository institution, has custody of a *covered member's* assets other than depository accounts, including retirement plan assets, during the *period of the professional engagement*, a self-interest *threat* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist. For specific guidance applicable to depository accounts held at a bank or similar depository institution, see the "Depository Accounts" interpretation [1.255.010] of the "Independence Rule."

.02 *Threats* would not be at an *acceptable level* and *independence* would be *impaired* unless the following safeguards are met

- a. The *attest client's* services were rendered under the *attest client's* normal terms, procedures, and requirements.
- b. Any *covered member's* assets subject to the risk of loss are immaterial to the *covered member's* net worth.

**.03** In determining if there is a risk of loss, the *covered member* should consider losses arising from the *attest client's* insolvency, bankruptcy, or acts of fraud or other illegal acts but should not consider potential losses arising from a market decline in the value of the assets.

**.04** When considering the materiality of assets subject to the risk of loss, the *covered member* should consider the following:

- a. Protection that state or federal regulators provide for the assets, such as state insurance funds
- b. Private insurance or other forms of protection that the financial services company obtains to protect its customers' assets, such as coverage by the Securities Investor Protection Corporation
- c. Protection from creditors, such as assets held in a pooled separate account or separate escrow accounts [Prior reference: paragraphs .081–.082 of ET section 191]

## 1.257 Insurance Products

### 1.257.010 Insurance Policies With No Investment Option

**.01** An insurance policy obtained from a stock or mutual insurance company that does not offer the policy holder an investment option is not considered a *financial interest*.

**.02** If during the *period of the professional engagement*, a *covered member* owns an insurance policy with no investment option issued by an *attest client*, a self-interest *threat* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist. *Threats* would not be at an *acceptable level*, and could not be reduced to an *acceptable level* through the application of *safeguards*, if the *covered member* purchased the policy not under the normal terms, procedures, and requirements. Accordingly, *independence* would be *impaired*. [Prior reference: paragraph .17 of ET section 101]

### 1.257.020 Insurance Policies With Investment Options

**.01** If during the *period of the professional engagement* the *covered member* owns an insurance policy with investment options issued by an *attest client*, but the *covered member* did not purchase the policy under the insurance company's normal terms, procedures, and requirements, *threats* would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*.

**.02** When a *covered member* purchases an insurance policy, under the insurance company's normal terms, procedures, and requirements, which offers an investment option that allows the *covered member* to invest part of the policy's cash value in various investment products, the policy's underlying investments are considered to be *financial interests* of the *covered member*. Accordingly, a self-interest *threat* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist.

**.03** If the *covered member* has the ability to select the policy's underlying investments or the authority to supervise or participate in the investment decisions and the *covered member* invests in an *attest client* during the *period*

of the professional engagement, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired* because the investment would be considered a *direct financial interest*. For example, if the *covered member* invested the policy's cash value into a mutual fund that is an *attest client*, the investment in the mutual fund would be considered a *direct financial interest* and *independence* would be *impaired*. However, the mutual fund's underlying investments are considered to be *indirect financial interests*.

.04 Refer to the "Financial Interests" subtopic [1.240] and the "Joint Closely Held Investments" interpretation [1.265.020] of the "Independence Rule" [1.200.001] for additional guidance. [Prior reference: paragraph .17 of ET section 101]

### **1.257.030 Insurer Undergoes Demutualization**

.01 If a mutual insurance company begins demutualization, a *covered member* who holds an insurance policy from the insurer should apply the guidance in the "Unsolicited Financial Interests" interpretation [1.240.020] of the "Independence Rule" [1.200.001]. [Prior reference: paragraph .17 of ET section 101]

## **1.260 Loans, Leases, and Guarantees**

### **1.260.010 Loans**

.01 If a *covered member* has a *loan* to or from an *attest client*, any officer or director of the *attest client*, or any individual owning 10 percent or more of the *attest client's* outstanding equity securities or other ownership interests, a self-interest *threat* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist. *Threats* would not be at an *acceptable level* and *independence* would be *impaired* if the *loan* exists during the *period of the professional engagement*, except as provided for in the "Loans and Leases With Lending Institutions" interpretation [1.260.020] of the "Independence Rule." [Prior reference: paragraph .02A(4) of ET section 101]

### **1.260.020 Loans and Leases With Lending Institutions**

.01 The "Loans" interpretation [1.260.010] of the "Independence Rule" [1.200.001] provides that a self-interest *threat* would not be at an *acceptable level* and *independence* would be *impaired* if a *covered member* had a *loan* to or from an *attest client*, any officer or director of the *attest client*, or any individual owning 10 percent or more of the *attest client's* outstanding equity securities or other ownership interests, except as provided for in this interpretation.

.02 *Home mortgages, secured loans, and immaterial unsecured loans*. However, *threats* would be at an *acceptable level* and *independence* would not be *impaired* if a *covered member* or his or her *immediate family* has an unsecured *loan* that is not material to the *covered member's* net worth (that is, immaterial unsecured *loan*), a home mortgage, or a secured *loan* from a *lending institution attest client*, if all the following *safeguards* are met:

- a. The home mortgage, secured *loan*, or immaterial unsecured *loan* was obtained under the *lending institution's normal lending procedures, terms, and requirements*. In determining when the home mortgage, secured *loan*, or immaterial unsecured *loan* was obtained, the date a commitment or line of credit is granted must

be used, rather than the date a transaction closes or funds are obtained.

- b. The home mortgage, secured *loan*, or immaterial unsecured *loan* was obtained
  - i. from the *lending institution* prior to its becoming an *attest client*;
  - ii. from a *lending institution* for which *independence* was not required and was later sold to an *attest client*;
  - iii. after May 31, 2002, from a *lending institution attest client* by a borrower prior to his or her becoming a *covered member* with respect to that *attest client*; or
  - iv. prior to May 31, 2002 and the requirements of the loan transition provision in [www.aicpa.org/interestareas/professionalethics/community/downloadabledocuments/transistion%20periods.pdf](http://www.aicpa.org/interestareas/professionalethics/community/downloadabledocuments/transistion%20periods.pdf) are met.
- c. After becoming a *covered member*, any home mortgage, secured *loan*, or immaterial unsecured *loan* must be kept current regarding all terms at all times, and the terms may not change in any manner not provided for in the original agreement. Examples of changed terms are a new or extended maturity date, a new interest rate or formula, revised collateral, and revised or waived covenants.
- d. The estimated fair value of the collateral for a home mortgage or other secured *loan* must equal or exceed the outstanding balance during the term of the home mortgage or other secured *loan*. If the estimated fair value of the collateral is less than the outstanding balance of the home mortgage or other secured *loan*, the portion that exceeds the estimated fair value of the collateral may not be material to the *covered member's* net worth.

**.03** *Loans to partnerships and other similar entities.* For purposes of applying the loan provision in paragraph .02 when the *covered member* is a partner in a partnership, a *loan* to a limited partnership (or similar type of entity) or general partnership would be ascribed to each *covered member* who is a partner in the partnership on the basis of his or her legal liability as a limited or general partner if

- a. the *covered member's* interest in the limited partnership, either individually or combined with the interest of one or more *covered members*, exceeds 50 percent of the total limited partnership interest, or
- b. the *covered member*, either individually or together with one or more *covered members*, can *control* the general partnership.

Even if no amount of a partnership *loan* is ascribed to the *covered member(s)* previously identified, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* through the application of *safeguards* if the partnership renegotiates a loan or obtains a new *loan* that is not a permitted *loan*, as described in paragraph .04 of this interpretation. Accordingly, *independence* would be *impaired*.

**.04** *Other loans and leases.* *Threats* would be at an *acceptable level* and *independence* would not be *impaired* if a *covered member* obtains one of the following types of *loans* or leases under the *lending institution's* normal *lending procedures, terms, and requirements*, provided the *covered member* complies

with the terms of the loan or lease agreement at all times (for example, keeping payments current):

- a. Automobile *loans* and leases collateralized by the automobile
- b. *Loans* fully collateralized by the cash surrender value of an insurance policy
- c. *Loans* fully collateralized by cash deposits at the same *lending institution* (for example, passbook *loans*)
- d. Aggregate outstanding balances from credit cards and overdraft reserve accounts that have a balance of \$10,000 or less after payment of the most recent monthly statement made by the due date or within any available grace period

**.05** *Members* should consider that certain state and federal agencies may proscribe more restrictive requirements over *lending institutions* that are subject to their oversight and that, in turn, impose more restrictive requirements upon *members* that perform *attest engagements* for these *lending institutions*. For example, the Securities and Exchange Commission (SEC) proscribes more restrictive requirements over *members* providing attest services to *lending institutions* and broker-dealers within their purview. [Prior reference: paragraph .07 of ET section 101 and paragraphs .150–.151 of ET section 191]

**.06** *Covered members* may be subject to additional restrictions, as described in the "Depository Accounts" interpretation [1.255.010] and the "Member of a Credit Union" interpretation [1.280.040] of the "Independence Rule" [1.200.001].

### **1.260.030 Servicing of a Loan**

**.01** The self-interest *threat* to compliance with the "Independence Rule" [1.200.001] would be at an *acceptable level* and *independence* would not be *impaired* if a *lending institution attest client* services a *loan* originally extended to a *covered member* by another *lending institution*. [Prior reference: paragraphs .134–.135 of ET section 191]

### **1.260.040 Leases**

**.01** If a *covered member* enters into a leasing agreement with an *attest client* during the *period of the professional engagement*, the self-interest *threat* would be at an *acceptable level* and *independence* would not be *impaired* if all the following *safeguards* are met:

- a. The lease meets the criteria of an operating lease (as described in GAAP).
- b. The terms and conditions set forth in the lease agreement are comparable with other leases of a similar nature.
- c. All amounts are paid in accordance with the lease terms or provisions.

This paragraph excludes leases addressed by paragraph .04 of the "Loans and Leases With Lending Institutions" interpretation [1.260.020] of the "Independence Rule" [1.200.001].

**.02** *Threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired*, if a *covered member* has a lease that meets the criteria of a capital lease (as described in GAAP). Accordingly, *independence* would be *impaired* because the lease would be considered to be a *loan* with an *attest client*. This paragraph excludes a lease

that is in compliance with the "Loans and Leases With Lending Institutions" interpretation [1.260.020] of the "Independence Rule." [Prior reference: paragraphs .182–.183 of ET section 191]

### **1.260.050 Association With an Entity That Has a Loan To or From an Attest Client**

.01 If a *covered member* is an officer, a director, or a shareholder of an entity and the entity has a *loan* to or from an *attest client* during the *period of the professional engagement*, a self-interest *threat* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist. *Threats* to compliance with the "Independence Rule" would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* if the *covered member* has *control* over the entity. Accordingly, *independence* would be *impaired* because the lease would be considered to be a *loan* with an *attest client*. This paragraph excludes a lending relationship that is permitted under the "Loans and Leases With Lending Institutions" interpretation [1.260.020] of the "Independence Rule."

.02 If any *partner* or professional employee of the *firm* is an officer, a director, or a shareholder of an entity and the entity has a *loan* to or from an *attest client*, *threats* to the *partner's* or professional employee's objectivity may exist. If the *partner* or professional employee is able to exercise *significant influence* over the entity but is not a *covered member* who can *control* the entity (see paragraph .01), the *partner* or professional employee should consider the "Conflicts of Interest" interpretation [1.110.010] of the "Integrity and Objectivity Rule" [1.100.001].

.03 When making the decision about whether to perform a *professional service* and in making disclosure to the appropriate parties, the *member* should consider the "Confidential Client Information Rule" [1.700.001]. [Prior reference: paragraphs .220–.221 of ET section 191]

## **1.265 Business Relationships**

### **1.265.010 Cooperative Arrangements With Attest Clients**

.01 If a *member* or his or her *firm* has a cooperative arrangement with an *attest client*, self-interest, familiarity, and undue influence *threats* to the *member* or his or her *firm's* compliance with the "Independence Rule" [1.200.001] may exist. *Threats* to compliance with the "Independence Rule" would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* if, during the *period of the professional engagement*, the cooperative arrangement is material to the *firm* or *attest client*. Accordingly, *independence* would be *impaired*.

.02 A cooperative arrangement exists when a *member* or the *member's firm* and an *attest client* jointly participate in a business activity. However, a cooperative arrangement would not exist when all of the following *safeguards* are met:

- a. The participation of the *firm* and *attest client* are governed by separate agreements, arrangements, or understandings that do not create rights or obligations between the *firm* and *attest client*.
- b. Neither the *firm* nor the *attest client* assumes responsibility for the other's activities or results.
- c. Neither party has the authority to act as the other's representative or agent.

**.03** Examples of cooperative arrangements include the following:

- a. Prime and subcontractor arrangements to provide services or products to a third party
- b. Joint ventures to develop or market products or services
- c. Arrangements to combine one or more of the *firm's* services or products with one or more of the *attest client's* services or products and market the package with references to both parties
- d. Arrangements under which the *firm* acts as a distributor or marketer of the *attest client's* products or services or the *attest client* acts as the distributor or marketer of the *firm's* products or services

**.04** Refer to the "Contingent Fees Rule" [1.510.001] and the "Commissions and Referral Fees Rule" [1.520.001] for additional guidance. [Prior reference: paragraph .14 of ET section 101]

### **1.265.020 Joint Closely Held Investments**

**.01** If a *covered member* has a *joint closely held investment*, a self-interest *threat* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist. *Threats* to compliance with the "Independence Rule" would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* if the *covered member* holds a material *joint closely held investment* during the *period of the professional engagement*. Accordingly, *independence* would be *impaired*. [Prior reference: paragraph .02A(3) of ET section 101]

**.02** A *joint closely held investment* includes a joint interest in a vacation home shared by a *covered member* and an *attest client* (or one of the client's officers or directors, or any owner who has the ability to exercise significant influence over the *attest client*), if the *covered member* and *attest client* (or one of the client's officers or directors or any owner who has the ability to exercise significant influence over the *attest client*) control the investment and the vacation home is material to the *covered member*. Such is the case even if the vacation home is solely intended for the personal use of the owners. [Prior reference: paragraphs .184–.185 of ET section 191]

## **1.270 Family Relationships With Attest Clients**

### **1.270.010 Immediate Family Members**

**.01** The *immediate family* of a *covered member* must comply with the "Independence Rule" [1.200.001] and its *interpretations*, except as permitted in the following interpretations:

- a. "Immediate Family Member Is Employed by the Attest Client" [1.270.020]
- b. "Immediate Family Member Participation in an Employee Benefit Plan That Is an Attest Client or Is Sponsored by an Attest Client (Other Than Certain Share-Based Arrangements or Nonqualified Deferred Compensation Plans)" [1.270.030]
- c. "Immediate Family Member Participation in an Employee Benefit Plan With Financial Interests in an Attest Client" [1.270.040]
- d. "Immediate Family Member Participation in Share-Based Compensation Arrangements Resulting in Beneficially Owned Financial Interests in Attest Clients" [1.270.050]

- e. "Immediate Family Member Participation in Share-Based Compensation Arrangements Resulting in Rights to Acquire Shares in an Attest Client" [1.270.060]
- f. "Immediate Family Member Participation in Share-Based Compensation Arrangements Based Upon Stock Appreciation" [1.270.070]
- g. "Immediate Family Member Participation in a Nonqualified Deferred Compensation Plan" [1.270.080]

**.02** Notwithstanding any exceptions provided for in paragraph .01, the ownership interests of a *covered member's immediate family* may not exceed those specified in paragraph .03 of the "Overview of Financial Interests" interpretation [1.240.010] of the "Independence Rule" [1.200.001].

**.03** When materiality of a *financial interest* is identified as a factor affecting *independence* in the *interpretations* of the "Independence Rule" [1.200.001], interests of the *immediate family* member and the *covered member* should be combined to determine materiality to the *covered member*. [Prior reference: paragraph .02 of ET section 101]

A nonauthoritative white paper, *Independence Rules Modernization Project*, provides some discussion on changes made to the independence provisions that are applicable to close relatives. The white paper is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/IndependenceModernizationWhitePaper.doc](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/IndependenceModernizationWhitePaper.doc).

A nonauthoritative basis-for-conclusions document summarizing considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc).

### **1.270.020 Immediate Family Member Is Employed by the Attest Client**

**.01** When an individual in a *covered member's immediate family* is employed by an *attest client*, management participation, familiarity, and self-interest *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist.

**.02** If a *covered member's immediate family* is employed by an *attest client* but is not in a *key position*, *threats* would be at an *acceptable level* and *independence* would not be *impaired*.

**.03** If a *covered member's immediate family* is in a *key position* with an *attest client* during the period covered by the *financial statements* or during the *period of the professional engagement*, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*.

### **Grandfathered Employment Relationships**

**.04** For information about grandfathered employment relationships for immediate family members, refer to [www.aicpa.org/interestareas/professional-ethics/community/downloadabledocuments/transistion%20periods.pdf](http://www.aicpa.org/interestareas/professional-ethics/community/downloadabledocuments/transistion%20periods.pdf). [Prior reference: paragraph .02 of ET section 101]

A nonauthoritative white paper, *Independence Rules Modernization Project*, provides some discussion on changes made to the independence provisions that are applicable to close relatives. The white paper is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/IndependenceModernizationWhitePaper.doc](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/IndependenceModernizationWhitePaper.doc).

A nonauthoritative basis-for-conclusions document summarizing considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc).

**1.270.030 Immediate Family Member Participation in an Employee Benefit Plan That Is an Attest Client or Is Sponsored by an Attest Client (Other Than Certain Share-Based Arrangements or Nonqualified Deferred Compensation Plans)**

.01 If during the period covered by the *financial statements* or during the *period of the professional engagement*, an *immediate family member* of a *covered member* participates in an employee benefit plan (plan) that is an *attest client* or is sponsored by an *attest client* (other than an *attest client's share-based compensation arrangement* and nonqualified deferred compensation plan), *threats* would be at an *acceptable level* and *independence* would not be *impaired* if all of the following *safeguards* were met:

- a. The *immediate family member* does not serve in a *key position* for the *attest client*, as discussed in the "Immediate Family Member Is Employed by the Attest Client" interpretation [1.270.020] of the "Independence Rule" [1.200.001].
- b. The plan is offered to all employees in comparable employment positions.
- c. The *immediate family member* does not serve in a position of governance (for example, board of trustees) for the plan.
- d. The *immediate family member* does not have the ability to supervise or participate in the plan's investment decisions or in the selection of the investment options made available to plan participants. [Prior reference: paragraph .02 of ET section 101]

.02 *Share-based compensation arrangements* and nonqualified deferred compensation plans are discussed in the following interpretations:

- a. "Immediate Family Member Participation in Share-Based Compensation Arrangements Resulting in Beneficially Owned Financial Interests in Attest Clients" interpretation [1.270.050] of the "Independence Rule" [1.200.001]
- b. "Immediate Family Member Participation in Share-Based Compensation Arrangements Resulting in Rights to Acquire Shares in an Attest Client" interpretation [1.270.060] of the "Independence Rule"
- c. "Immediate Family Member Participation in Share-Based Compensation Arrangements Based Upon Stock Appreciation" interpretation [1.270.070] of the "Independence Rule"

- d. "Immediate Family Member Participation in a Nonqualified Deferred Compensation Plan" interpretation [1.270.080] of the "Independence Rule"

A nonauthoritative basis-for-conclusions document that summarizes considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc).

### **1.270.040 Immediate Family Member Participation in an Employee Benefit Plan With Financial Interests in an Attest Client**

**.01** If during the *period of the professional engagement*, an *immediate family member* of a *covered member* is employed at a non-client or employed in a non-key position at an *attest client*, the *immediate family member* may hold a *direct financial interest* or material *indirect financial interest* in an *attest client* through participation in an employee benefit plan if *threats* are at an *acceptable level*. *Threats* would be at an *acceptable level*, and *independence* would not be *impaired*, if all of the following *safeguards* were met:

- a. The *covered member* neither participates on the *attest engagement team* nor is an *individual in a position to influence the attest engagement*.
- b. Such investment is an unavoidable consequence of such participation. Unavoidable consequence means that the *immediate family member* has no other investment options available for selection, including money market or invested cash options, except for selecting an investment option in an *attest client*.
- c. In the event that a plan provides an option that permits the *immediate family member* to invest in a nonattest *client* or a non-client investment option that becomes available, the *immediate family member* is required to select the investment option in the non-client or nonattest *client* and dispose of *financial interests* in the *attest client* as soon as practicable but no later than 30 days after such option becomes available. When legal or other similar restrictions exist on an *immediate family member's* right to dispose of a *financial interest* at a particular time, the *immediate family member* need not dispose of the interest until the restrictions have lapsed. For example, an *immediate family member* is not required to dispose of a *financial interest* in an *attest client* if doing so would violate an employer's policies on insider trading. On the other hand, waiting for more advantageous market conditions to dispose of the interest would not fall within this exception. [Prior reference: paragraph .02 of ET section 101]

This paragraph excludes participation in *share-based compensation arrangements* and nonqualified deferred compensation arrangements (see paragraph .02).

**.02** *Share-based compensation arrangements* and nonqualified deferred compensation plans are discussed in the following interpretations:

- a. "Immediate Family Member Participation in Share-Based Compensation Arrangements Resulting in Beneficially Owned

Financial Interests in Attest Clients" interpretation [1.270.050] of the "Independence Rule" [1.200.001]

- b. "Immediate Family Member Participation in Share-Based Compensation Arrangements Resulting in Rights to Acquire Shares in an Attest Client" interpretation [1.270.060] of the "Independence Rule"
- c. "Immediate Family Member Participation in Share-Based Compensation Arrangements Based Upon Stock Appreciation" interpretation [1.270.070] of the "Independence Rule"
- d. "Immediate Family Member Participation in a Nonqualified Deferred Compensation Plan" interpretation [1.270.080] of the "Independence Rule"

A nonauthoritative basis-for-conclusions document that summarizes considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc).

### **1.270.050 Immediate Family Member Participation in Share-Based Compensation Arrangements Resulting in Beneficially Owned Financial Interests in Attest Clients**

.01 If during the *period of the professional engagement*, an *immediate family member* of a *covered member* participates in a *share-based compensation arrangement* of an *attest client*, such as an ESOP, that results in the *immediate family member* holding a *financial interest* in an *attest client* that is *beneficially owned*, *threats* are at an *acceptable level* and *independence* would not be *impaired* if all of the following *safeguards* were met:

- a. The *immediate family member* does not serve in a *key position* for the *attest client*, as discussed in the "Immediate Family Member Is Employed by the Attest Client" interpretation [1.270.020] of the "Independence Rule" [1.200.001].
- b. The *covered member* neither participates on the *attest engagement team* nor is an *individual in a position to influence the attest engagement*.
- c. The *immediate family member* does not serve as a trustee for the *share-based compensation arrangement* and does not have the ability to supervise or participate in the selection of any investment options made available to plan participants.
- d. When the *financial interests* that are *beneficially owned* are distributed or the *immediate family member* has the right to dispose of the *financial interests*, the *immediate family member* is required to do one of the following:
  - i. Dispose of the *financial interests* as soon as practicable but no later than 30 days after he or she has the right to dispose of the *financial interests*.
  - ii. Exercise his or her put option to require the employer to repurchase the *financial interests* as soon as permitted by the terms of the *share-based compensation arrangement*.

In addition, any repurchase obligation due to the *immediate family* member arising from exercise of the option that is outstanding for more than 30 days needs to be immaterial to the *covered member* during the payout period. When legal or other similar restrictions exist on an *immediate family* member's right to dispose of a *financial interest* at a particular time, the *immediate family* member need not dispose of the interest until the restrictions have lapsed. For example, an *immediate family* member does not have to dispose of a *financial interest* in an *attest client* if doing so would violate an employer's policies on insider trading. On the other hand, waiting for more advantageous market conditions to dispose of the interest does not qualify for this exception.

- e. Benefits payable from the *share-based compensation arrangement* to the *immediate family* member upon termination of employment, whether through retirement, death, disability, or voluntary or involuntary termination, are funded by investment options other than the employer's *financial interests*, and any unfunded benefits payable are immaterial to the *covered member* at all times during the payout period. [Prior reference: paragraph .02 of ET section 101]

A nonauthoritative basis-for-conclusions document that summarizes considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc).

### **1.270.060 Immediate Family Member Participation in Share-Based Compensation Arrangements Resulting in Rights to Acquire Shares in an Attest Client**

.01 If during the *period of the professional engagement* an *immediate family* member of a *covered member* participates in a *share-based compensation arrangement* resulting in a right to acquire shares in an *attest client*, such as an ESOP or restricted stock rights plan, *threats* are at an *acceptable level* and *independence* would not be *impaired* if all of the following *safeguards* were met:

- a. The *immediate family* member does not serve in a *key position* for the *attest client*, as discussed in the "Immediate Family Member Is Employed by the Attest Client" interpretation [1.270.020] of the "Independence Rule" [1.200.001].
- b. The *covered member* neither participates on the *attest engagement team* nor is an *individual in a position to influence the attest engagement*.
- c. The *immediate family* member exercises or forfeits these rights once he or she is vested, and the closing market price of the underlying stock equals or exceeds the exercise price for 10 consecutive days (market period). The exercise or forfeiture should occur as soon as practicable but no later than 30 days after the end of the market period. In addition, if the *immediate family* member exercises his or her right to acquire shares in the *attest client*, he

or she should dispose of the shares as soon as practicable but no later than 30 days after the exercise date. Also, note the following:

- i. When legal or other similar restrictions exist on an *immediate family* member's right to dispose of a *financial interest* at a particular time, the *immediate family* member need not dispose of the interest until the restrictions have lapsed. For example, an *immediate family* member does not have to dispose of a *financial interest* in an *attest client* if doing so would violate an employer's policies on insider trading. On the other hand, waiting for more advantageous market conditions to dispose of the interest would not qualify for this exception.
- ii. If the employer repurchases the shares, any employer repurchase obligation due to the *immediate family* member that is outstanding for more than 30 days needs to be immaterial to the *covered member* during the payout period.

.02 Refer to paragraph .06 of the "Retirement, Savings, Compensation, or Similar Plans" interpretation [1.240.040] of the "Independence Rule" [1.200.001] for additional guidance. [Prior reference: paragraph .02 of ET section 101]

A nonauthoritative basis-for-conclusions document that summarizes considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc).

### **1.270.070 Immediate Family Member Participation in Share-Based Compensation Arrangements Based Upon Stock Appreciation**

.01 If during the *period of the professional engagement* an *immediate family* member of a *covered member* participates in a *share-based compensation arrangement* based on the appreciation of an *attest client's* underlying shares, such as a stock appreciation plan or phantom stock plan, *threats* are at an *acceptable level* and *independence* would not be impaired if all of the following *safeguards* were met:

- a. The *immediate family* member does not serve in a *key position* for the *attest client*, as discussed in the "Immediate Family Member Is Employed by the Attest Client" interpretation [1.270.020] of the "Independence Rule" [1.200.001].
- b. The *share-based compensation arrangement* does not provide for the issuance of rights to acquire the employer's *financial interests*.
- c. The *covered member* neither participates on the *attest engagement team* nor is an *individual in a position to influence the attest engagement*.
- d. The *immediate family* member exercises or forfeits these rights once he or she is vested, if the underlying price of the employer's shares equals or exceeds the exercise price for 10 consecutive days (market period). Exercise or forfeiture should occur as soon as practicable but no later than 30 days after the end of the market period.

- e. Any resulting compensation payable to the *immediate family* member that is outstanding for more than 30 days is immaterial to the *covered member* during the payout period. [Prior reference: paragraph .02 of ET section 101]

A nonauthoritative basis-for-conclusions document that summarizes considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc).

### **1.270.080 Immediate Family Member Participation in a Nonqualified Deferred Compensation Plan**

**.01** If during the *period of the professional engagement* an *immediate family* member of a *covered member* participates in a nonqualified deferred compensation plan of an *attest client* as a result of his or her employment, *threats* are at an *acceptable level* and *independence* would not be *impaired* if all of the following *safeguards* were met:

- a. The *immediate family* member does not serve in a *key position* for the *attest client*, as discussed in the "Immediate Family Member Is Employed by the Attest Client" interpretation [1.270.020] of the "Independence Rule" [1.200.001].
- b. The *covered member* neither participates on the *attest engagement team* nor is an *individual in a position to influence the attest engagement*.
- c. The amount of the deferred compensation payable to the *immediate family* member is funded through life insurance, an annuity, a trust, or similar vehicle, and any unfunded portion is immaterial to the *covered member*.
- d. Any funding of the deferred compensation does not include *financial interests* in the *attest client*. [Prior reference: paragraph .02 of ET section 101]

A nonauthoritative basis-for-conclusions document summarizing considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsImmediateFamilyMember6-1-10Final.doc).

### **1.270.100 Close Relatives**

**.01** When a *close relative* of a *covered member* is employed by an *attest client* or has *financial interests* in an *attest client*, management participation, familiarity, and self-interest *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist.

**.02** *Threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired*, if an individual participating on the *attest engagement team* has a *close relative* who has either of the following:

- a. A *key position* with the *attest client* during the period covered by the *financial statements* or during the *period of the professional engagement*.
- b. A *financial interest* in the *attest client* during the *period of the professional engagement* that
  - i. the individual knows or has reason to believe was material to the *close relative* or
  - ii. enabled the *close relative* to exercise *significant influence* over the *attest client*.

**.03** *Threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* and *independence* will be *impaired* if an *individual in a position to influence the attest engagement* or any *partner* or *partner equivalent* in the *office* in which the lead *attest engagement partner* or *partner equivalent* primarily practices in connection with the *attest engagement* has a *close relative* who has either of the following:

- a. A *key position* with the *attest client* during the period covered by the *financial statements* or during the *period of the professional engagement*.
- b. A *financial interest* in the *attest client* during the *period of the professional engagement* that
  - i. the individual, *partner*, or *partner equivalent* knows or has reason to believe was material to the *close relative* and
  - ii. enabled the *close relative* to exercise *significant influence* over the *attest client*.

### **Grandfathered Employment Relationships**

**.04** For information about grandfathered employment relationships for close relatives, refer to [www.aicpa.org/interestareas/professionalethics/community/downloadabledocuments/transistion%20periods.pdf](http://www.aicpa.org/interestareas/professionalethics/community/downloadabledocuments/transistion%20periods.pdf). [Prior reference: paragraph .02 of ET section 101]

### **Effective Date**

**.05** The addition of partner equivalents to paragraph .03 is effective for engagements covering periods beginning on or after December 15, 2014.

A nonauthoritative white paper, *Independence Rules Modernization Project*, provides some discussion about changes made to the independence provisions that are applicable to close relatives. The white paper is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/IndependenceModernizationWhitePaper.doc](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/IndependenceModernizationWhitePaper.doc).

## **1.275 Current Employment or Association With an Attest Client**

### **1.275.005 Simultaneous Employment or Association With an Attest Client**

**.01** In this interpretation, simultaneous employment or association with an *attest client* is serving as a director, an officer, an employee, a promoter, an underwriter, a voting trustee, a trustee for any pension or profit-sharing

trust of the *attest client*, or in any capacity equivalent to that of a member of management of an *attest client* during the period covered by the *financial statements* or the *period of the professional engagement*.

**.02** If a *partner* or professional employee of the *member's firm* is simultaneously employed or associated with an *attest client*, familiarity, management participation, advocacy, or self-review *threats* to the *member's* compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*. [Prior reference: paragraph .02C of ET section 101]

**.03** However, *threats* will be at an *acceptable level* and *independence* will not be *impaired* if a *partner* or professional employee of a *firm* serves as an adjunct faculty member of an educational institution that is an *attest client* of the *firm*, provided that the *partner* or professional employee meets all of the following *safeguards*:

- a. Does not hold a *key position* at the educational institution
- b. Does not participate on the *attest engagement team*
- c. Is not an *individual in a position to influence the attest engagement*
- d. Is employed by the educational institution on a part-time and non-tenure basis
- e. Does not participate in any employee benefit plans sponsored by the educational institution, unless participation is required
- f. Does not assume any management responsibilities or set policies for the educational institution

Upon termination of employment, the *partner* or professional employee should comply with the requirements of the "Former Employment or Association With an Attest Client" interpretation [1.277.010] of the "Independence Rule" [1.200.001]. [Prior reference: paragraph .21 of ET section 101]

**.04** *Members* that are simultaneously employed or associated with an *attest client* should consider their obligations as a *member in business* under part 2 of the code. [No prior reference: new content]

### Effective Date

**.05** Paragraph .04 of this interpretation is effective December 15, 2014.

A nonauthoritative question and answer regarding independent contractors retained by the firm who are simultaneously employed or associated with an attest client is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf).

### 1.275.010 Honorary Director or Trustee of a Not-for-Profit Organization

**.01** When a *partner* or professional employee of a *member's firm* is asked to lend the prestige of his or her name to a not-for-profit organization (the assumption is that the organization limits its activities to charitable, religious, or civic or other matters of a similar nature) by serving as an honorary director or trustee of the organization during the period covered by the *financial statements* or during the *period of the professional engagement*, familiarity, self-review, or management participation *threats* to the *member's* compliance with the "Independence Rule" [1.200.001] may exist. However, *threats* would be at an

*acceptable level* and *independence* would not be *impaired* if all of the following *safeguards* are met:

- a. The position is clearly honorary and the individual holds the position in name only.
- b. The individual cannot vote or otherwise participate in board or management responsibilities.
- c. If the individual is named in letterheads and externally circulated materials, the individual is identified as an honorary director or honorary trustee. [Prior reference: paragraph .06 of ET section 101]

**.02** *Members* that are simultaneously employed or associated with an *attest client* should consider their obligations as a *member in business* under part 2 of the code. [No prior reference: new content]

### **Effective Date**

**.03** Paragraph .02 of this interpretation is effective December 15, 2014.

### **1.275.015 Member of Advisory Board**

**.01** If a *partner* or professional employee of a *member's firm* serves on an advisory board of an *attest client*, familiarity, self-review, or management participation *threats* to the *member's* compliance with the "Independence Rule" [1.200.001] may exist. However, *threats* would be at an *acceptable level* and *independence* would not be *impaired* if all of the following *safeguards* are met:

- a. The responsibilities of the advisory board are in fact advisory in nature.
- b. The advisory board has no authority to make nor does it appear to make management decisions on behalf of the *attest client*.
- c. The advisory board and those having authority to make management decisions, including the board of directors or its equivalent, are distinct groups with minimal, if any, common membership. [Prior reference: paragraphs .144–.145 of ET section 191]

**.02** *Members* in such positions should consider their obligations as *members in business* under part 2 of the code. [No prior reference: new content]

### **Effective Date**

**.03** Paragraph .02 of this interpretation is effective December 15, 2014.

### **1.275.020 Member of Governmental Advisory Committee**

**.01** If a *partner* or professional employee of the *firm* serves on a citizens' advisory committee that is studying possible changes in the form of a county government that is an *attest client* of the *member's firm*, familiarity, self-review, or management participation *threats* to the *member's* compliance with the "Independence Rule" [1.200.001] may exist. However, *threats* would be at an *acceptable level* and *independence* would not be *impaired* with respect to the county.

**.02** If a *partner* or professional employee of the *firm* serves on an advisory committee appointed to study the financial status of the state in which the county is located, *threats* to the *member's* compliance with the "Independence Rule" [1.200.001] would be at an *acceptable level*. Accordingly, *independence* would not be *impaired* with respect to the county. [Prior reference: paragraphs .039–.040 of ET section 191]

.03 *Members* in such positions should consider their obligations as *members in business* under part 2 of the code. [No prior reference: new content]

### **Effective Date**

.04 Paragraph .03 of this interpretation is effective December 15, 2014.

### **1.275.025 Individual in a Campaign Treasurer or Similar Financial Position**

.01 For purposes of this interpretation, a campaign treasurer would also include individuals with similar financial responsibilities as a campaign treasurer. While other campaign positions may result in *threats* to compliance with the "Independence Rule" [1.200.001], such positions are not covered by this interpretation. Accordingly, *members* should consult the Conceptual Framework for Independence [1.210.010] if *partners* or professional employees serve in campaign positions not specifically addressed by this interpretation.

### **Campaign Organization Is Attest Client**

.02 If during the *period of the professional engagement* or during the period covered by the *financial statements*, a *partner* or professional employee of a *member's firm* serves as a campaign treasurer and the campaign organization is an *attest client*, the management participation *threat* to the *member's* compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*.

### **Candidate Running for Election of a Governmental Entity That Is an Attest Client**

.03 If, during the *period of the professional engagement* or during the period covered by the *financial statements*, a *partner* or professional employee serves as a campaign treasurer for either (a) an elected official of a governmental entity that is an *attest client*, or (b) for a candidate who is running for election but is not yet an elected official of such *attest client*, then advocacy, adverse interest, and familiarity *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*.

### **Political Party Is Attest Client**

.04 If during the *period of the professional engagement* or during the period covered by the *financial statements* a *partner* or professional employee serves as a campaign treasurer for a candidate and the political party for which the candidate is a member is an *attest client*, advocacy and familiarity *threats* may exist. Accordingly, a responsible individual within the *firm* should evaluate the significance of the *threats* to determine if the *threats* are at an *acceptable level*. If the responsible individual within the *firm* determines that *threats* are not at an *acceptable level*, he or she should apply *safeguards* to eliminate or reduce the *threats* to an *acceptable level*. However, *threats* would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* and *independence* would be *impaired* if the candidate is a member of one of the political party's governing bodies.

### **General**

.05 In the state and local government environment, *members* should consult the "Entities Included in State and Local Government Financial

Statements" interpretation [1.224.020] to determine which entities related to their *attest client* require the *member's independence*. Also refer to the "Conflicts of Interest for Members in Public Practice" interpretation [1.110.010] of the "Integrity and Objectivity Rule" [1.100.001] for additional guidance. In addition, *members* in such positions should consider their obligations as *members in business* under part 2 of the code. [Prior reference: paragraphs .164–.165 of ET section 191]

### **Grandfathered Positions**

.06 *Independence* would not be *impaired* as a result of the more restrictive requirements of this interpretation that are effective on May 31, 2015, provided the *attest engagement* commenced prior to April 30, 2015, and the *member* was in compliance with the preexisting requirements of this interpretation.

[See Revision History Table.]

### **1.275.030 Member of Federated Fund-Raising Organization**

.01 When a *partner* or professional employee of a *member's firm* serves as a director or an officer of a federated fund-raising organization, such as United Way (the organization), during the period covered by the *financial statements* or during the *period of the professional engagement*, and a charity that receives funds from the organization is an *attest client* of the *member's firm*, management participation or self-review *threats* to the *member's* compliance with the "Independence Rule" [1.200.001] may exist.

.02 If the organization has managerial control over the charity, the *threats* to the *member's* compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*.

.03 Even if the organization does not have managerial control over the charity, a conflict of interest could arise that may create a *threat* to the *member's* compliance with the "Integrity and Objectivity Rule" [1.100.001]. In such situations, the *member* should consult the "Conflicts of Interest" interpretation [1.110.010]. [Prior reference: paragraphs .027–.028 of ET section 191]

.04 In addition, *members* in such positions should consider their obligations as *members in business* under part 2 of the code. [No prior reference: new content]

### **Effective Date**

.05 Paragraph .04 of this interpretation is effective December 15, 2014.

### **1.275.035 Member of Organization that Receives Funds From Fund-Raising Organization**

.01 When a *partner* or professional employee of a *member's firm* serves on the board of directors of an organization during the period covered by the *financial statements* or during the *period of the professional engagement* and the organization receives funds from a fund-raising foundation that is an *attest client*, management participation or self-review *threats* to the *member's* compliance with the "Independence Rule" [1.200.001] may exist.

.02 If the fund-raising foundation functions solely to raise funds for that organization, the *threat* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable*

level by the application of *safeguards*. Accordingly, *independence* would be *impaired*.

**.03** However, if the directorship is clearly honorary, in accordance with the "Honorary Director or Trustee of a Not-for-Profit Organization" interpretation [1.275.010] of the "Independence Rule" [1.200.001], *threats* would be at an *acceptable level*. Accordingly, *independence* would not be *impaired*. [Prior reference: paragraphs .128–.129 of ET section 191]

**.04** *Members* in such positions should consider their obligations as a *member in business* under part 2 of the code. [No prior reference: new content]

### **Effective Date**

**.05** Paragraph .04 of this interpretation is effective December 15, 2014.

## **1.277 Former Employment or Association With an Attest Client**

### **1.277.010 Former Employment or Association With an Attest Client**

**.01** This interpretation applies to *covered members* who were formerly employed by an entity or associated with an entity as an officer, a director, a promoter, an underwriter, a voting trustee, or a trustee for the entity's pension or profit sharing trust and subsequently became employed by a *firm* that provides attest service to that entity.

**.02** When a *member* becomes a *partner* or professional employee of a *firm* that provides attest services to an entity where the *member* was formerly employed or otherwise associated, familiarity, self-interest, self-review, or management participation *threats* to the *member's* compliance with the "Independence Rule" [1.200.001] may exist.

**.03** If a *covered member* participates on the *client's attest engagement* or is an *individual in a position to influence the attest engagement* covering any period that includes the *covered member's* former employment or association with the *attest client*, *threats* to the *member's* compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*.

**.04** If a *member* fails to disassociate from the *attest client* before becoming a *covered member*, *threats* to the *member's* compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and *independence* would be *impaired* unless all of the following *safeguards* are met:

- a. The *covered member* ceases to participate in all employee health and welfare plans sponsored by the *attest client*, unless the *attest client* is legally required to allow the *member* to participate in the plan (for example, the Consolidated Omnibus Budget Reconciliation Act [COBRA]) and the *member* pays 100 percent of the *member's* portion of the cost of participation on a current basis.
- b. The *covered member* ceases to participate in all other employee benefit plans by liquidating or transferring, at the earliest date permitted under the plan, all vested benefits in the *attest client's* defined benefit plans, defined contribution plans, *share-based compensation arrangements*, deferred compensation plans, and other similar arrangements.

However, when a *covered member's* participation in one of these plans results from former employment or association with an *at-*

*test client, threats would be at an acceptable level and independence would not be impaired* provided the liquidation or transfer of any vested benefits is either not permitted under the terms of the plan or would result in a penalty significant to the benefits being imposed upon such liquidation or transfer and the *covered member*

- i. does not participate on the *attest engagement team* or
- ii. is not an *individual in a position to influence the attest engagement*.

A penalty includes an early withdrawal penalty levied under the applicable tax law but excludes other income taxes that would be owed, or market losses that may be incurred, as a result of such liquidation or transfer.

- c. The *covered member* disposes of any *direct financial interest* or material *indirect financial interests* in the *attest client*.
- d. The *covered member* collects or repays any *loans* to or from the *attest client*, except for *loans* specifically permitted or grandfathered by the *interpretations* of the "Loans, Leases, and Guarantees" subtopic [1.260] under the "Independence Rule."
- e. *Covered members* should evaluate whether other relationships with the *attest client* create *threats* that require the *member* to apply *safeguards* to reduce those *threats* to an *acceptable level*. [Prior reference: paragraph .02 of ET section 101]

## 1.279 Considering or Subsequent Employment or Association With an Attest Client

### 1.279.010 Considering Employment or Association With an Attest Client

.01 This interpretation applies to a member of the *attest engagement team* or an *individual in a position to influence the attest engagement* (individual) who intends to seek or discuss potential employment or association with an *attest client* or is in receipt of a specific offer of employment from an *attest client*.

.02 The undue influence and self-interest *threats* to compliance with the "Independence Rule" [1.200.001] would be at an *acceptable level and independence* would not be *impaired* if all of the following *safeguards* are met:

- a. The individual promptly reports such consideration or offer to an appropriate person in the *firm*.
- b. The individual immediately ceases participation in the engagement and does not provide any services to the *attest client* until the employment offer is rejected or employment is no longer sought.
- c. If a *covered member* becomes aware that an individual is considering employment or association with an *attest client*, the *covered member* should notify an appropriate person in the *firm*.
- d. The appropriate person in the *firm* should consider whether, based on the nature of the engagement and the individual involved, the *firm* should perform additional procedures to provide reasonable assurance that any work that the individual performed for the *attest client* was performed in compliance with the "Integrity and Objectivity Rule" [1.100.001].

.03 If the individual accepts an offer of employment or otherwise becomes associated with the *attest client* in a *key position*, see the "Subsequent Employment or Association With an Attest Client" interpretation [1.279.020] of the "Independence Rule" [1.200.001] for additional requirements. [Prior reference: paragraph .04 of ET section 101]

### **1.279.020 Subsequent Employment or Association With an Attest Client**

.01 This interpretation applies to *partners* and professional employees who leave their *firms* and are subsequently employed by, or associated with, one of the *firm's attest clients* in a *key position*.

.02 The familiarity, self-interest, undue influence, or management participation *threats* to the *member's* compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and *independence* would be *impaired* unless all of the *safeguards* in items *a–e* of the following list are met:

#### *Individual Safeguards*

- a. Amounts due to the former *partner* or professional employee for his or her previous interest in the *firm* and unfunded, vested retirement benefits cannot be material to the *firm*, and the underlying formula used to calculate the payments remain fixed during the payout period. The *firm* may adjust the retirement benefits for inflation and pay interest on amounts due.
- b. The former *partner* or professional employee is not in a position to influence the *firm's* operations or financial policies.
- c. The former *partner* or professional employee does not participate or appear to participate in the *firm's* business and is not otherwise associated with the *firm*, regardless of whether he or she is compensated for such participation or association, once employment or association with the *attest client* begins. For example, the individual would appear to participate in, or be associated with, the *firm* if
  - i. the individual provides consultation to the *firm*;
  - ii. the *firm* provides the individual with an *office* and related amenities, such as administrative and technology services;
  - iii. the individual's name is included in the *firm's office* directory; or
  - iv. the individual is identified as a member of the *firm* in membership lists of business, professional, or civic organizations, unless the *member* is clearly designated as retired.

#### *Ongoing Attest Engagement Team Safeguards*

- d. The ongoing *attest engagement team* should consider whether to modify the engagement procedures to adjust for the risk that the former *partner's* or professional employee's prior knowledge of the audit plan could reduce audit effectiveness. In addition, if the individual will have significant interaction with the *attest engagement team*, an appropriate individual in the *firm* should evaluate whether the existing *attest engagement team* members have sufficient experience and stature to deal effectively with the individual in conducting the engagement.
- e. If the former *partner* or professional employee joins the *attest client* in a *key position* within one year of disassociating from the *firm* and has significant interaction with the *attest engagement team*, an appropriate professional in the *firm* should review the

subsequent *attest engagement* to determine whether the engagement team members maintained the appropriate level of skepticism when evaluating the individual's representations and work. The professional applying this *safeguard* should have appropriate stature, expertise, and objectivity. In performing this review, the professional should consider relevant factors, such as the following:

- i. The position that the individual assumed at the *attest client*.
- ii. The position that the individual held at the *firm*.
- iii. The nature of the services that the individual provided to the *attest client*. The professional should take appropriate actions, as deemed necessary, based on the results of this review.

**.03** The procedures performed in applying items *d–e* of paragraph .02 of this interpretation will depend on several factors, including the following:

- a. Whether the individual served on the engagement team
- b. The positions that the individual held at the *firm* and has accepted at the *attest client*
- c. The length of time that has elapsed since the individual left the *firm*
- d. The circumstances of the individual's departure

**.04** An inadvertent and isolated failure to apply items *d–e* in paragraph .02 of this interpretation would not *impair independence* provided that the relevant parties perform the required procedures promptly upon discovery of the failure to do so and all other provisions of this interpretation are met. [Prior reference: paragraph .04 of ET section 101]

## 1.280 Memberships

### 1.280.010 Member of a Social Club

**.01** If a *covered member* belongs to a social club (for example, a country club, tennis club) that is an *attest client* and is required to acquire a pro rata share of the club's equity or debt securities, then management participation, self-review, and self-interest *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist. *Threats* would be at an *acceptable level* if the club membership is essentially a social matter, because such equity or debt ownership would not be considered to be a *direct financial interest*. Accordingly, *independence* would not be *impaired*.

**.02** *Threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* if a *partner* or professional employee is simultaneously employed or associated with the *attest client's* social club as described in the "Simultaneous Employment or Association With an Attest Client" interpretation [1.275.005] of the "Independence Rule." Accordingly, *independence* would be *impaired*. [Prior reference: paragraphs .033–.034 of ET section 191]

### 1.280.020 Member of a Trade Association

**.01** If a *covered member* belongs to a trade association that is an *attest client*, management participation or self-review *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist.

.02 *Threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* if a *partner* or professional employee is simultaneously employed or associated with the trade association as described in the "Simultaneous Employment or Association With an Attest Client" interpretation [1.275.005] of the "Independence Rule." Accordingly, *independence* would be *impaired*. [Prior reference: paragraphs .003–.004 of ET section 191]

### **1.280.030 Member of Common Interest Realty Association**

.01 If a *covered member* belongs to a common interest realty association (CIRA) because the *covered member* owns or leases real estate, then management participation, self-interest, self-review, or advocacy *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist. Examples of CIRAs include cooperatives, condominium associations, planned unit developments, homeowners associations, and timeshare developments.

.02 *Threats* would be at an *acceptable level* and *independence* would not be *impaired* if all of the following *safeguards* are met:

- a. The CIRA performs functions similar to local governments, such as public safety, road maintenance, and utilities.
- b. The *covered member's* annual assessment is not material to either the *covered member* or the CIRA's operating budgeted assessments.
- c. The liquidation of the CIRA or the sale of common assets would not result in a distribution to the *covered member*.
- d. The CIRA's creditors would not have recourse to the *covered member's* assets if the CIRA became insolvent.

.03 *Threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and cannot be reduced to an *acceptable level* by the application of *safeguards* if a *partner* or professional employee is simultaneously employed or associated with the CIRA as described in the "Simultaneous Employment or Association With an Attest Client" interpretation [1.275.005] of the "Independence Rule." Accordingly, *independence* would be *impaired*.

.04 A *member* who has a personal or professional relationship with a real estate developer or management company that is associated with the CIRA should consider the "Conflicts of Interest" interpretation [1.110.010] under the "Integrity and Objectivity Rule" [1.100.001]. [Prior reference: paragraphs .061–.062 of ET section 191]

### **1.280.040 Member of a Credit Union**

.01 When a *covered member* is a member of a credit union that is an *attest client*, the self-interest *threat* would be at an *acceptable level*, and *independence* would not be *impaired*, if the *covered member* individually qualifies to join the credit union other than by virtue of the *professional services* provided to the *client*. However, if during the *period of the professional engagement* the *member's* qualification to join the credit union is a result of the *professional services* provided to the *client*, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*.

.02 *Covered members* may be subject to additional restrictions, as described in the "Depository Accounts" interpretation [1.255.010] and the "Loans

and Leases With Lending Institutions" interpretation [1.260.020] of the "Independence Rule" [1.200.001]. In addition, *partners* and professional employees may be subject to additional restrictions, as described in paragraph .03 of the "Overview of Financial Interests" interpretation [1.240.010] of the "Independence Rule." [Prior reference: paragraphs .150–.151 of ET section 191]

## 1.285 Gifts and Entertainment

### 1.285.010 Offering or Accepting Gifts or Entertainment

.01 For purposes of this interpretation, the *attest client* also includes an individual in a *key position* with the *attest client* and individuals owning 10 percent or more of the *attest client's* outstanding equity securities or other ownership interests.

.02 Accepting a gift from an attest client during the *period of the professional engagement* may create undue influence or self-interest *threats* to a *member's* compliance with the "Independence Rule" [1.200.001]. If a *member's firm*, a member of the *attest engagement team*, or an *individual in a position to influence the attest engagement* accepts a gift from an attest client and the value is not clearly insignificant to the recipient, the *threat* to the *member's* compliance with the "Independence Rule" would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*.

.03 Accepting entertainment from an attest client during the *period of the professional engagement* may create undue influence or self-interest *threats* to a *member's* compliance with the "Independence Rule" [1.200.001]. If a *covered member* accepts entertainment from an attest client that is not reasonable in the circumstances, the *threats* to the *member's* compliance with the "Independence Rule" would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*.

.04 Offering gifts or entertainment to an attest client during the *period of the professional engagement* may create a familiarity *threat* to a *member's* compliance with the "Independence Rule" [1.200.001]. If a *covered member* offers a gift or entertainment to an attest client that is not reasonable in the circumstances, the *threat* to the *member's* compliance with the "Independence Rule" would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*.

.05 The *member* should exercise judgment in determining whether gifts or entertainment would be considered reasonable in the circumstances. Examples of relevant facts and circumstances include the following:

- a. The nature of the gift or entertainment
- b. The occasion giving rise to the gift or entertainment
- c. The cost or value of the gift or entertainment
- d. The nature, frequency, and value of other gifts and entertainment offered or accepted
- e. Whether the entertainment was associated with the active conduct of business directly before, during, or after the entertainment
- f. Whether other attest clients also participated in the entertainment

- g. The individuals from the attest client's and *member's firm* who participated in the entertainment

**.06** Refer to the "Offering or Accepting Gifts or Entertainment" interpretation [1.120.010] of the "Integrity and Objectivity Rule" [1.100.001] for additional guidance. [Prior reference: paragraphs .228–.229 of ET section 191]

A nonauthoritative basis-for-conclusions document summarizing considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Gifts\\_Basis\\_Document.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Gifts_Basis_Document.pdf).

A nonauthoritative question and answer regarding campaign contributions made to the campaign of an individual that is associated with an attest client in a key position or holds a financial interest in an attest client that is material or enables the individual to exercise significant influence over the attest client is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf).

## 1.290 Actual or Threatened Litigation

### 1.290.010 Actual or Threatened Litigation

**.01** The relationship between an *attest client's* management and a *covered member* must be characterized by complete candor and full disclosure regarding all aspects of the *attest client's* business operations. In addition, the *covered member* must not be biased so that the *covered member* can exercise professional judgment and objectivity in evaluating management's financial reporting decisions.

**.02** Litigation or the expressed intention to commence litigation between a *covered member* and an *attest client* or its management and, in some cases, other parties during the *period of the professional engagement* may create self-interest or adverse interest *threats* to the *member's* compliance with the "Independence Rule" [1.200.001]. Accordingly, *covered members* should evaluate all such circumstances in accordance with this interpretation.

**.03** Litigation or the expressed intention to commence litigation between a *covered member* and an *attest client* or its management and, in some cases, other parties requires the *covered member* to assess the materiality of the litigation to the *covered member*, the *covered member's firm*, and the *attest client*. The *covered member's* assessment should include an evaluation of the nature of the matter(s) underlying the litigation and all other relevant factors.

### ***Litigation Between the Attest Client and Member***

**.04** When an *attest client's* present management commences, or expresses an intention to commence, legal action against a *covered member*, the *covered member* and the *attest client's* management may be placed in adversarial positions in which self-interest may affect the *covered member's* objectivity and management's willingness to make complete disclosures.

**.05** Accordingly, *independence* may be *impaired* whenever the *covered member* and the *covered member's attest client* or its management are in threatened or actual positions of material adverse interests due to threatened or actual litigation.

**.06** Situations involving threatened or actual litigation are complex and diverse, making it difficult to identify precise points at which *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] would be at an *acceptable level*. There are situations regarding litigation between *covered members* and *attest clients* in which *threats* to the *covered member's* compliance with the "Independence Rule" would not be at an *acceptable level* and could not be reduced to an *acceptable level* by *safeguards* and *independence* would be *impaired*. Examples of these situations are:

- a. An *attest client's* present management commences litigation alleging deficiencies in audit work performed for the *attest client* or expresses its intention to commence such litigation, and the *covered member* concludes that it is probable that such a claim will be filed.
- b. A *covered member* commences litigation against an *attest client's* present management alleging management fraud or deceit.

**.07** If threatened or actual litigation is unrelated to the performance of a *client's attest engagement* and is for an amount that is not material to the *covered member's firm* or the *attest client*, *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] would be at an *acceptable level*, and *independence* would not be *impaired*. Such claims may arise, for example, out of immaterial disputes regarding billings for services, results of tax or management services advice, or similar matters.

### **Litigation by Security Holders**

**.08** A *covered member* may also become involved in litigation (primary litigation) in which the *covered member* and the *attest client* or its management are defendants. For example, one or more stockholders may bring a stockholders' derivative action or class-action lawsuit against the *attest client* or its management, the *attest client's* officers, directors, or underwriters, and *covered members*.

**.09** Such primary litigation by itself would not *threaten* the *covered member's* compliance with the "Independence Rule" [1.200.001]. However, if other circumstances exist that may create *threats*, the *covered member* should apply the "Conceptual Framework for Independence" interpretation [1.210.010] to evaluate whether the *threats* are at an *acceptable level*. For example, *threats* will exist if cross-claims are filed against the *covered member* alleging that the *covered member* is responsible for any deficiencies in work performed for the *attest client* or if the *covered member*, as a defense, alleges that the *attest client's* management engaged in fraud or deceit.

**.10** The following are examples of situations in which *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by *safeguards*, thereby *impairing independence*:

- a. The *attest client* or its management or directors have filed cross-claims to protect a right to legal redress in the event of a future adverse decision in the primary litigation (or, in lieu of cross-claims, agreements to extend the statute of limitations), and there is a significant risk that the cross-claim will result in a settlement or judgment in an amount that is material to the *covered member's firm* or the *attest client*.
- b. The *attest client's* underwriter and the *attest client* or its present management assert cross-claims against the *covered member*.

.11 If only the underwriter or officers or directors of other *clients* of the *covered member* file cross-claims against the *covered member*, *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] would be at an *acceptable level* unless other circumstances create *threats* to compliance with the "Independence Rule."

### **Other Third-Party Litigation**

.12 A *lending institution* or other creditor, security holder, or insurance company that alleges reliance on the *attest client's financial statements* as a basis for having extended credit or insurance coverage to an *attest client* may commence third-party litigation against the *covered member* to recover their loss. An example is an insurance company commencing litigation either as a result of receiving an assignment of a claim or under subrogation rights against the *covered member* in the *attest client's* name to recover losses that the insurer reimbursed to the *attest client*. If the *attest client* is only the nominal plaintiff, *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] would be at an *acceptable level* unless other circumstances exist, such as when the *covered member* alleges, as a defense, that present management engaged in fraud or deceit. The *attest client* is a nominal plaintiff when the insurance company or lender sues in the name of the *attest client* as a result of obtaining subrogation rights or an assignment from the *attest client* and the *attest client* does not have a beneficial interest in the claim.

.13 If the real party in interest in the litigation (for example, the insurance company) is also the *covered member's attest client* (the plaintiff client), *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist if the litigation carries a significant risk of a settlement or judgment in an amount that would be material to the *covered member's firm* or the plaintiff client.

### **Termination of Impairment**

.14 *Threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] would be eliminated or reduced to an *acceptable level* when the parties reach a final resolution of the matter(s) at issue and the matter(s) no longer affects the relationship between the *covered member* and the *attest client*, as described in paragraph .01 of this interpretation. The *covered member* should determine whether the conditions of such resolution have effectively eliminated such *threats* or reduced them to an *acceptable level*. [Prior reference: paragraph .08 of ET section 101]

## **1.295 Nonattest Services**

### **1.295.010 Scope and Applicability of Nonattest Services**

.01 When a *member* performs nonattest services for an *attest client*, self-review, management participation, or advocacy *threats* to the *member's* compliance with the "Independence Rule" [1.200.001] may exist. When significant *independence threats* exist during the *period of the professional engagement* or the period covered by the *financial statements* (except as provided for in paragraph .03), *independence* will be *impaired* unless the *threats* are reduced to an *acceptable level* and any requirements included in the *interpretations* of the "Nonattest Services" subtopic [1.295] under the "Independence Rule" have been met.

.02 For purposes of the *interpretations* of the "Nonattest Services" subtopic [1.295] under the "Independence Rule" [1.200.001], the term *member* includes the *member's firm*.

**.03** *Period of engagement.* A member's *independence* would not be *impaired* if the member performed nonattest services that would have otherwise *impaired independence* during the period covered by the *financial statements* if all of the following conditions exist:

- a. The nonattest services were provided prior to *period of the professional engagement*.
- b. The nonattest services related to periods prior to the period covered by the *financial statements*.
- c. The *financial statements* for the period to which the nonattest services relate were audited by another *firm* (or in the case of a review engagement, reviewed or audited by another *firm*).

nonauthoritative questions and answers regarding the period of the professional engagement are available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf).

**.04** *Activities related to attest services.* Performing attest services often involves communications between the member and *client* management regarding

- a. the *client's* selection and application of accounting standards or policies and *financial statement* disclosure requirements;
- b. the appropriateness of the *client's* methods used in determining accounting and financial reporting;
- c. adjusting journal entries that the member has prepared or proposed for *client* management consideration; and
- d. the form or content of the *financial statements*.

These communications are considered a normal part of the *attest engagement* and are not considered nonattest services subject to the "General Requirements for Performing Nonattest Services" [1.295.040] and "Documentation Requirements When Providing Nonattest Services" [1.295.050] interpretations.

**.05** However, the member should exercise judgment in determining whether his or her involvement has become so extensive that it would constitute performing a separate service which would be subject to the "General Requirements for Performing Nonattest Services" interpretation [1.295.040].

**.06** For example, activities such as *financial statement* preparation, cash-to-accrual conversions, and reconciliations are considered outside the scope of the *attest engagement* and, therefore, constitute a nonattest service. Such activities would not *impair independence* if the requirements of the *interpretations* of the "Nonattest Services" subtopic [1.295] are met.

Nonauthoritative questions and answers regarding routine activities are available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf).

**.07** *Engagements subject to independence rules of certain regulatory or standard-setting bodies.* *Threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* through the application of *safeguards* if a member is not in compliance with the *independence* regulations of authoritative regulatory bodies that are more restrictive than the *interpretations* of the "Nonattest Services" subtopic [1.295] under the "Independence Rule" (examples of such authoritative bodies are the SEC, the Government Accountability Office [GAO],

the Department of Labor [DOL], the Public Company Accounting Oversight Board [PCAOB], and state boards of accountancy) when a member performs nonattest services for an *attest client* and is required to be independent of the *attest client* under the regulations of the applicable regulatory body. Independence would be *impaired* under these circumstances. [Prior reference: paragraph .05 of ET section 101]

### **Effective Date**

.08 Paragraph .06 of this interpretation is effective for engagements covering periods beginning on or after December 15, 2014.

### **1.295.020 Cumulative Effect on Independence When Providing Multiple Nonattest Services**

.01 The *interpretations* of the "Nonattest Services" subtopic [1.295] under the "Independence Rule" [1.200.001] include various examples of nonattest services that individually would not *impair independence* because the *safeguards* in the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] reduce the self-review and management participation *threats* to an *acceptable level*. However, performing multiple nonattest services can increase the significance of these *threats* as well as other *threats to independence*.

.02 Before agreeing to perform nonattest services, the member should evaluate whether the performance of multiple nonattest services by the *member* or *member's firm* in the aggregate creates a significant *threat* to the member's *independence* that cannot be reduced to an *acceptable level* by the application of the *safeguards* in the "General Requirements for Performing Nonattest Services" interpretation [1.295.040].

.03 In situations in which a member determines that *threats* are not at an *acceptable level*, *safeguards* in addition to those in the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] should be applied to eliminate the *threats* or reduce them to an *acceptable level*. If no *safeguards* exist that will eliminate or reduce the *threats* to an *acceptable level*, *independence* would be *impaired*.

.04 For purposes of this interpretation, the member is not required to consider the possible *threats to independence* created due to the provision of nonattest services by other *network firms* within the *firm's network*. [Prior reference: paragraph .05 of ET section 101]

### **Effective Date**

.05 This interpretation is effective for engagements covering periods beginning on or after December 15, 2014.

### **1.295.030 Management Responsibilities**

.01 If a member were to assume a management responsibility for an *attest client*, the management participation *threat* would be so significant that no *safeguards* could reduce the *threat* to an *acceptable level* and *independence* would be *impaired*. It is not possible to specify every activity that is a management responsibility. However, management responsibilities involve leading and directing an entity, including making significant decisions regarding the acquisition, deployment, and control of human, financial, physical, and intangible resources.

.02 Whether an activity is a management responsibility depends on the circumstances and requires the exercise of judgment. Examples of activities

that would be considered management responsibilities and, as such, *impair independence* if performed for an *attest client*, include

- a. setting policy or strategic direction for the *attest client*.
- b. directing or accepting responsibility for actions of the *attest client's* employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards.
- c. authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of an *attest client* or having the authority to do so.
- d. preparing *source documents*, in electronic or other form, that evidence the occurrence of a transaction.
- e. having custody of an *attest client's* assets.
- f. deciding which recommendations of the member or other third parties to implement or prioritize.
- g. reporting to *those charged with governance* on behalf of management.
- h. serving as an *attest client's* stock transfer or escrow agent, registrar, general counsel or equivalent.
- i. accepting responsibility for the management of an *attest client's* project.
- j. accepting responsibility for the preparation and fair presentation of the *attest client's financial statements* in accordance with the applicable financial reporting framework.
- k. accepting responsibility for designing, implementing, or maintaining internal control.
- l. performing ongoing evaluations of the *attest client's* internal control as part of its monitoring activities.

[Prior reference: paragraph .05 of ET section 101]

Nonauthoritative questions and answers regarding management responsibilities and controllership services are available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf).

### **1.295.040 General Requirements for Performing Nonattest Services**

.01 When a member performs a nonattest service for an *attest client*, *threats* to the member's compliance with the "Independence Rule" [1.200.001] may exist. Unless an *interpretation* of the "Nonattest Services" subtopic [1.295] under the "Independence Rule" states otherwise, *threats* would be at an *acceptable level*, and *independence* would not be *impaired*, when all the following *safeguards* are met:

- a. The member determines that the *attest client* and its management agree to
  - i. assume all management responsibilities as described in the "Management Responsibilities" interpretation [1.295.030].
  - ii. oversee the service, by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience. The member should assess and be satisfied that such 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.
- iii. evaluate the adequacy and results of the services performed.
  - iv. accept responsibility for the results of the services.
- b. The member does not assume management responsibilities (See the "Management Responsibilities" interpretation [1.295.030] of the "Independence Rule") when providing nonattest services and the member is satisfied that the *attest client* and its management will
- i. be able to meet all of the criteria delineated in item *a*;
  - ii. make an informed judgment on the results of the member's nonattest services; and
  - iii. accept responsibility for making the significant judgments and decisions that are the proper responsibility of management.

If the *attest client* is unable or unwilling to assume these responsibilities (for example, the *attest client* cannot oversee the nonattest services provided or is unwilling to carry out such responsibilities due to lack of time or desire), the member's performance of nonattest services would *impair independence*.

- c. Before performing nonattest services the member establishes and documents in writing his or her understanding with the *attest client* (board of directors, audit committee, or management, as appropriate in the circumstances) regarding
- i. objectives of the engagement,
  - ii. services to be performed,
  - iii. *attest client's* acceptance of its responsibilities,
  - iv. member's responsibilities, and
  - v. any limitations of the engagement.

**.02** The *safeguards* in paragraph .01 and the "Documentation Requirements When Providing Nonattest Services" interpretation [1.295.050] of the "Independence Rule" [1.200.001] do not apply to certain routine activities performed by the member, such as providing advice and responding to the *attest client's* questions as part of the *client*-member relationship. However, in providing such services, the member must not assume management responsibilities, as described in the "Management Responsibilities" interpretation [1.295.030] of the "Independence Rule." [Prior reference: paragraph .05 of ET section 101]

Nonauthoritative questions and answers regarding suitable skill, knowledge, and experience are available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf).

### **1.295.050 Documentation Requirements When Providing Nonattest Services**

**.01** Before performing nonattest services, the member should document in writing the member's understanding established with the *attest client*,

as described in paragraph .01c of the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule" [1.200.001].

**.02** Failure to prepare the required documentation does not *impair independence* provided that the member did establish the understanding with the *attest client*. However, failure to prepare the required documentation would be considered a violation of the "Compliance With Standards Rule" [1.310.001].

**.03** The documentation requirement does not apply to nonattest services performed prior to the *period of the professional engagement* for an *attest client*. However, for nonattest services provided during the period covered by the *financial statements*, the member should document in writing that the requirements of the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] were met prior to the *period of the professional engagement*, including the requirement to establish an understanding with the *attest client*. [Prior reference: paragraph .05 of ET section 101]

Sample language for how to document your understanding with the attest client is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf).

### 1.295.105 Advisory Services

**.01** Self-review or management participation *threats* to compliance with the "Independence Rule" [1.200.001] may exist when a member performs advisory services for an *attest client*.

**.02** If the member's services are only advisory in nature and the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule" [1.200.001], *threats* would be at an *acceptable level* and *independence* would not be *impaired*. For example, a member may

- a. provide advice, research materials, and recommendations to assist management in performing its functions and making decisions.
- b. attend board meetings as a nonvoting advisor.
- c. interpret *financial statements*, forecasts, or other analyses.
- d. provide management with advice regarding its potential plans, strategies, or relationships.

**.03** However, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* if a member assumes any management responsibilities, as described in the "Management Responsibilities" interpretation [1.295.030]. Accordingly, *independence* is *impaired*. [Prior reference: paragraph .05 of ET section 101 and paragraphs .015–.016 of ET section 191]

### 1.295.110 Appraisal, Valuation, and Actuarial Services

**.01** Self-review or management participation *threats* to compliance with the "Independence Rule" [1.200.001] may exist when a member performs appraisal, valuation, or actuarial service for an *attest client*.

**.02** *Threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the

application of *safeguards* if the member performs an appraisal, a valuation, or an actuarial service for an *attest client* when (a) the services involve a significant degree of subjectivity and (b) the results of the service, individually or when combined with other valuation, appraisal, or actuarial services, are material to the *attest client's financial statements*. Accordingly, *independence* would be *impaired* under these circumstances.

.03 When performing appraisal, valuation, and actuarial services for an *attest client* that are permitted under this interpretation, all requirements of the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule" [1.200.001] should be met, including that all significant assumptions and matters of judgment are determined or approved by the *attest client*, and the *attest client* is in a position to have an informed judgment on, and accepts responsibility for, the results of the service.

### **Valuations Involving a Significant Degree of Subjectivity**

.04 Examples of valuations that generally involve a significant degree of subjectivity include, ESOPs, business combinations, or appraisals of assets or liabilities. Accordingly, if these services produce results that are material to the *attest client's financial statements*, *independence* would be *impaired*.

### **Actuarial Valuations of Pension or Postemployment Benefit Liabilities**

.05 An actuarial valuation of an *attest client's* pension or postemployment benefit liabilities generally does not involve a significant degree of subjectivity because reasonably consistent results are produced when the same assumptions and information are used in performing the valuation. Therefore, *threats* would be at an *acceptable level* and *independence* would not be *impaired*.

### **Appraisal, Valuations, and Actuarial Services for Nonfinancial Statement Purposes**

.06 *Threats* would be at an *acceptable level* if a member provided appraisal, valuation, or actuarial services solely for nonfinancial statement purposes. Some examples are appraisal, valuation, and actuarial services performed for tax planning or tax compliance, estate and gift taxation, and divorce proceedings. Accordingly, *independence* would not be *impaired*. [Prior reference: paragraph .05 of ET section 101]

Nonauthoritative questions and answers regarding appraisal, valuation, and actuarial services are available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf).

### **1.295.115 Benefit Plan Administration**

.01 When a member provides benefit plan administration services to an *attest client*, self-review and management participation *threats* to the member's compliance with the "Independence Rule" [1.200.001] may exist.

.02 Notwithstanding the conclusions reached in paragraph .03 of this interpretation, a member should comply with the more restrictive independence provisions of the Employee Retirement Income Security Act (ERISA) of 1974 and DOL regulations when performing audits of employee benefit plans subject to those regulations.

**.03** If the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule" [1.200.001], *threats* would be at an *acceptable level* and *independence* would not be *impaired*. For example, the member may

- a. communicate summary plan data to a plan trustee.
- b. advise management regarding the application and impact of provisions in a plan document.
- c. process certain transactions that have been initiated by plan participations or approved by the plan administrators using the member's electronic media, such as an interactive voice response system or Internet connection or other media. Such transactions may include processing investment or benefit elections, changes in contributions to the plan, data entry, participant confirmations, and distributions and *loans*.
- d. prepare account valuations for plan participants using data collected through the member's electronic or other media.
- e. prepare and transmit participant statements to plan participants based on data collected through the member's electronic or other media.

**.04** However, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level*, and could not be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired* if, for example, a member

- a. makes policy decisions on behalf of management.
- b. interprets the provisions in a plan document for a plan participant on behalf of management without first obtaining management's concurrence.
- c. makes disbursements on behalf of the plan.
- d. has custody of the plan's assets.
- e. serves in a fiduciary capacity, as defined by ERISA. [Prior reference: paragraph .05 of ET section 101]

### **1.295.120 Bookkeeping, Payroll, and Other Disbursements**

**.01** When a member provides bookkeeping, payroll, and other disbursement services to an *attest client*, self-review and management participation *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist.

**.02** If the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule" [1.200.001], *threats* would be at an *acceptable level* and *independence* would not be *impaired*. For example, a member may

- a. record transactions to an *attest client's* general ledger when management has determined or approved the account classifications for the transaction.
- b. post *client*-coded transactions to an *attest client's* general ledger.
- c. prepare *financial statements* based on information in the *attest client's* trial balance.
- d. post *client*-approved journal or other entries to an *attest client's* trial balance.

- e. propose standard, adjusting, or correcting journal entries or other changes affecting the *financial statements* to the *attest client*. Prior to the member posting these journal entries or changes, the member should be satisfied that management has reviewed the entries and understands the nature of the proposed entries and the effect the entries will have on the *attest client's financial statements*.
- f. generate unsigned checks using *source documents* or other records provided and approved by the *attest client*.
- g. process an *attest client's* payroll using payroll time records that the *attest client* has provided and approved.
- h. transmit *client*-approved payroll or other disbursement information to a bank or similar entity subsequent to the *attest client's* review and authorization for the member to make the transmission. Prior to such transmission, the *attest client* is responsible for making the arrangements with the bank or similar entity to limit the corresponding individual payments regarding the amount and payee. In addition, once transmitted, the *attest client* must authorize the bank or similar entity to process the payroll information.
- i. prepare a reconciliation (for example, bank and accounts receivable) that identifies reconciling items for the *client's* evaluation.

**.03** However, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired*, if, for example, a member

- a. determines or changes journal entries, any account coding or classification of transactions, or any other accounting records without first obtaining the *attest client's* approval.
- b. authorizes or approves transactions.
- c. prepares *source documents*.
- d. makes changes to *source documents* without the *attest client's* approval.
- e. accepts responsibility to authorize payment of *attest client* funds, electronically or otherwise, except for electronic payroll tax payments when the member complies with the requirements of the "Tax Services" interpretation [1.295.160] of the "Independence Rule."
- f. accepts responsibility to sign or cosign an *attest client's* checks, even if only in emergency situations.
- g. maintains an *attest client's* bank account or otherwise has custody of an *attest client's* funds or makes credit or banking decisions for the *attest client*.
- h. approves vendor invoices for payment. [Prior reference: paragraph .05 of ET section 101]

Nonauthoritative questions and answers about bookkeeping services are available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf).

### 1.295.125 Business Risk Consulting

**.01** When a member provides business risk consulting services to an *attest client*, self-review and management participation *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist.

**.02** If the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule" [1.200.001], *threats* would be at an *acceptable level* and *independence* would not be *impaired*. For example, a member may

- a. assist management in its assessment of the *attest client's* business risk control processes.
- b. recommend improvements to an *attest client's* business risk control processes and assists in the implementation of these improvements.

**.03** However, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired*, if, for example, a member

- a. makes or approves business risk decisions.
- b. presents business risk considerations to the board or others on behalf of management. [Prior reference: paragraph .05 of ET section 101]

### 1.295.130 Corporate Finance Consulting

**.01** When a member provides corporate finance consulting services to an *attest client*, self-review, management participation, and advocacy *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist.

**.02** If the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule" [1.200.001], *threats* would be at an *acceptable level* and *independence* would not be *impaired*. For example, a member may

- a. assist management in developing its corporate strategies.
- b. assist management in identifying possible sources of capital that meet the *attest client's* specifications or criteria.
- c. introduce management to possible sources of capital that meet the *attest client's* specifications or criteria.
- d. assist management in analyzing the effects of proposed transactions with potential buyers, sellers, or capital sources.
- e. advise an *attest client* during its negotiations with potential buyers, sellers, or capital sources.
- f. assist the *attest client* in drafting its offering document or memorandum.
- g. participate with management in its transaction negotiations in an advisory capacity.
- h. be named as a financial adviser in an *attest client's* private placement memoranda or offering documents.

**.03** However, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to

an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired*, if, for example, a member

- a. commits the *attest client* to the terms of a transaction.
- b. consummates a transaction on behalf of the *attest client*.
- c. acts as a promoter, an underwriter, a broker-dealer, or a guarantor of an *attest client's* securities or as a distributor of private placement memoranda or offering documents.
- d. maintains custody of an *attest client's* securities. [Prior reference: paragraph .05 of ET section 101]

### 1.295.135 Executive or Employee Recruiting

**.01** When a member provides executive or employee recruiting services to an *attest client*, self-review and management participation *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist.

**.02** If the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule" [1.200.001], *threats* would be at an *acceptable level* and *independence* would not be *impaired*. For example, a member may

- a. recommend a position description or candidate specifications.
- b. solicit and screen candidates based on *client*-approved criteria, such as required education, skills, or experience.
- c. recommend qualified candidates to the *attest client* for their consideration based on *client*-approved criteria.
- d. participate in employee hiring or compensation discussions in an advisory capacity.

**.03** However, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired*, if, for example, a member

- a. commits the *attest client* to employee compensation or benefit arrangements.
- b. hires or terminates the *attest client's* employees. [Prior reference: paragraph .05 of ET section 101]

### 1.295.140 Forensic Accounting

**.01** *Forensic accounting services*. For purposes of this interpretation, forensic accounting services are nonattest services that involve the application of (a) special skills in accounting, auditing, finance, quantitative methods or certain areas of the law, and research and (b) investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings. Forensic accounting services consist of investigative services and litigation services.

**.02** *Attest client*. For purposes of this interpretation, the term *attest client* refers to an underlying party to the litigation for whom the member is providing services, not the law firm that engages the member on behalf of the law firm's client. If the law firm that engages the member on behalf of the member's *attest client* is also an *attest client* of the member, the member should consider the applicability of the "Cooperative Arrangements With Attest Clients" interpretation [1.265.010] of the "Independence Rule" [1.200.001].

**.03** *Investigative services*. For purposes of this interpretation, investigative services include all forensic services that do not involve actual or threatened

litigation, such as performing analyses or investigations that may require the same skills used in litigation services. When a member provides investigative services to an *attest client*, self-review and management participation *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist. However, if the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule," *threats* will be at an *acceptable level* and *independence* will not be *impaired*.

**.04 Litigation services.** For purposes of this interpretation, litigation services recognize the role of the member as an expert or a consultant and consist of providing assistance for actual or potential legal or regulatory proceedings before a trier of fact in connection with the resolution of disputes between parties. Litigation services consist of expert witness services, litigation consulting services, or other litigation services:

- a. *Expert witness services.* For purposes of this interpretation, expert witness services are those litigation services in which a member is engaged to render an opinion before a trier of fact about the matter(s) in dispute based on the member's expertise, rather than his or her direct knowledge of the disputed facts or events:
  - i. Expert witness services create the appearance that a member is advocating or promoting an *attest client's* position. Therefore, the advocacy *threat* would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, if a member is engaged conditionally or unconditionally to provide expert witness services or expert testimony for an *attest client*, *independence* would be *impaired*, except as discussed in the following item ii.
  - ii. *Threats* to compliance with the "Independence Rule" [1.200.001] would be at an acceptable level, and *independence* would not be *impaired*, if a member provides expert witness services for a large group of plaintiffs or defendants that includes one or more *attest clients* of the *firm*, provided that at the outset of the engagement
    1. the member's *attest clients* constitute less than 20 percent of the members of the group, voting interests of the group, and the claim;
    2. no *attest client* within the group is designated as the lead plaintiff or defendant of the group; and
    3. no *attest client* has the sole decision-making power to select or approve the selection of the expert witness.
  - iii. *Fact witness testimony.* Acting as a fact witness (also referred to as a "percipient witness" or "sensory witness") would not be considered a nonattest service. Fact witness testimony is based on the member's direct knowledge of the matters, facts, or events in dispute obtained through the member's performance of prior *professional services* for the *attest client*. As a fact witness, the member's role is to provide factual testimony to the trier of fact. While testifying as a fact witness, the trier of fact or counsel may question a member about the member's opinions pertaining to matters within the member's area of expertise.

Answering such questions would not *impair* the member's *independence*.

- iv. In determining whether the member's services are considered expert witness services or fact witness testimony, members should refer to Rules 701–703 of Article VII, "Opinions and Expert Testimony," of the *Federal Rules of Evidence* and also refer to other applicable laws, regulations, and rules.
  - v. When providing expert witness services or fact witness testimony, members are required to comply with the "Integrity and Objectivity Rule" [1.100.001].
- b. *Litigation consulting services.* For purposes of this interpretation, litigation consulting services are those litigation services in which a member provides advice about the facts, issues, or strategy pertaining to a matter. The consultant does not testify as an expert witness before a trier of fact:
- i. When a member provides litigation consulting services, advocacy and management participation *threats* to the *covered member's* compliance with the "Independence Rule" may exist. If the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule," *threats* would be at an *acceptable level* and *independence* would not be *impaired*. For purposes of complying with paragraph .01b of the "General Requirements for Performing Nonattest Services" interpretation of the "Independence Rule," the *attest client* may designate its attorney to oversee the litigation consulting services.
  - ii. However, if the member providing litigation consulting services subsequently agrees to serve as an expert witness, *threats* to the member's compliance with the "Independence Rule" would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*. Accordingly, *independence* would be *impaired*.
- c. *Other litigation services.* The advocacy *threat* would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* if a member serves as a trier of fact, a special master, a court-appointed expert, or an arbitrator (including serving on an arbitration panel) in a matter involving an *attest client*. These services create the appearance that the member is not independent; accordingly, *independence* would be *impaired*.
- d. However, if the member applies the "General Requirements for Performing Nonattest Services" interpretation of the "Independence Rule," *threats* would be at an *acceptable level* and *independence* would not be *impaired* when a member serves as a mediator or any similar role in a matter involving an *attest client*, provided that the member is not making any decisions on behalf of the parties but, rather, is acting as a facilitator by assisting the parties in reaching their own agreement. When providing such services, the member should consider the requirements of the "Conflicts of

Interest" interpretation [1.110.010] of the "Integrity and Objectivity Rule." [Prior reference: paragraph .05 of ET section 101]

.05 See [www.aicpa.org/interestareas/professionalethics/community/downloadabledocuments/transition%20periods.pdf](http://www.aicpa.org/interestareas/professionalethics/community/downloadabledocuments/transition%20periods.pdf) for information about transition provision for engagements commenced prior to February 28, 2007.

.06 When providing any type of forensic accounting service, members are required to comply with the "Integrity and Objectivity Rule" [1.100.001].

### **1.295.145 Information Systems Design, Implementation, or Integration**

.01 When a member provides information systems design, implementation, or integration services to an *attest client*, self-review and management participation *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist.

.02 If the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule" [1.200.001], *threats* would be at an *acceptable level* and *independence* would not be *impaired*. For example, a member may

- a. install or integrate an *attest client's* financial information system that the member did not design or develop (for example, an off-the-shelf accounting package).
- b. assist in setting up the *attest client's* chart of accounts and *financial statement* format with respect to the *attest client's* financial information system.
- c. design, develop, install, or integrate an *attest client's* information system that is unrelated to the *attest client's financial statements* or accounting records.
- d. provide training and instruction to an *attest client's* employees on an information and control system.
- e. perform network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings consistent with management's request.

.03 However, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired*, if, for example, a member

- a. designs or develops an *attest client's* financial information system.
- b. makes other than insignificant modifications to source code underlying an *attest client's* existing financial information system.
- c. supervises *attest client* personnel in the daily operation of an *attest client's* information system.
- d. operates an *attest client's* network. [Prior reference: paragraph .05 of ET section 101]

Nonauthoritative questions and answers regarding information systems design, implementation, and integration services are available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf).

### 1.295.150 Internal Audit

.01 For purposes of this interpretation, internal audit services involve assisting the *attest client* in the performance of its internal audit activities, sometimes referred to as "internal audit outsourcing." When a member provides internal audit services to an *attest client*, self-review and management participation *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist.

.02 The *attest client's* management is responsible for directing the internal audit function, including the management thereof. Such responsibilities include, but are not limited to, designing, implementing and maintaining internal control. *Threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level*, cannot be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired* if the *attest client* outsources the internal audit function to the member, whereby the member, in effect, manages the *attest client's* internal audit activities.

.03 However, except for the outsourcing services discussed in paragraph .02, *threats* to compliance with the "Independence Rule" [1.200.001] would be at an *acceptable level* and *independence* would not be *impaired* if the member assists the *attest client* in performing financial and operational internal audit activities, provided that, in addition to the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule," the member is satisfied that management

- a. designates an individual or individuals who possess suitable skill, knowledge, and experience, preferably within senior management, to be responsible for the internal audit function.
- b. determines the scope, risk, and frequency of internal audit activities, including those the member will perform in providing the services.
- c. evaluates the findings and results arising from the internal audit activities, including those the member will perform in providing the services.
- d. evaluates the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures.

.04 For example, if the member applies the *safeguards* in paragraph .03, the member may assess whether performance is in compliance with management's policies and procedures, identify opportunities for improvement, and recommend improvement or further action for management consideration and decision making.

.05 The member may assist the individual responsible for the internal audit function in performing preliminary audit risk assessments, preparing audit plans, and recommending audit priorities. The member should also be satisfied that *those charged with governance* are informed about the member's and management's respective roles and responsibilities in connection with the engagement. Such information should provide *those charged with governance* a basis for developing guidelines for management and the member to follow in carrying out these responsibilities and monitoring how well the respective responsibilities have been met.

.06 *Threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired*, if, for example, in addition to those activities listed in the "Management Responsibilities" interpretation [1.295.030] of the "Independence Rule," a member

- a. performs ongoing evaluations (see paragraph .10 that follows) or control activities (for example, reviewing *loan* originations as part of the *attest client's* approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed or accounted for, or both, and performs routine activities in connection with the *attest client's* operating or production processes that are equivalent to those of an ongoing compliance or quality control function.
- b. performs separate evaluations on the effectiveness of a significant control such that the member is, in effect, performing routine operations that are built into the *attest client's* business process.
- c. has *attest client* management rely on the member's work as the primary basis for the *attest client's* assertions on the design or operating effectiveness of internal controls.
- d. determines which, if any, recommendations for improving the internal control system should be implemented.
- e. reports to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function.
- f. approves or is responsible for the overall internal audit work plan, including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures.
- g. is connected with the *attest client* as an employee or in any capacity equivalent to a member of management (for example, being listed as an employee in the *attest client's* directories or other *attest client* publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the *attest client's* internal audit function, or using the *attest client's* letterhead or internal correspondence forms in communications).

**.07** *Monitoring activities.* Designing, implementing, or maintaining the *attest client's* monitoring activities are management responsibilities. Accordingly, *independence* would be *impaired* if a member accepts responsibility for performing such activities. Monitoring activities are procedures performed to assess whether components of internal control are present and functioning. Monitoring can be done through ongoing evaluations, separate evaluations, or some combination of the two. Ongoing evaluations are generally defined, routine operations built in to the *attest client's* business processes and performed on a real-time basis. Ongoing evaluations, including managerial activities and everyday supervision of employees, monitor the presence and functioning of the components of internal control in the ordinary course of managing the business. A member who performs such activities for an *attest client* would be considered to be accepting responsibility for maintaining the *attest client's* internal control. Accordingly, the management participation *threat* created by a member performing ongoing evaluations is so significant that no *safeguards* could reduce the *threat* to an *acceptable level*, and thus *independence* would be *impaired*.

**.08** Separate evaluations are conducted periodically and generally not ingrained within the business but can be useful in taking a fresh look at whether internal controls are present and functioning. Such evaluations include observations, inquiries, reviews, and other examinations, as appropriate, to ascertain whether controls are designed, implemented, and conducted. The scope and frequency of separate evaluations is a matter of judgment and vary depending on

assessment of risks, effectiveness of ongoing evaluations, and other considerations. Because separate evaluations are not built into the *attest client's* business process, separate evaluations generally do not create a significant management participation *threat to independence*.

**.09** Members should refer to the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) *Internal Control—Integrated Framework*, for additional guidance on monitoring activities and distinguishing between ongoing and separate evaluations.

**.10** Members should use judgment in determining whether otherwise permitted internal audit services performed may result in a significant management participation *threat to independence*, considering factors such as the significance of the controls being tested, the scope or extent of the controls being tested in relation to the overall *financial statements* of the *client*, as well as the frequency of the internal audit services. If the *threat to independence* is considered significant, the member should apply *safeguards* to eliminate or reduce the *threat* to an *acceptable level*. If no *safeguards* could reduce the *threat* to an *acceptable level*, then *independence* would be *impaired*.

**.11** *Attest-related services*. Services considered extensions of the member's audit scope applied in the audit of the *attest client's financial statements*, such as confirming accounts receivable and analyzing fluctuations in account balances, are not considered internal audit services and would be subject to this interpretation even if the extent of such testing exceeds that required by generally accepted auditing standards (GAAS). In addition, engagements performed under the attestation standards would not be considered internal audit services and, therefore, would not *impair independence*.

**.12** When a member performs internal audit services that would not *impair independence* under this interpretation and is subsequently engaged to perform an attestation engagement to report on management's assertion regarding the effectiveness of its internal control, *independence* would not be considered *impaired*, provided the member is satisfied that *attest client* management does not rely on the member's work as the primary basis for its assertion. [Prior reference: paragraph .05 of ET section 101]

### **1.295.155 Investment Advisory or Management**

**.01** When a member provides investment advisory or management services to an *attest client*, self-review and management participation *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist.

**.02** If the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule" [1.200.001], *threats* would be at an *acceptable level* and *independence* would not be *impaired*. For example, a member may

- a. recommend the *attest client's* allocation of funds among various investments or asset classes based upon the *attest client's* desired rate of return, risk tolerance, or other parameters.
- b. perform recordkeeping and reporting of the *attest client's* portfolio balances, including providing the *attest client* with a comparative analysis of the *attest client's* investments to third-party benchmarks.
- c. evaluate the manner in which an *attest client's* portfolio is being managed by investment account managers, including assessing whether the managers are

- i. following the guidelines of the *attest client's* investment policy statement.
  - ii. meeting the *attest client's* investment objectives.
  - iii. conforming to the *attest client's* stated investment parameters or risk tolerance.
- d. transmit an *attest client's* investment selection, with the *attest client's* consent, to the *attest client's* broker-dealer or equivalent, provided that the *attest client* has authorized the broker-dealer or equivalent to execute the transaction.

**.03** However, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired*, if, for example, a member

- a. makes investment decisions on behalf of management or otherwise has discretionary authority over an *attest client's* investments.
- b. executes a transaction to buy or sell an *attest client's* investments.
- c. has custody of an *attest client's* assets, such as taking temporary possession of securities purchased by an *attest client*. [Prior reference: paragraph .05 of ET section 101]

### 1.295.160 Tax Services

**.01** For purposes of this interpretation, tax services include preparation of a tax return, transmittal of a tax return, and transmittal of any related tax payment to the taxing authority, signing and filing a tax return, having a power of attorney limited strictly to tax matters; and authorized representation of *attest clients* in administrative proceedings before a taxing authority.

**.02** For purposes of this interpretation, a tax return includes all tax filings, including informational tax forms (such as estimated tax vouchers), extension forms, and Forms 990, 5500, 1099, and W-2, filed with a taxing authority or other regulatory agency.

**.03** *Preparation and transmittal.* When a member prepares a tax return and transmits the tax return and related tax payment to a taxing authority in paper or electronic form, self-review and management participation *threats* to the member's compliance with the "Independence Rule" [1.200.001] may exist. If the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule," *threats* would be at an *acceptable level* and *independence* would not be *impaired*, provided that the member does not have custody or control over the *attest client's* funds or assets and the individual designated by the *attest client* to oversee the tax services

- a. reviews and approves the tax return and related tax payment.
- b. if required for filing, signs the tax return prior to the member transmitting the return to the taxing authority.

The following are not considered having custody or control over an *attest client's* funds: making electronic tax payments authorized by an *attest client* pursuant to a taxing authority's prescribed criteria (as discussed in paragraph .04), affixing the *attest client's* depository account information on a tax return, or remitting an *attest client's* check made payable to the taxing authority.

**.04** If the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule"

[1.200.001], *threats* would be at an *acceptable level* and *independence* would not be *impaired* when a member signs and files a tax return on behalf of management, provided that the member has the legal authority to do so and

- a. the taxing authority has prescribed procedures in place for an *attest client* to permit a member to sign and file a tax return on behalf of the *attest client* (for example, Forms 8879 or 8453), and such procedures meet, at the minimum, standards for electronic return originators and officers outlined in Form 8879, or
- b. an individual in management who is authorized to sign and file the *attest client's* tax return provides the member with a signed statement that clearly identifies the return being filed and represents that such individual
  - i. is authorized to sign and file the tax return.
  - ii. has reviewed the tax return, including accompanying schedules and statements, and it is true, correct, and complete to the best of the individual's knowledge and belief.
  - iii. authorizes the *member* or another named individual in the *member's firm* to sign and file the tax return on the *attest client* behalf.

**.05** *Authorized representation in administrative proceedings.* If the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule" [1.200.001], *threats* would be at an *acceptable level* and *independence* would not be *impaired* if a member acts as the *attest client's* authorized representative in administrative proceedings before a taxing authority, provided that the member obtains the *attest client's* agreement prior to committing the *attest client* to a specific resolution with the taxing authority. [Prior reference: paragraph .05 of ET section 101]

**.06** *Power of attorney.* When a member has an *attest client's* power of attorney, the self-review, management participation, and advocacy *threats* to the *covered member's* compliance with the "Independence Rule" [1.200.001] may exist. If the member applies the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule," *threats* would be at an *acceptable level* and *independence* would not be *impaired*, provided that the member's use of the power of attorney is limited strictly to tax matters and the member does not bind the *attest client* to any agreement with a taxing authority or other regulatory agency. [No prior reference: new content]

**.07** *Representation in court.* *Threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level*, and could not be reduced to an *acceptable level* through the application of *safeguards*, and *independence* would be *impaired* if a member represents an *attest client* in court to resolve a tax dispute. For purposes of this interpretation, court encompasses a tax, district, or federal court of claims and the equivalent state, local, or foreign forums. [Prior reference: paragraph .05 of ET section 101]

**.08** For information about transition provision for engagements commenced prior to February 28, 2007, see [www.aicpa.org/interestareas/professionalethics/community/downloadabledocuments/transistion%20periods.pdf](http://www.aicpa.org/interestareas/professionalethics/community/downloadabledocuments/transistion%20periods.pdf).

### **Effective Date**

**.09** Paragraph .06 of this interpretation is effective December 15, 2014.

A nonauthoritative basis-for-conclusions document that summarizes considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsNonAttestServices.doc](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsNonAttestServices.doc).

In addition, nonauthoritative questions and answers regarding performance tax services are available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf).

## **1.297 Independence Standards for Engagements Performed in Accordance With Statements on Standards for Attestation Engagements**

### ***1.297.010 Application of the Independence Rule to Engagements Performed in Accordance With Statements on Standards for Attestation Engagements***

**.01** The "Independence Rule" [1.200.001] and its *interpretations* apply to all *attest engagements*. However, when performing engagements to issue reports in accordance with Statements on Standards for Attestation Engagements (SSAEs), when *independence* is required or when the *member's* compilation report does not disclose a lack of *independence*, the *covered member* needs to be independent with respect to the responsible party(ies), as defined in the SSAEs.

**.02** If the individual or entity that engages the *covered member* is not the responsible party, the *covered member* need not be independent of that individual or entity. However, the *covered member* should consider the "Conflicts of Interest" interpretation [1.110.010] of the "Integrity and Objectivity Rule" [1.100.001], with regard to any relationships that may exist with the individual or entity that engages the *covered member* to perform these services.

**.03** In addition, application of the "Independence Rule" [1.200.001] is further modified as set forth in the "Agreed-Upon Procedures Engagements in Accordance With SSAEs" interpretation [1.297.020] and the "Engagements, Other Than AUPs, Performed in Accordance With SSAEs" interpretation [1.297.030] of the "Independence Rule." [Prior reference: paragraph .13 of ET section 101]

### ***1.297.020 Agreed-Upon Procedure Engagements Performed in Accordance With SSAEs***

**.01** For purposes of this interpretation, subject matter is as defined in the SSAEs.

**.02** When performing agreed-upon procedures (AUP) engagements in accordance with the SSAEs, the application of the "Independence Rule" [1.200.001] is modified, as described in the "Application of the Independence Rule to Engagements Performed in Accordance With Statements on Standards for Attestation Engagements" interpretation [1.297.010] of the "Independence Rule" and this interpretation.

**.03** When providing nonattest services that would otherwise *impair independence* under the *interpretations* of the "Nonattest Services" subtopic [1.295] under the "Independence Rule" [1.200.001], *threats* would be at an *acceptable level* and *independence* would not be *impaired*, provided that the nonattest services do not relate to the specific subject matter of the SSAE engagement. *Threats* would be at an *acceptable level* and *independence* would also not be *impaired* if the "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule" were not applied when providing the nonattest services, provided that the nonattest services do not relate to the specific subject matter of the AUP engagement.

**.04** In addition, when performing an AUP engagement under the SSAEs, *threats* would be at an *acceptable level* and *independence* would not be *impaired*, if the following *covered members* and their *immediate families* are independent of the responsible party(ies):

- a. Individuals participating on the AUP engagement team
- b. Individuals who directly supervise or manage the AUP engagement *partner* or *partner equivalent*
- c. Individuals who consult with the *attest engagement team* regarding technical or industry-related issues specific to the AUP engagement

**.05** Furthermore, *threats* to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired*, if the *firm* had a material financial relationship with the responsible party(ies) that was covered by any of the following interpretations of the "Independence Rule":

- a. Paragraph .02 of "Overview of Financial Interests" [1.240.010]
- b. "Trustee or Executor" [1.245.010]
- c. "Joint Closely Held Investments" [1.265.020]
- d. "Loans" [1.260.010] [Prior reference: paragraph .13 of ET section 101]

### **Effective Date**

**.06** The addition of *partner equivalents* to paragraph .04 is effective for engagements covering periods beginning on or after December 15, 2014.

### **1.297.030 Engagements, Other Than AUPs, Performed in Accordance With SSAEs**

**.01** For purposes of this interpretation, subject matter is as defined in the SSAEs.

**.02** When performing an engagement, other than an AUP, in accordance with the SSAEs, the application of the "Independence Rule" [1.200.001] is modified, as described in the "Application of the Independence Rule to Engagements Performed in Accordance With Statements on Standards for Attestation Engagements" interpretation [1.297.010] of the "Independence Rule" and this interpretation.

**.03** When providing nonattest services that would otherwise *impair independence* under the *interpretations* of the "Nonattest Services" subtopic [1.295],

*threats* would be at an *acceptable level* and *independence* would not be *impaired* if the following safeguards are met:

- a. Nonattest services do not relate to the specific subject matter of the SSAE engagement.
- b. The "General Requirements for Performing Nonattest Services" interpretation [1.295.040] of the "Independence Rule" [1.200.001] are met when providing the nonattest service. [Prior reference: paragraph .13 of ET section 101]

## 1.298 Breach of an Independence Interpretation

### 1.298.010 Breach of an Independence Interpretation

#### **Introduction**

.01 AICPA bylaws require *members* to comply with the "Independence Rule" [1.200.001]. This interpretation provides guidance to assist *members* in evaluating and addressing the consequences of a breach of an *independence interpretation* and the effect on the *attest engagement team's* integrity, objectivity, and professional skepticism so the *member* or *member's firm* can determine if the consequences of a breach can be satisfactorily addressed. This interpretation also provides specific steps and actions the *member* should take when the *member* becomes aware that a breach of an *independence interpretation* has occurred. However, a *member's* determination that the consequences of a breach of an *independence interpretation* have been satisfactorily addressed will not preclude an investigation or enforcement action. In any case, the *member* should be prepared to justify such determination.

#### **Required Policies and Procedures Established by the Firm**

.02 In order for the consequences of an *independence* breach to be addressed by a *member* or the *member's firm* pursuant to the provisions of this interpretation, the *firm* must be compliant with QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), which requires the *member's firm* to have established policies and procedures designed to provide it with reasonable assurance that the *firm*, its personnel, and, when applicable, others subject to *independence* requirements, maintain *independence* when required. The policies and procedures should enable the *firm* to communicate its *independence* requirements to its personnel and, when applicable, others subject to them; to 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. These policies and procedures should be designed to provide the *firm* with reasonable assurance that it is notified of breaches of *independence* requirements and to enable it to take appropriate actions to resolve such situations.

#### **Breaches Resulting in Significant Threats**

.03 In situations in which a *partner* or professional employee of the *firm* breaches an *independence interpretation* and the *threat* to *independence* resulting from the breach is significant such that the *attest engagement team's* integrity, objectivity, and professional skepticism are compromised, the provisions of this interpretation could not address the consequences of the breach

as no actions could be taken to satisfactorily address the consequences of the breach.

.04 In situations in which the lead *attest engagement* partner or an *individual in a position to influence the attest engagement* either (1) committed the breach or (2) knows of a breach and fails to ensure the breach is promptly communicated to or known by an appropriate individual within the firm as described in this interpretation, there is a rebuttable presumption the provisions of this interpretation would not be able to address the breach as the *threats* to the *attest engagement team's* integrity, objectivity, and professional skepticism and the threats to the appearance of *independence* would be considered so significant that no actions could be taken to satisfactorily address the consequences of the breach.

### **Identifying and Communicating a Breach**

.05 When a breach is identified, the *member* should, in accordance with his or her *firm's* policies and procedures, promptly communicate the breach to an appropriate individual within the *firm*, for example, an individual or individuals with responsibility for the policies and procedures relating to *independence*, or the *attest engagement partner* (the responsible individual).

.06 The responsible individual should report the breach to those who need to take appropriate action and, when appropriate, should report the breach to relevant *network firms*. The responsible individual should be satisfied that the interest or relationship that caused the breach has been terminated, suspended, or eliminated and should address the consequences of the breach. A consequence of a breach may be that termination of the *attest engagement* is necessary.

### **Evaluating the Significance of a Breach**

.07 The responsible individual should evaluate the significance of the breach and its effect on the *attest engagement team's* integrity, objectivity, and professional skepticism and the ability to issue an attest report. The significance of the breach will depend on factors such as the following:

- a. The nature and duration of the breach
- b. The number and nature of any previous breaches with respect to the current *attest engagement*
- c. Whether a *member* of the *attest engagement team* had knowledge of the interest or relationship that caused the breach
- d. Whether the individual who caused the breach is a *member* of the *attest engagement team* or another individual for whom there are *independence* requirements
- e. The role of the individual if the breach relates to a *member* of the *attest engagement team*
- f. The effect of the service, if any, on the accounting records or the *attest client's financial statements* if the breach was caused by the provision of a *professional service*
- g. Whether a *partner* or *partner equivalent* of the *firm* had knowledge of the breach and failed to ensure that the breach was promptly communicated to an appropriate individual within the *firm*
- h. Whether the breach involved solely an *affiliate* of a *financial statement attest client* and if so, the nature of the *affiliate* relationship

- i. The extent of the self-interest, advocacy, undue influence, or other *threats* created by the breach

### **Addressing the Consequences of a Breach**

**.08** Depending upon the significance of the breach, it may be necessary to terminate the *attest engagement* or it may be possible to take action that satisfactorily addresses the consequences of the breach. Certain breaches described in this interpretation cannot be addressed by the provisions of this interpretation. For all other breaches, the responsible individual should determine whether satisfactory action can be taken and is appropriate in the circumstances. In making this determination, the responsible individual should exercise professional judgment and take into account whether a reasonable and informed third party, weighing the significance of the breach, the action to be taken, and all the specific facts and circumstances available to the *member* at that time, would likely conclude that the *attest engagement team's* integrity, objectivity, and professional skepticism would be compromised and therefore whether *independence* is *impaired*.

**.09** Examples of actions that the responsible individual may consider include the following:

- a. Removing the relevant individual from the *attest engagement team*
- b. Conducting an additional review of the affected attest work or re-performing that work to the extent necessary; in either case, using different personnel
- c. Recommending that the *attest client* engage another *firm* to review or re-perform the affected attest work to the extent necessary
- d. Engaging another *firm* to evaluate the results of the nonattest service or having another firm re-perform the nonattest service to the extent necessary to enable it to take responsibility for the service if the breach relates to a nonattest service that affects the accounting records or an amount that is recorded in the *financial statements*

### **Communicating With Those Charged With Governance at the Attest Client**

**.10** If the responsible individual determines that action cannot be taken to satisfactorily address the consequences of the breach, the responsible individual should inform *those charged with governance* as soon as practicable and take the steps necessary to terminate the *attest engagement* in compliance with any applicable legal or regulatory requirements relevant to terminating the *attest engagement*. Where termination is not permitted by law or regulation, the responsible individual should comply with any reporting or disclosure requirements.

**.11** If the responsible individual determines that action can be taken to satisfactorily address the consequences of the breach, the responsible individual should discuss the breach and the action taken or proposed to be taken with *those charged with governance* as soon as practicable, unless *those charged with governance* have specified an alternative timing for reporting less significant breaches. The matters to be discussed should include the following:

- a. The significance of the breach, including its nature and duration
- b. How the breach occurred and how it was identified

- c. The action taken or proposed to be taken and the responsible individual's rationale for how the action will satisfactorily address the consequences of the breach and enable the *firm* to issue the attest report
- d. The conclusion that, in the responsible individual's professional judgment, the integrity, objectivity, and professional skepticism of the *attest engagement team* has not been compromised and the rationale for that conclusion
- e. Any steps that the responsible individual has taken or proposes to take to reduce or avoid the risk of further breaches occurring

.12 The responsible individual should communicate in writing with *those charged with governance* all matters discussed in accordance with the paragraph above and obtain the concurrence of *those charged with governance* that action can be, or has been, taken to satisfactorily address the consequences of the breach. The communication shall include a description of the *firm's* policies and procedures relevant to the breach designed to provide it with reasonable assurance that *independence* is maintained and any steps that the *firm* has taken, or proposes to take, to reduce or avoid the risk of further breaches occurring. If *those charged with governance* do not concur that the action satisfactorily addresses the consequences of the breach, the responsible individual should take the steps necessary to terminate the *attest engagement*, where permitted by law or regulation, in compliance with any applicable legal or regulatory requirements relevant to terminating the *attest engagement*. Where termination is not permitted by law or regulation, the responsible individual should comply with any reporting or disclosure requirements.

### ***Breaches Relating to Previously Issued Reports***

.13 If the breach occurred prior to the issuance of the previous attest report, the responsible individual should comply with this section in evaluating the significance of the breach and its effect on the *attest engagement team's* objectivity, integrity, and professional skepticism and its ability to issue an attest report in the current period. The responsible individual should also consider the effect of the breach, if any, on the *attest engagement team's* integrity, objectivity, and professional skepticism in relation to any previously issued attest reports, and the possibility of withdrawing such attest reports in accordance with professional standards, and discuss the matter with *those charged with governance*.

### ***Documentation***

.14 The responsible individual should document the breach, the action taken, key decisions made and all the matters discussed with *those charged with governance* and any discussions with a professional body, relevant regulator, or oversight authority. When the *firm* continues with the *attest engagement*, the matters to be documented should also include the conclusion that, in the responsible individual's professional judgment, the integrity, objectivity, and professional skepticism of the *attest engagement team* have not been compromised and the rationale for why the action taken satisfactorily addressed the consequences of the breach such that the *firm* could issue an attest report. Failure to prepare the required documentation does not *impair independence* provided the *member* can demonstrate the *member* satisfactorily addressed the consequences of the breach and discussed the breach, the action taken, and key decisions made with *those charged with governance*, and as applicable, a

professional body, relevant regulator, or oversight authority. However, failure to prepare the required documentation would be considered a violation of the "Compliance With Standards Rule" [1.310.001].

.15 Refer to the "Unsolicited Financial Interests" interpretation [1.240.020] of the "Independence Rule" [1.200.001] for guidance on unsolicited financial interests.

### ***Effective Date***

.16 This interpretation is effective March 31, 2016. Early implementation is allowed.

## **1.300 General Standards**

### **1.300.001 General Standards Rule**

.01 A *member* shall comply with the following standards and with any *interpretations* thereof by bodies designated by *Council*:

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

(See appendix A, "*Council* Resolution Designating Bodies to Promulgate Technical Standards.") [Prior reference: paragraph .01 of ET section 201]

## **Interpretations Under the General Standards Rule**

### **1.300.005 Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts**

.01 In the absence of an *interpretation* of the "General Standards Rule" [1.300.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Public Practice" [1.000.010].

.02 A *member* would be considered in violation of the "General Standards Rule" [1.300.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

.03 A *member* should consider the guidance in "Ethical Conflicts" [1.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional or legal standards, or both. [No prior reference: new content]

### **Effective Date**

.04 Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

### **1.300.010 Competence**

.01 Competence, in this context, means that the *member* or *member's* staff possess the appropriate technical qualifications to perform *professional services* and that the *member*, as required, supervises and evaluates the quality of work performed. Competence encompasses knowledge of the profession's standards, the techniques and technical subject matter involved, and the ability to exercise sound judgment in applying such knowledge in the performance of *professional services*.

.02 A *member's* agreement to perform *professional services* implies that the *member* has the necessary competence to complete those services according to professional standards and to apply the *member's* knowledge and skill with reasonable care and diligence. However, the *member* does not assume a responsibility for infallibility of knowledge or judgment.

.03 The *member* may have the knowledge required to complete the services in accordance with professional standards prior to performance. A normal part of providing *professional services* involves performing additional research or consulting with others to gain sufficient competence.

.04 If a *member* is unable to gain sufficient competence, the *member* should suggest, in fairness to the *client* and public, the engagement of a competent person to perform the needed *professional service*, either independently or as an associate. [Prior reference: paragraph .02 of ET section 201]

### **1.300.020 Supervision of a Specialist on Consulting Engagements**

.01 A *member* who employs a specialist to perform consulting services for the *member's clients* must be qualified to supervise and evaluate the work of that specialist. Although the *member* is not required to be able to perform each of the specialist's tasks, the *member* should be able to define the tasks and evaluate the end product. [Prior reference: paragraphs .017–.018 of ET section 291]

### **1.300.030 Submission of Financial Statements**

.01 When a *member* prepares or submits *financial statements* as a stockholder, a partner, a director, an officer, or an employee of an entity using the *firm's* letterhead or similar identification, the *member* should comply with the "Compliance With Standards Rule" [1.310.001], including any requirements to disclose a lack of *independence* in the *member's* report.

.02 Refer to the "Use of a CPA Credential" interpretation [2.400.100] of the "Acts Discreditable Rule" [2.400.001] and the "Submission of Financial Statements" interpretation [2.300.030] of the "General Standards Rule" [2.300.001] for additional guidance. [Prior reference: paragraphs .019–.020 of ET section 291]

## 1.300.040 Use of a Third-Party Service Provider

.01 A *member* who uses a *third-party service provider* to assist the *member* in providing *professional services* such as bookkeeping, tax preparation, or consulting or attest services, including related clerical or data entry functions, is required to comply with the "General Standards Rule" [1.300.001] and the "Compliance With Standards Rule" [1.310.001]. To accomplish this,

- a. before using a *third-party service provider*, the *member* should ensure that the *third-party service provider* has the required professional qualifications, technical skills, and other resources. Factors that can be helpful in evaluating a prospective *third-party service provider* include business, financial, and personal references from banks, other CPAs, and other customers of the *third-party service provider*; the *third-party service provider's* professional reputation and recognition in the community; published materials (articles and books that he or she has authored); and the *member's* personal evaluation of the *third-party service provider*.
- b. the *member* must adequately plan and supervise the *third-party service provider's professional services* so that the *member* ensures that the services are performed with competence and due professional care. The *member* must also obtain sufficient relevant data to support the work product and comply with all technical standards applicable to the *professional services*.

.02 The *member's* responsibility for planning and supervising the *third-party service provider's* work does not extend beyond the requirements of applicable professional standards, which may vary depending upon the nature of the *member's* engagement.

.03 Refer to the "Use of a Third-Party Service Provider" interpretation [1.150.040] of the "Integrity and Objectivity Rule" [1.100.001] and the "Disclosing Information to a Third-Party Service Provider" interpretation [1.700.040] of the "Confidential Client Information Rule" [1.700.001] for additional guidance. [Prior references: paragraphs .015–.016 and .023–.024 of ET section 291]

A nonauthoritative basis-for-conclusion document summarizing considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsOutsourcing.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsOutsourcing.pdf).

## 1.310 Compliance With Standards

### 1.310.001 Compliance With Standards Rule

.01 A *member* who performs auditing, review, compilation, management consulting, tax, or other *professional services* shall comply with standards promulgated by bodies designated by *Council*.

.02 See Appendix A "Council Resolution Designating Bodies to Promulgate Technical Standards." [Prior reference: paragraph .01 of ET section 202]

## Interpretations Under the Compliance with Standards Rule

### 1.310.005 Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts

.01 In the absence of an *interpretation* of the "Compliance With Standards Rule" [1.310.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Public Practice" [1.000.010].

.02 A *member* would be considered in violation of the "Compliance With Standards Rule" [1.310.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

.03 A *member* should consider the guidance in "Ethical Conflicts" [1.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional or legal standards, or both. [No prior reference: new content]

#### **Effective Date**

.04 Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

## 1.320 Accounting Principles

### 1.320.001 Accounting Principles Rule

.01 A *member* shall not (1) express an opinion or state affirmatively that the *financial statements* or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by *Council* to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the *member* can demonstrate that due to unusual circumstances the *financial statements* or data would otherwise have been misleading, the *member* can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

.02 See appendix A "Council Resolution Designating Bodies to Promulgate Technical Standards." [Prior reference: paragraph .01 of ET section 203]

### 1.320.005 Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts

.01 In the absence of an *interpretation* of the "Accounting Principles Rule" [1.320.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Public Practice" [1.000.010].

.02 A *member* would be considered in violation of the "Accounting Principles Rule" [1.320.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

.03 A *member* should consider the guidance in "Ethical Conflicts" [1.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional or legal standards, or both. [No prior reference: new content]

### **Effective Date**

.04 Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

## **1.320.010 Responsibility for Affirming That Financial Statements Are in Conformity With the Applicable Financial Reporting Framework**

.01 A *member* shall not state affirmatively that an entity's *financial statements* or other financial data are presented in conformity with generally accepted accounting principles (GAAP) if such statements or data contain any departure from an accounting principle promulgated by a body designated by *Council* to establish such principles. *Members* who affirm that *financial statements* or other financial data are presented in conformity with GAAP should comply with the "Accounting Principles Rule" [1.320.001]. A *member's* representation in a letter or other communication that an entity's *financial statements* are in conformity with GAAP may be considered an affirmative statement within the meaning of this rule with respect to the *member* who signed the letter or other communication (for example, the *member* signed a report to a regulatory authority). [Prior reference: paragraph .05 of ET section 203]

## **1.320.020 Status of Financial Accounting Standards Board, Governmental Accounting Standards Board, Federal Accounting Standards Advisory Board, and International Accounting Standards Board Interpretations**

.01 The "Accounting Principles Rule" [1.320.001] authorizes *Council* to designate bodies to establish accounting principles. *Council* has designated the Financial Accounting Standards Board (FASB) as such a body and has resolved that FASB *Accounting Standards Codification* (ASC) constitutes accounting principles as contemplated in the rule. *Council* designated the Governmental Accounting Standards Board (GASB), with respect to Statements of Governmental Accounting Standards issued in July 1984 and thereafter, as the body to establish financial accounting principles for state and local governmental entities, pursuant to the "Accounting Principles Rule." *Council* designated the Federal Accounting Standards Advisory Board (FASAB), with respect to Statements of Federal Accounting Standards adopted and issued in March 1993 and subsequently, as the body to establish accounting principles for federal government entities, pursuant to the "Accounting Principles Rule." *Council* designated the International Accounting Standards Board (IASB) as an accounting body for purposes of establishing international financial accounting and reporting principles.

.02 Reference to GAAP in the "Accounting Principles Rule" [1.320.001] means those accounting principles promulgated by bodies designated by *Council*, which are listed in paragraph .01 and in appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards."

.03 The Professional Ethics Division will look to the codification or statements and any *interpretations* thereof issued by FASB, GASB, FASAB, or IASB in determining whether a *member* has departed from an accounting principle established by a designated accounting standard-setter in FASB ASC, a Statement of Governmental Accounting Standards, a Statement of Federal Accounting Standards, or International Financial Reporting Standards (IFRS). [Prior reference: paragraph .03 of ET section 203]

### 1.320.030 Departures From Generally Accepted Accounting Principles

.01 It is difficult to anticipate all the circumstances in which accounting principles may be applied. However, there is a strong presumption that adherence to GAAP would, in nearly all instances, result in *financial statements* that are not misleading. The "Accounting Principles Rule" [1.320.001] recognizes that, upon occasion, there may be unusual circumstances when the literal application of GAAP would have the effect of rendering *financial statements* misleading. In such cases, the proper accounting treatment to apply is that which will not render the *financial statements* misleading.

.02 The question of what constitutes unusual circumstances, as referred to in the "Accounting Principles Rule" [1.320.001], is a matter of professional judgment involving the ability to support the position that adherence to a promulgated principle within GAAP would be regarded generally by reasonable persons as producing misleading *financial statements*.

.03 Examples of circumstances that may justify a departure from GAAP include new legislation or evolution of a new form of business transaction. Examples of circumstances that do not justify departures from GAAP include an unusual degree of materiality or conflicting industry practices. [Prior reference: paragraph .02 of ET section 203]

.04 If the statements or data contain such departures, see the "Accounting Principles Rule" [1.320.001] for further guidance.

### 1.320.040 Financial Statements Prepared Pursuant to Financial Reporting Frameworks Other Than GAAP

.01 Reference to GAAP in the "Accounting Principles Rule" [1.320.001] means those accounting principles promulgated by bodies designated by *Council*, which are listed in appendix A. The bodies designed by *Council* to promulgate accounting principles are

- a. FASAB,
- b. FASB,
- c. GASB, and
- d. IASB.

.02 *Financial statements* prepared pursuant to other accounting principles would be considered financial reporting frameworks other than GAAP within the context of the "Accounting Principles Rule" [1.320.001].

.03 However, the "Accounting Principles Rule" [1.320.001] does not preclude a *member* from preparing or reporting on *client financial statements* that

have been prepared pursuant to financial reporting frameworks other than GAAP, such as

- a. financial reporting frameworks generally accepted in another country, including jurisdictional variations of IFRS such that the *client's financial statements* do not meet the requirements for full compliance with IFRS, as promulgated by the IASB;
- b. financial reporting frameworks prescribed by an agreement or a contract; or
- c. other special purpose frameworks, including statutory financial reporting provisions required by law or a U.S. or foreign governmental regulatory body to whose jurisdiction the entity is subject.

**.04** In such circumstances, however, the *client's financial statements* and *member's* reports thereon should not purport that the *financial statements* are in accordance with GAAP, and the *financial statements* or reports on those *financial statements*, or both, should clarify the financial reporting framework(s) used. [Prior reference: paragraph .06 of ET section 203]

## 1.400 Acts Discreditable

### 1.400.001 Acts Discreditable Rule

**.01** A *member* shall not commit an act discreditable to the profession. [Prior reference: paragraph .01 of ET section 501]

## Interpretations Under the Acts Discreditable Rule

### 1.400.005 Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts

**.01** In the absence of an *interpretation* of the "Acts Discreditable Rule" [1.400.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Public Practice" [1.000.010].

**.02** A *member* would be considered in violation of the "Acts Discreditable Rule" [1.400.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

**.03** A *member* should consider the guidance in "Ethical Conflicts" [1.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional and legal standards, or both. [No prior reference: new content]

### **Effective Date**

**.04** Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

### **1.400.010 Discrimination and Harassment in Employment Practices**

.01 A *member* would be presumed to have committed an act discreditable to the profession, in violation of the "Acts Discreditable Rule" [1.400.001] if a final determination, no longer subject to appeal, is made by a court or an administrative agency of competent jurisdiction that a *member* has violated any antidiscrimination laws of the United States, a state, or a municipality, including those related to sexual and other forms of harassment. [Prior reference: paragraph .03 of ET section 501]

### **1.400.020 Solicitation or Disclosure of CPA Examination Questions and Answers**

.01 A *member* who solicits or knowingly discloses the Uniform CPA Examination question(s) or answer(s), or both, without the AICPA's written authorization shall be considered to have committed an act discreditable to the profession, in violation of the "Acts Discreditable Rule" [1.400.001]. [Prior reference: paragraph .07 of ET section 501]

### **1.400.030 Failure to File a Tax Return or Pay a Tax Liability**

.01 A *member* who fails to comply with applicable federal, state, or local laws or regulations regarding (a) the timely filing of the *member's* personal tax returns or tax returns of the *member's firm* that the *member* has the authority to timely file or (b) the timely remittance of all payroll and other taxes collected on behalf of others may be considered to have committed an act discreditable to the profession, in violation of the "Acts Discreditable Rule" [1.400.001]. [Prior reference: paragraph .08 of ET section 501]

### **1.400.040 Negligence in the Preparation of Financial Statements or Records**

.01 A *member* shall be considered in violation of the "Acts Discreditable Rule" [1.400.001] if the *member*, by virtue of his or her negligence, does any of the following:

- a. Makes, or permits or directs another to make, materially false and misleading entries in the *financial statements* or records of an entity.
- b. Fails to correct an entity's *financial statements* that are materially false and misleading when the *member* has the authority to record an entry.
- c. Signs, or permits or directs another to sign, a document containing materially false and misleading information. [Prior reference: paragraph .05 of ET section 501]

### **1.400.050 Governmental Bodies, Commissions, or Other Regulatory Agencies**

.01 Many governmental bodies, commissions, or other regulatory agencies have established requirements, such as audit standards, guides, rules, and regulations, that *members* are required to follow in the preparation of *financial statements* or related information or in performing attest or similar services for entities subject to their jurisdiction. For example, the SEC; the Federal

Communications Commission; state insurance commissions; and other regulatory agencies, such as the PCAOB, have established such requirements.

**.02** If a *member* prepares *financial statements* or related information for purposes of reporting to such bodies, commissions, or regulatory agencies, the *member* should follow the requirements of such organizations, in addition to the applicable financial reporting framework.

**.03** If a *member* agrees to perform an attest or a similar service for the purpose of reporting to such bodies, commissions, or regulatory agencies, the *member* should follow such requirements, in addition to the applicable financial reporting framework.

**.04** A *member's* material departure from such requirements would be considered a violation of the "Acts Discreditable Rule" [1.400.001] unless the *member* discloses in the *financial statements* or his or her report, as applicable, that such requirements were not followed and the applicable reasons. [Prior reference: paragraph .06 of ET section 501]

### 1.400.055 Governmental Audits

**.01** Engagements for audits of government grants, government units, or other recipients of government monies typically require that such audits be in compliance with government audit standards, guides, procedures, statutes, rules, and regulations, in addition to GAAS.

**.02** If a *member* accepts such an engagement and undertakes an obligation to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, the *member* is obligated to follow such requirements, in addition to GAAS.

**.03** Failure to do so is a violation of the "Acts Discreditable Rule" [1.400.001] unless the *member* discloses in his or her report that such requirements were not followed and the applicable reasons for not following the requirements. [Prior reference: paragraph .04 of ET section 501]

### 1.400.060 Indemnification and Limitation of Liability Provisions

**.01** Certain governmental bodies, commissions, or other regulatory agencies (collectively, regulators) have established requirements through laws, regulations, or published interpretations that

- a. prohibit entities subject to their regulation (regulated entity) from including certain types of indemnification and limitation of liability provisions in agreements for the performance of audit or other attest services that are required by such regulators or
- b. provide that the existence of such provisions disqualifies a *member* from rendering such services to these entities.

For example, federal banking regulators, state insurance commissions, and the SEC have established such requirements.

**.02** If a *member* enters into or directs or knowingly permits another individual to enter into a contract for the performance of audit or other attest services that are subject to the requirements of these regulators, the *member* should not include or knowingly permit or direct another individual to include an indemnification or limitation of liability provision that would cause the regulated entity or a *member* to be in violation of such requirements or disqualify a *member* from providing such services to the regulated entity. A *member* who enters into or directs or knowingly permits another individual to enter into

such an agreement for the performance of audit or other attest services would be considered in violation of the "Acts Discreditable Rule" [1.400.001].

**.03** Refer to the "Indemnification of a Covered Member" [1.228.010] and "Indemnification of an Attest Client" [1.228.020] interpretations of the "Independence Rule" [1.200.001] for additional guidance. [Prior reference: paragraph .09 of ET section 501]

### **1.400.070 Confidential Information Obtained From Employment or Volunteer Activities**

**.01** A *member* should maintain the confidentiality of his or her employer's or *firm's* (employer) confidential information and should not use or disclose any confidential employer information obtained as a result of an employment relationship, such as discussions with the employer's vendors, customers, or lenders (for example, any confidential information pertaining to a current or previous employer, subsidiary, affiliate, or parent thereof, as well as any entities for which the *member* is working in a volunteer capacity).

**.02** For purposes of this interpretation, confidential employer information is any proprietary information pertaining to the employer or any organization for whom the *member* may work in a volunteer capacity that is not known to be available to the public and is obtained as a result of such relationships.

**.03** A *member* should be alert to the possibility of inadvertent disclosure, particularly to a close business associate or *close relative or immediate family member*. The *member* should also take reasonable steps to ensure that staff under his or her control or others within the *employing organization* and persons from whom advice and assistance are obtained are aware of the confidential nature of the information.

**.04** When a *member* changes employment, a *member* should not use confidential employer information acquired as a result of a prior employment relationship to his or her personal advantage or the advantage of a third party, such as a current or prospective employer. The requirement to maintain the confidentiality of an employer's confidential information continues even after the end of the relationship between a *member* and the employer. However, the *member* is entitled to use experience and expertise gained through prior employment relationships.

**.05** A *member* would be considered in violation of the "Acts Discreditable Rule" [1.400.001] if the *member* discloses or uses any confidential employer information acquired as a result of employment or volunteer relationships without the proper authority or specific consent of the employer or organization for whom the *member* may work in a volunteer capacity, unless there is a legal or professional responsibility to use or disclose such information.

**.06** The following are examples of situations in which *members* are permitted or may be required to disclose confidential employer information or when such disclosure may be appropriate:

- a. Disclosure is permitted by law and authorized by the employer.
- b. Disclosure is required by law, for example, to
  - i. comply with a validly issued and enforceable subpoena or summons or
  - ii. inform the appropriate public authorities of violations of law that have been discovered.
- c. There is a professional responsibility or right to disclose information, when not prohibited by law, to

- i. initiate a complaint with, or respond to any inquiry made by, the Professional Ethics Division or trial board of the AICPA or a duly constituted investigative or disciplinary body of a state CPA society, board of accountancy, or other regulatory body;
  - ii. protect the *member's* professional interests in legal proceedings;
  - iii. comply with professional standards and other ethics requirements; or
  - iv. report potential concerns regarding questionable accounting, auditing, or other matters to the employer's confidential complaint hotline or *those charged with governance*.
- d. Disclosure is permitted on behalf of the employer to
- i. obtain financing with lenders;
  - ii. communicate with vendors, *clients*, and customers; or
  - iii. communicate with the employer's external accountant, attorneys, regulators, and other business professionals.

**.07** In deciding whether to disclose confidential employer information, relevant factors to consider include the following:

- a. Whether all the relevant information is known and substantiated to the extent that it is practicable. When the situation involves unsubstantiated facts, incomplete information, or unsubstantiated conclusions, the *member* should use professional judgment in determining the type of disclosure to be made, if any.
- b. Whether the parties to whom the communication may be addressed are appropriate recipients.

**.08** A *member* may wish to consult with his or her legal counsel prior to disclosing, or determining whether to disclose, confidential employer information.

**.09** Refer to the "Subordination of Judgment" interpretation [1.130.020] of the "Integrity and Objectivity Rule" [1.100.001] and the "Confidential Information" topic [1.700] for additional guidance. [Prior reference: paragraph .10 of ET section 501]

## **1.400.090 False, Misleading, or Deceptive Acts in Promoting or Marketing Professional Services**

**.01** A *member* would be in violation of the "Acts Discreditable Rule" [1.400.001] if the *member* promotes or markets the *member's* abilities to provide *professional services* or makes claims about the *member's* experience or qualifications in a manner that is false, misleading, or deceptive.

**.02** Promotional efforts would be false, misleading, or deceptive if they contain any claim or representation that would likely cause a reasonable person to be misled or deceived. This includes any representation about CPA licensure or any other professional certification or accreditation that is not in compliance with the requirements of the relevant licensing authority or designating body.

**.03** Refer to the "False, Misleading, or Deceptive Acts in Advertising or Solicitations" interpretation [1.600.010] of the "Advertising and Other Forms of Solicitation Rule" [1.600.001] for additional guidance. [No prior reference: new content]

**Effective Date**

.04 Effective December 15, 2014.

**1.400.100 Use of the CPA Credential**

.01 A *member* should refer to applicable state accountancy laws and board of accountancy rules and regulations for guidance regarding the use of the CPA credential. A *member* who fails to follow the accountancy laws, rules, and regulations on use of the CPA credential in any of the jurisdictions in which the CPA practices would be considered to have used the CPA credential in a manner that is false, misleading, or deceptive and in violation of the "Acts Discreditable Rule" [1.400.001]. [Prior reference .12 section 501]

**1.400.200 Records Requests****Terminology**

.01 The following terms are defined here solely for use with this interpretation:

- a. A client includes current and former *clients*.
- b. A member means the *member* or the *member's firm*.
- c. Client-provided records are accounting or other records, including hardcopy and electronic reproductions of such records, belonging to the client that were provided to the member by, or on behalf of, the client.
- d. Member-prepared records are accounting or other records that the member was not specifically engaged to prepare and that are not in the client's books and records or are otherwise not available to the client, thus rendering the client's financial information incomplete. Examples include adjusting, closing, combining, or consolidating journal entries (including computations supporting such entries) and supporting schedules and documents that the member proposed or prepared as part of an engagement (for example, an audit).
- e. Member's work products are deliverables set forth in the terms of the engagement, such as tax returns.
- f. Working papers are all other items prepared solely for purposes of the engagement and include items prepared by the
  - i. member, such as audit programs, analytical review schedules, and statistical sampling results and analyses.
  - ii. client at the request of the member and reflecting testing or other work done by the member.

**Interpretation**

.02 Members must comply with the rules and regulations of authoritative regulatory bodies, such as the member's state board(s) of accountancy, when the member performs services for a client and is subject to the rules and regulations of such regulatory body. For example, a member's state board(s) of accountancy may not permit a member to withhold certain records, even though fees are due to the member for the work performed. Failure to comply with the more restrictive provisions of the applicable regulatory body's rules and regulations

concerning the return of certain records would constitute a violation of this interpretation.

**.03** The member should return client-provided records in the member's custody or control to the client at the client's request.

**.04** Unless a member and the client have agreed to the contrary, when a client makes a request for member-prepared records or a member's work products that are in the member's custody or control and that have not previously been provided to the client, the member should respond to the client's request as follows:

- a. The member should provide member-prepared records relating to a completed and issued work product to the client, except that such records may be withheld if fees are due to the member for that specific work product.
- b. Member's work products should be provided to the client, except that such work products may be withheld
  - i. if fees are due to the member for the specific work product;
  - ii. if the work product is incomplete;
  - iii. if for purposes of complying with professional standards (for example, withholding an audit report due to outstanding audit issues); or
  - iv. if threatened or outstanding litigation exists concerning the engagement or member's work.

**.05** Once a member has complied with these requirements, he or she is under no ethical obligation to

- a. comply with any subsequent requests to again provide records or copies of records described in paragraphs .03–.04. However, if subsequent to complying with a request, a client experiences a loss of records due to a natural disaster or an act of war, the member should comply with an additional request to provide such records.
- b. retain records for periods that exceed applicable professional standards, state and federal statutes and regulations, and contractual agreements relating to the service performed. [Prior reference: paragraph .02 of ET section 501]

**.06** A member who has provided records to an individual designated or held out as the client's representative, such as the general partner, majority shareholder, or spouse, is not obligated to provide such records to other individuals associated with the client. [Prior reference: paragraphs .377–.378 of ET section 591]

**.07** Working papers are the member's property, and the member is not required to provide such information to the client. However, state and federal statutes and regulations and contractual agreements may impose additional requirements on the member.

**.08** In fulfilling a request for client-provided records, member-prepared records, or a member's work products, the member may

- a. charge the client a reasonable fee for the time and expense incurred to retrieve and copy such records and require that the client pay the fee before the member provides the records to the client.

- b. provide the requested records in any format usable by the client. However, the member is not required to convert records that are not in electronic format to electronic format. If the client requests records in a specific format and the records are available in such format within the member's custody and control, the client's request should be honored. In addition, the member is not required to provide the client with formulas, unless the formulas support the client's underlying accounting or other records or the member was engaged to provide such formulas as part of a completed work product.
- c. make and retain copies of any records that the member returned or provided to the client.

**.09** A member who is required to return or provide records to the client should comply with the client's request as soon as practicable but, absent extenuating circumstances, no later than 45 days after the request is made.

**.10** The fact that the statutes of the state in which the member practices grant the member a lien on certain records in his or her custody or control does not relieve the member of his or her obligation to comply with this interpretation. [Prior reference: paragraph .02 of ET section 501]

**.11** A member would be considered in violation of the "Acts Discreditable Rule" [1.400.001] if the member does not comply with the requirements of this interpretation.

### **1.400.210 Removing Client Files or Proprietary Information From a Firm**

**.01** A *member* whose employment relationship is terminated would be considered in violation of the "Acts Discreditable Rule" [1.400.001] if the *member* takes or retains (a) originals or copies (in any format) from the *firm's client* files or (b) proprietary information without the *firm's* permission, unless the *member* has a contractual arrangement with the *firm* allowing such action. [Prior reference: paragraphs .381–.382 of ET section 591]

**.02** A *firm's* ownership agreement would govern ownership of *client* files and proprietary information; accordingly, this interpretation would not apply to owners of *firms*. [No prior reference: new content]

#### **Effective Date**

**.03** Paragraph .02 of this interpretation is effective December 15, 2014.

### **1.400.240 Use of Confidential Information From Nonclient Sources**

**.01** If a *member* discloses confidential information obtained from a prospective *client* or nonclient without consent, the *member* would be in violation of the "Acts Discreditable Rule" [1.400.001]. [Prior reference: paragraphs .027–.028 of ET section 391 and new content]

#### **Effective Date**

**.02** This interpretation is effective December 15, 2014.

## 1.500 Fees and Other Types of Remuneration

### 1.500.008 Unpaid Fees

.01 Refer to the "Fees" topic [1.230] of the "Independence Rule" [1.200.001] for guidance. [No prior reference: new content]

#### **Effective Date**

.02 Effective December 15, 2014.

### 1.510 Contingent Fees

#### 1.510.001 **Contingent Fees Rule**

.01 A *member* in *public practice* shall not

- a. Perform for a contingent fee any *professional services* for, or receive such a fee from a *client* for whom the *member* or the *member's firm* performs,
  - i. an audit or review of a *financial statement*; or
  - ii. a compilation of a *financial statement* when the *member* expects, or reasonably might expect, that a third party will use the *financial statement* and the *member's* compilation report does not disclose a lack of *independence*; or
  - iii. an examination of prospective financial information; or
- b. Prepare an original or amended tax return or claim for a tax refund for a contingent fee for any *client*.

.02 The prohibition in a. above applies during the period in which the *member* or *member's firm* is engaged to perform any of the services listed above and the period covered by any historical *financial statements* involved in any such listed services.

.03 Except as stated in the next sentence, a contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service. Solely for purposes of this rule, fees are not regarded as being contingent if fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies.

.04 A *member's* fees may vary depending, for example, on the complexity of services rendered. [Prior reference: paragraph .01 of ET section 302]

### Interpretations Under the Contingent Fees Rule

#### 1.510.005 **Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts**

.01 In the absence of an *interpretation* of the "Contingent Fees Rule" [1.510.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Public Practice" [1.000.010].

**.02** A *member* would be considered in violation of the "Contingent Fees Rule" [1.510.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

**.03** A *member* should consider the guidance in "Ethical Conflicts" [1.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional and legal standards, or both. [No prior reference: new content]

### **Effective Date**

**.04** Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

### **1.510.010 Tax Matters**

**.01** This interpretation defines certain terms used in the "Contingent Fees Rule" [1.510.001] and provides examples of the application of the rule in tax matters. When practicing before the IRS or before other taxing authorities, *members* should also comply with other applicable and more restrictive requirements.

### **Contingent Fee Language**

**.02** Preparation of an original or amended tax return or claim for tax refund includes giving advice on events that have occurred at the time that the advice is given if such advice is directly relevant to determining the existence, character, or amount of a schedule, an entry, or another portion of a return or claim for refund

**.03** A fee is considered determined based on the findings of governmental agencies and, therefore, is not a contingent fee if the *member* can demonstrate a reasonable expectation, at the time of a fee arrangement, that a government agency will provide substantive consideration of the subject matter with respect to the *member's client*. Such an expectation is not reasonable if the *member* prepares a *client's* original tax returns as outlined in paragraph .02 above.

### **Examples of When a Contingent Fee Is Permitted**

**.04** The following are examples of circumstances in which a contingent fee is permitted under the "Contingent Fees Rule" [1.510.001]:

- a. Representing a *client* in connection with a revenue agent's examination of the *client's* federal or state income tax return
- b. Filing an amended federal or state income tax return claiming a tax refund based on a tax issue that is the subject of a test case involving a different taxpayer or with respect to which the taxing authority is developing a position
- c. Filing an amended federal or state income tax return (or refund claim) claiming a tax refund in an amount greater than the threshold for review by the Joint Committee on Taxation or state taxing authority
- d. Requesting a refund of either overpayments of interest or penalties charged to a *client's* account or tax deposits that a federal or state taxing authority improperly accounted for in circumstances

in which the taxing authority has established procedures for the substantive review of such refund requests

- e. Requesting, by means of a protest or similar document, the state or local taxing authority's consideration of a reduction in a property's assessed value under an established taxing authority's review process for hearing all taxpayer arguments relating to assessed value
- f. Representing a *client* in connection with obtaining a private letter ruling or influencing the drafting of a regulation or statute

### **Example of When a Contingent Fee Is Not Permitted**

.05 A contingent fee is not permitted if a *member* prepared a *client's* amended federal or state income tax return claiming a refund of taxes because a valid deduction was inadvertently omitted from the originally filed return. [Prior reference: paragraph .02 of ET section 302]

### **1.510.020 Receipt of Contingent Fee**

.01 A contingent fee is considered to be received when the *member* has completed the related services and the fee is determined. [Prior reference: paragraphs .033–.034 of ET section 391]

### **1.510.030 Services Performed by a Member's Spouse For a Contingent Fee**

.01 A *member's* spouse may provide services for a contingent fee to a *client* for whom the *member* performs a service listed in paragraph .01a of the "Contingent Fees Rule" [1.510.001] without causing the *member* to be in violation of the "Contingent Fees Rule" if

- a. the activities of the *member's* spouse are separate from the *member's* practice and
- b. the *member* is not significantly involved in the spouse's activities.

.02 In all such situations, the *members* should consider the "Conflicts of Interest" interpretation [1.110.010] of the "Integrity and Objectivity Rule" [1.100.001] to determine the appropriate action. [Prior reference: paragraphs .037–.038 of ET section 391]

### **1.510.040 Contingent Fee Arrangements With an Investment Advisory Services Nonattest Client That Is Related to a Client**

.01 A *member* or *member's firm* may provide investment advisory services for a contingent fee to

- a. owners, officers, or employees of a *client* for whom the *member* performs a service listed in paragraph .01a of the "Contingent Fees Rule" [1.510.001].
- b. a nonattest *client* employee benefit plan that is sponsored by a *client* for whom the *member* performs a service listed in paragraph .01a of the "Contingent Fees Rule."

.02 The *member* should also consider the "Conflicts of Interest" interpretation [1.110.010] and the "Confidential Client Information Rule" [1.700.001] to determine the appropriate action(s). [Prior reference: paragraphs .049–.050 of ET section 391]

### **1.510.050 Investment Advisory Services**

**.01** A *member* or *member's firm* may provide investment advisory services for a fee based on a percentage of the investment portfolio to a *client* for whom the *member* performs a service listed in paragraph .01a of the "Contingent Fees Rule" [1.510.001] without violating that rule if all of the following *safeguards* are met:

- a. The fee is determined based on a specified percentage of the *client's* investment portfolio.
- b. The dollar amount of the portfolio on which the fee is based is determined at the beginning of each quarter (or longer period of time as may be agreed upon) and is adjusted only for the *client's* additions or withdrawals during the period.
- c. The fee arrangement is not renewed with the *client* more frequently than on a quarterly basis. [Prior reference: paragraphs .047–.048 of ET section 391]

**.02** When performing such services, the *member* should also consider the "Independence Rule" [1.200.001], especially the *interpretations* of the "Nonattest Services" subtopic [1.295] under the "Independence Rule."

## **1.520 Commissions and Referral Fees**

### **1.520.001 Commissions and Referral Fees Rule**

**.01** *Prohibited commissions.* A *member* in *public practice* shall not for a commission recommend or refer to a *client* any product or service, or for a commission recommend or refer any product or service to be supplied by a *client*, or receive a commission, when the *member* or *member's firm* also performs for that *client*

- a. an audit or review of a *financial statement*; or
- b. a compilation of a *financial statement* when the *member* expects, or reasonably might expect, that a third party will use the *financial statement* and the *member's* compilation report does not disclose a lack of *independence*; or
- c. an examination of prospective financial information.

**.02** This prohibition applies during the period in which the *member* is engaged to perform any of the services listed above and the period covered by any historical *financial statements* involved in such listed services.

**.03** *Disclosure of permitted commissions.* A *member* in *public practice* who is not prohibited by this rule from performing services for or receiving a commission and who is paid or expects to be paid a commission shall disclose that fact to any person or entity to whom the *member* recommends or refers a product or service to which the commission relates.

**.04** *Referral fees.* Any *member* who accepts a referral fee for recommending or referring any service of a CPA to any person or entity or who pays a referral fee to obtain a *client* shall disclose such acceptance or payment to the *client*. [Prior reference: paragraph .01 of ET section 503]

A nonauthoritative question and answer regarding disclosure of a commission is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf).

## Interpretations Under the Commission and Referral Fees Rule

### **1.520.005 Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts**

**.01** In the absence of an *interpretation* of the "Commissions and Referral Fees Rule" [1.520.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Public Practice" [1.000.010].

**.02** A *member* would be considered in violation of the "Commissions and Referral Fees Rule" [1.520.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

**.03** A *member* should consider the guidance in "Ethical Conflicts" [1.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional and legal standards, or both. [No prior reference: new content]

#### **Effective Date**

**.04** Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

### **1.520.020 Receipt of Commission**

**.01** A commission is considered to be received when the performance of the related services is complete and the fee has been determined. For example, if in one year a *member* sells a life insurance policy to a *client*, and the *member's* commission payments are determined to be a fixed percentage of future years' renewal premiums, the commission is deemed to be received in the year that the policy is sold. [Prior reference: paragraphs .367–.368 of ET section 591]

### **1.520.030 Services Performed by a Member's Spouse For a Commission**

**.01** A *member's* spouse may receive a commission for referring products or services to or from a *client* for whom the *member* performs a service listed in paragraph .01 of the "Commissions and Referral Fees Rule" [1.520.001] without causing the *member* to be in violation of the "Commissions and Referral Fees Rule" if both

- a. the activities of the *member's* spouse are separate from the *member's* practice and
- b. the *member* is not significantly involved in the spouse's activities.

**.02** In such situations, *members* should consider the "Conflicts of Interest" interpretation [1.110.010] of the "Integrity and Objectivity Rule" [1.100.001] to determine the appropriate action. [Prior reference: paragraphs .373–.374 of ET section 591]

### **1.520.040 Referral of Products of Others**

**.01** Paragraph .04 of the "Application of the AICPA Code" [0.200.020] section of the preface provides that a *member* shall not permit others to perform

acts on the *member's* behalf that, if carried out by the *member*, would place the *member* in violation of the rules. Therefore, the *member* would be held responsible for the actions of third parties, such as distributors or agents, that act on the *member's* behalf.

**.02** For example, if the *member* or *member's firm* performs for a *client* a service listed in paragraph .01 of the "Commissions and Referral Fees Rule" [1.520.001], the *member* may not recommend or refer to that *client* any product or services for a commission that will be paid through a distributor or an agent or receive a commission for the recommendation or referral. This prohibition applies during the period in which the *member* is engaged to perform any of the services listed in paragraph .01 of the rule and during the period covered by any historical *financial statements* in such services.

**.03** In addition, if a *member* receives a commission for referring a third party's product or service to a *client* for whom the *member* does not perform a service listed in paragraph .01 of the "Commissions and Referral Fees Rule" [1.520.001] through a distributor or an agent and receives a commission from the third party, the *member* should disclose the commission to the *client*, as discussed in paragraph .03 of the "Commissions and Referral Fees Rule." However, any subsequent performance of a service listed in paragraph .01 of that rule during a period in which the commission was received would be considered to violate the rule. [Prior reference: paragraphs .375–.376 of ET section 591]

### **1.520.050 Commission Arrangements With an Investment Advisory Services Nonattest Client That Is Related to a Client**

**.01** A *member* or *member's firm* may receive a commission for referring a nonclient or nonattest *client's* products or services to the following:

- a. Owners, officers, or employees of a *client* for whom the *member* performs a service listed in paragraph .01 of the "Commissions and Referral Fees Rule" [1.520.001]
- b. A nonattest *client* employee benefit plan that is sponsored by a *client* for whom the *member* performs a service listed in paragraph .01 of the "Commissions and Referral Fees Rule"

**.02** In such instances, the *member* should disclose the commission arrangement to the *client's* owners, officers, or employees or the employee benefit plan. The *member's* failure to disclose the commission would be in violation of the "Commissions and Referral Fees Rule" [1.520.001].

**.03** When making the disclosure, *members* should also consider the applicability of the "Conflicts of Interest" interpretation [1.110.010] of the "Integrity and Objectivity Rule" [1.100.001] and the *member's* professional responsibilities under the "Confidential Client Information Rule" [1.700.001] to determine the appropriate action(s). [Prior reference: paragraphs .383–.384 of ET section 591]

### **1.520.060 Sale of Products to Clients**

**.01** If a *member* purchases a product, taking title to the product and assuming all the associated risks of ownership, any profit the *member* receives on reselling it to a *client* would not constitute a commission. [Prior reference: paragraphs .369–.370 of ET section 591]

### **1.520.070 Billing for a Subcontractor's Services**

.01 If, in providing *professional services* to a *client*, a *member* subcontracts the services of another person or entity, any mark-up of the cost of the subcontracted services would not constitute a commission.

.02 Refer to the following for additional guidance:

- "Use of a Third-Party Service Provider" interpretation [1.150.040] of the "Integrity and Objectivity Rule" [1.100.001]
- "Fees" subtopic [1.230] under the "Independence Rule" [1.200.001]
- "Use of a Third-Party Service Provider" interpretation [1.300.040] of the "General Standards Rule" [1.300.001]
- "Disclosing Information to a Third-Party Service Provider" interpretation [1.700.040] of the "Confidential Client Information Rule" [1.700.001] [Prior reference: paragraphs .371–.372 of ET section 591]

#### **Effective Date**

.03 The revisions to this interpretation are effective December 15, 2014.

## **1.600 Advertising and Other Forms of Solicitation**

### **1.600.001 Advertising and Other Forms of Solicitation Rule**

.01 A *member* in *public practice* shall not seek to obtain *clients* by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, over-reaching, or harassing conduct is prohibited. [Prior reference: paragraph .01 of ET section 502]

### **Interpretations Under the Advertising and Other Forms of Solicitation Rule**

#### **1.600.005 Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts**

.01 In the absence of an *interpretation* of the "Advertising and Other Forms of Solicitation Rule" [1.600.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Public Practice" [1.000.010].

.02 A *member* would be considered in violation of the "Advertising and Other Forms of Solicitation Rule" [1.600.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

.03 A *member* should consider the guidance in "Ethical Conflicts" [1.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional and legal standards, or both. [No prior reference: new content]

**Effective Date**

.04 Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

**1.600.010 False, Misleading, or Deceptive Acts in Advertising or Solicitations**

.01 A *member* would be in violation of the "Advertising and Other Forms of Solicitation Rule" [1.600.001] if the *member's* promotional efforts are false, misleading, or deceptive. If a *member* is asked to perform *professional services* for a *client* or customer of a third party, the *member* should determine that the third party's promotional efforts comply with the "Advertising and Other Forms of Solicitation Rule." Such action is required because the *member* will receive the benefits of such efforts by third parties, and *members* must not do through others what they are prohibited from doing themselves. [Prior reference: paragraph .06 of ET section 502]

.02 Promotional efforts would be considered false, misleading, or deceptive if they

- a. create false or unjustified expectations of favorable results.
- b. imply the ability to influence any court, tribunal, regulatory agency, or similar body or official.
- c. contain a representation that the *member* will perform specific *professional services* in current or future periods for a stated fee, estimated fee, or fee range when it was likely at the time of the representation that such fees would be substantially increased and the *member* failed to advise the prospective *client* of that likelihood.
- d. contain any other representations that would be likely to cause a reasonable person to misunderstand or be deceived. [Prior reference: paragraph .03 of ET section 502]

**1.600.030 Use of AICPA-Awarded Designation**

.01 A *member* who holds an AICPA-awarded designation, such as the Personal Financial Specialist (PFS) designation, may use the designation after the *member's* name.

.02 A *member's firm* may use an AICPA-awarded designation, such as the PFS designation, on *firm* letterhead and in marketing materials if all the *firm's* partners hold the AICPA-awarded designation. [Prior reference: paragraphs .365–.366 of ET section 591]

**Effective Date**

.03 The revisions to this interpretation are effective December 15, 2014.

**1.600.100 Use of the CPA Credential**

.01 A *member* should refer to applicable state accountancy laws and board of accountancy rules and regulations for guidance regarding the use of the CPA credential. A *member* who fails to follow the accountancy laws, rules, and regulations on use of the CPA credential in any of the jurisdictions in which the CPA practices would be considered to have used the CPA credential in a manner

that is false, misleading, or deceptive and in violation of the "Advertising and Other Forms of Solicitation Rule" [1.600.001]. [Prior reference .07 section 502.]

## 1.700 Confidential Information

### 1.700.001 Confidential Client Information Rule

**.01** A *member* in *public practice* shall not disclose any *confidential client information* without the specific consent of the *client*.

**.02** This rule shall not be construed (1) to relieve a *member* of his or her professional obligations of the "Compliance With Standards Rule" [1.310.001] or the "Accounting Principles Rule" [1.320.001], (2) to affect in any way the *member's* obligation to comply with a validly issued and enforceable subpoena or summons, or to prohibit a *member's* compliance with applicable laws and government regulations, (3) to prohibit review of a *member's* professional practice under AICPA or state CPA society or Board of Accountancy authorization, or (4) to preclude a *member* from initiating a complaint with, or responding to any inquiry made by, the professional ethics division or trial board of the *Institute* or a duly constituted investigative or disciplinary body of a state CPA society or Board of Accountancy. *Members* of any of the bodies identified in (4) above and *members* involved with professional practice reviews identified in (3) above shall not use to their own advantage or disclose any *member's confidential client information* that comes to their attention in carrying out those activities. This prohibition shall not restrict *members'* exchange of information in connection with the investigative or disciplinary proceedings described in (4) above or the professional practice reviews described in (3) above. [Prior reference: paragraph .01 of ET section 301]

### Interpretations Under the Confidential Client Information Rule

#### 1.700.005 Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts

**.01** In the absence of an *interpretation* of the "Confidential Client Information Rule" [1.700.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Public Practice" [1.000.010].

**.02** A *member* would be considered in violation of the "Confidential Client Information Rule" [1.700.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

**.03** A *member* should consider the guidance in "Ethical Conflicts" [1.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional and legal standards, or both. [No prior reference: new content]

#### **Effective Date**

**.04** Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

### 1.700.010 Client Competitors

.01 When a *member* provides *professional services* to *clients* that are competitors, *threats* to compliance with the "Confidential Client Information Rule" [1.700.001] may exist because the *member* may have access to *confidential client information*, such as sales, purchases, and gross profit percentages of the respective competitors.

.02 To reduce the *threat* of disclosing *confidential client information* to a competitor, the *member* should emphasize to all relevant parties, including employees of the *firm* and affected *clients*, that the "Confidential Client Information Rule" [1.700.001] prohibits *members* from revealing to others any *confidential client information* obtained in their professional capacity. [Prior reference: paragraphs .011–.012 of ET section 391]

### 1.700.020 Disclosing Information From Previous Engagements

.01 When a *member* evaluates whether to accept a new *client* engagement, the *member* should consider whether knowledge and experience that the *member* or *member's firm* will share while providing the *professional services* to the prospective *client* would be *confidential client information*. If such information would be *confidential client information*, and the circumstances are such that the prospective *client* would be able to identify the *client* or *clients* that are the source of the information, the engagement should not be accepted unless the *member* obtains the original *client's* specific consent to disclose the information. [Prior reference: paragraphs .029–.030 of ET section 391]

.02 When a *member* withdraws from an engagement due to, for example, discovery of irregularities in a *client's* tax return, if contacted by the successor, the *member* should suggest that the successor ask the *client* to permit the *member* to discuss all matters freely with the successor. The successor is then on notice of some conflict.

.03 The "Confidential Client Information Rule" [1.700.001] is not intended to help an unscrupulous *client* cover up illegal acts or otherwise hide information by changing CPAs. Due to the possibility of legal implications in such matters, the *member* should seek legal advice on the *member's* status and obligations in the matter. [Prior reference: paragraphs .005–.006 of ET section 391]

### 1.700.030 Disclosing Information to Persons or Entities Associated With Clients

.01 When a *member* is engaged to prepare a married couple's joint tax return, both spouses are considered to be the *member's client*, even if the *member* was engaged by one spouse and deals exclusively with that spouse.

.02 Accordingly, if the married couple is undergoing a divorce and one spouse directs the *member* to withhold joint tax information from the other spouse, the *member* may provide the information to both spouses, in compliance with the "Confidential Client Information Rule" [1.700.001], because both are the *member's client*. The *member* should consider reviewing

- a. the legal implications of such disclosure with an attorney and
- b. responsibilities under any tax performance standards, such as Section 10.29 of IRS Circular 230. [Prior reference: paragraphs .031–.032 of ET section 391]

.03 If a *member* provides *professional services* to a company's executives at the request of the company, the *member's* disclosure of *confidential client*

*information* to the company without the consent of the applicable executives would be a violation of the "Confidential Client Information Rule" [1.700.001], even if the company is not otherwise a *client*. [Prior reference: paragraphs .041–.042 of ET section 391]

### 1.700.040 Disclosing Information to a Third-Party Service Provider

**.01** When a *member* uses a *third-party service provider* to assist the *member* in providing *professional services*, *threats* to compliance with the "Confidential Client Information Rule" [1.700.001] may exist.

**.02** *Clients* may not expect the *member* to use a *third-party service provider* to assist the *member* in providing the *professional services*. Therefore, before disclosing *confidential client information* to a *third-party service provider*, the *member* should do one of the following:

- a. Enter into a contractual agreement with the *third-party service provider* to maintain the confidentiality of the information and provide reasonable assurance that the *third-party service provider* has appropriate procedures in place to prevent the unauthorized release of confidential information to others. The nature and extent of procedures necessary to obtain reasonable assurance depends on the facts and circumstances, including the extent of publicly available information on the *third-party service provider's* controls and procedures to *safeguard confidential client information*.
- b. Obtain specific consent from the *client* before disclosing *confidential client information* to the *third-party service provider*.

**.03** Refer to the "Use of a Third-Party Service Provider" interpretation [1.150.040] of the "Integrity and Objectivity Rule" [1.100.001] and the "Use of a Third-Party Service Provider" interpretation [1.300.040] of the "General Standards Rule" [1.300.001] for additional guidance. [Prior reference: paragraphs .001–.002 of ET section 391]

A nonauthoritative basis-for-conclusions document that summarizes considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsOutsourcing.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsOutsourcing.pdf).

In addition, nonauthoritative sample client disclosure language that could be used to fulfill the requirement discussed in this interpretation is also available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Sample\\_Disclosure\\_Notification.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Sample_Disclosure_Notification.pdf).

### 1.700.050 Disclosing Client Information in Connection With a Review of the Member's Practice

**.01** For purposes of the "Confidential Client Information Rule" [1.700.001], a review of a *member's* professional practice includes a review performed in conjunction with a prospective purchase, sale, or merger of all or part of a *member's* practice. Such reviews may *threaten* a *member's* compliance with the "Confidential Client Information Rule." To reduce the *threat* to an *acceptable level*,

a *member* must take appropriate precautions (for example, through a written confidentiality agreement with the prospective purchaser) to help ensure that the prospective purchaser does not disclose any *confidential client information* obtained in the course of the review.

**.02** *Members* who perform such reviews shall not use to their advantage or disclose any *confidential client information* that comes to their attention during the review. [Prior reference: paragraph .04 of ET section 301]

### 1.700.060 Disclosure of Client Information to Third Parties

**.01** When a *member* receives a request from a third party (for example, a trade association, member of academia, or surveying or benchmarking organization) to disclose *client* information or intends to use such information for the *member's* own purposes (for example, publication of benchmarking data or studies) in a manner that may result in the *client's* information being disclosed to others without the *client* being specifically identified, *threats* to compliance with the "Confidential Client Information Rule" [1.700.001] may exist.

**.02** If the information is considered to be *confidential client information*, the *member* would be in violation of the "Confidential Client Information Rule" [1.700.001] if the *member* discloses or uses the information unless the *member* has the *client's* specific consent, preferably in writing, for the disclosure or use of such information. The consent should specify the nature of the information that may be disclosed, the type of third party to whom it may be disclosed, and its intended use.

**.03** If the information is not considered to be *confidential client information*, the disclosure or use of the information is not subject to the "Confidential Client Information Rule" [1.700.001]. However, the *member* should be cautious in the disclosure or use of the information so as not to disclose *client* information that may go beyond what is available to the public or that the *client* has agreed may be disclosed.

**.04** A *member* is not prohibited from marketing his or her services or advising a third party, such as a current or prospective *client*, of information based on his or her expertise or knowledge obtained from prior experiences with *clients* (for example, the nature of services provided to other *clients* or common practices within a *client's* industry). However, if the information may be identifiable to one or more *clients*, specific consent, preferably in writing, is required from such *client(s)*. Prior to disclosing *confidential client information* to a third party, the *member* should consider whether a contractual agreement with the third party to maintain the confidentiality or limit the use of the information is necessary.

**.05** In addition, the *member* should consider whether federal, state, or local statutes, rules, or regulations concerning the confidentiality of *client* information may be more restrictive than the requirements in this interpretation.

**.06** Refer to the "Use of a Third-Party Service Provider" interpretation [1.300.040] of the "General Standards Rule" [1.300.001] for additional guidance. [Prior reference: paragraphs .003–.004 of ET section 391]

A nonauthoritative table providing examples of client information that is available to the public, client information not available to the public, and other information in the member's possession is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Categories-of-Information.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Categories-of-Information.pdf).

## 1.700.070 Disclosing Client Information During Litigation

.01 The "Confidential Client Information Rule" [1.700.001] is not intended to prohibit a *member* from disclosing information necessary to initiate, pursue, or defend the *member* in an actual or a threatened lawsuit or alternative dispute resolution proceeding. Accordingly, releasing *confidential client information* to the *member's* liability insurance carrier solely to assist in the defense against an actual or a potential claim against the *member* would not violate the "Confidential Client Information Rule." [Prior reference: paragraphs .039–.040 and .045–.046 of ET section 391]

## 1.700.080 Disclosing Client Information in Director Positions

.01 When a *member* serves as a director of an organization, such as a bank or an insurance company, the *member's* fiduciary responsibilities to the organization may create *threats* to compliance with the "Integrity and Objectivity Rule" [1.100.001] and the "Confidential Client Information Rule" [1.700.001]. For example, the *member's* fiduciary duty to the organization may conflict with the *member's* obligations pursuant to the "Confidential Client Information Rule" (for example, failure to disclose information may constitute a breach of the director's fiduciary responsibilities) when the *member's clients* are customers of the organization.

.02 A *member's* general knowledge and experience may be very helpful to an organization in formulating a policy and making business decisions. Nevertheless, if the *member's clients* are likely to engage in significant transactions with the organization, it would be more appropriate for the *member* to serve as a consultant to the board. Under such an arrangement, the *member* could limit activities to those that do not *threaten* the *member's* compliance with the "Integrity and Objectivity Rule" [1.100.001] and the "Confidential Client Information Rule" [1.700.001]. If, however, the *member* serves as a board member of the organization, the *member* should evaluate the significance of any *threats* and apply *safeguards*, when necessary, to eliminate or reduce the *threats* to an *acceptable level*.

.03 See the "Director Positions" interpretation [1.110.020] of the "Integrity and Objectivity Rule" [1.100.001]. [Prior reference: paragraphs .035–.036 of ET section 391]

### **Effective Date**

.04 The revisions to this interpretation are effective December 15, 2014.

## 1.700.090 Disclosing Client Names

.01 The *member's* disclosure of a *client's* name would not violate the "Confidential Client Information Rule" [1.700.001] if disclosure of the *client's* name does not constitute the release of *confidential client information*. For example, if a *member's* practice is limited to bankruptcy matters, disclosure of the *client's* name could suggest that the *client* may be experiencing financial difficulties, which may be *confidential client information*. [Prior reference: paragraphs .013–.014 of ET section 391]

## 1.700.100 Disclosing Confidential Client Information as a Result of a Subpoena or Summons

.01 The *member's* disclosure of *confidential client information* in compliance with a validly issued and enforceable subpoena or summons would not violate the "Confidential Client Information Rule" [1.700.001].

.02 When complying with such subpoena or summons, the *member* is not required to notify the *client* that its records have been subpoenaed or that a summons related to the *client's* records has been issued. The *member* may also wish to consult with legal counsel to determine the validity and enforceability of the subpoena or summons and the specific *client* information required to be provided. The *member* may also wish to consult with his or her state board of accountancy. [No prior reference: New content from informal policy position]

### **Effective Date**

.03 Effective December 15, 2014.

## **1.800 Form of Organization and Name**

### **1.800.001 Form of Organization and Name Rule**

.01 A *member* may practice public accounting only in a form of organization permitted by law or regulation whose characteristics conform to resolutions of *Council*.

.02 A *member* shall not practice public accounting under a *firm* name that is misleading.

.03 Names of one or more past owners may be included in the *firm* name of a successor organization.

.04 A *firm* may not designate itself as "Members of the American Institute of Certified Public Accountants" unless all its CPA owners are *members* of the AICPA.

.05 See appendix B, "Council Resolution Concerning Form of Organization and Name." [Prior reference: paragraph .01 of ET section 505]

### **Interpretations Under the Form of Organization and Name Rule**

#### **1.800.005 Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts**

.01 In the absence of an *interpretation* of the "Form of Organization and Name Rule" [1.800.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Public Practice" [1.000.010].

.02 A *member* would be considered in violation of the "Form of Organization and Name Rule" [1.800.001] if the *member* cannot demonstrate the application of *safeguards* that eliminated or reduced significant *threats* to an *acceptable level*.

.03 A *member* should consider the guidance in "Ethical Conflicts" [1.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional and legal standards, or both. [No prior reference: new content]

### **Effective Date**

.04 Paragraphs .01 and .02 are effective December 15, 2015 and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

## **1.810 Form of Organization and Related Practice Issues**

### **1.810.010 Ownership of a Separate Business**

.01 A *member* may own an interest in a separate business that performs for *clients* accounting, tax, personal financial planning, or litigation support services or other services for which standards are promulgated by bodies designated by *Council*.

.02 If the *member*, either individually or collectively with the *member's firm* or others in the *firm*, *controls* the separate business, then the separate business, its owners (including the *member*), and its professional employees must comply with the code. For example, if one or more *members* individually or collectively *control* the separate business, the *member(s)* and others associated with the separate business are subject to the "Commissions and Referral Fees Rule" [1.520.001] and its *interpretations*. With respect to an *attest client*, the "Independence Rule" [1.200.001] and its *interpretations* would apply to the activities of the separate business, its owners, and its professional employees.

.03 When the *member*, individually or collectively with the *member's firm* or others in the *firm*, does not *control* the separate business, the provisions of the code would apply to the *member's* actions but not to the separate business, its other (nonmember) owners, and its professional employees. For example, the separate business could enter into a contingent fee arrangement with the *member's attest client* or accept commissions for the referral of products or services to the *member's attest client*. [Prior reference: paragraph .03 of ET section 505]

.04 When the owners of the separate business are non-CPAs, to prevent any misunderstanding or misrepresentation, the CPA *member* should advise *clients* and other interested parties that the CPA *member* is an owner in two separate businesses: one made up of non-CPAs (except for the CPA *member*) and another that is a CPA *firm*. [Prior reference: paragraphs .275–.276 of ET section 591]

.05 See the "Network and Network Firms" interpretation [1.220.010] of the "Independence Rule" [1.200.001] and the definitions of *networks* and *network firms* for guidance applicable to these entities.

### **1.810.020 Partner Designation**

.01 Only *members* of a *firm* who are legally *partners* should use the designation *partner*. *Members* who are not parties to the *firm's* partnership agreement should not hold themselves out in any manner that might lead *clients* or the public to believe that they are *partners*. For example, using the designation "nonproprietary partner" to describe a high-ranking professional employee would be misleading and in violation of the "Form of Organization and Name Rule" [1.800.001] even if the professional employee was a *partner* in one of the predecessor *firms* that merged into the *firm*. [Prior reference: paragraphs .273–.274 of ET section 591]

**1.810.030 A Member's Responsibility for Nonmember Practitioners**

.01 A *member* who becomes an employee of a *firm* made up of one or more nonmember practitioners must still comply with the code. If the *member* becomes an owner in the *firm*, the *member* will be responsible for *firm's* professional employees, including the nonmember practitioners.

.02 Similarly, if a *member* forms a partnership with a nonmember, the *member* is ethically responsible for all the activities of the partnership. If the nonmember *partner* violates the code, the *member* would be held accountable for that *partner's* actions.

.03 See paragraph .04 of the "Application of the AICPA Code" [0.200.020] section of the preface and appendix B. [Prior reference: paragraphs .005–.006 and .281–.282 of ET section 591]

**1.810.040 Attest Engagement Performed With a Former Partner**

.01 Unless there are laws, rules or regulations that are applicable to the *member* that conclude otherwise, two former *partners* may continue to jointly perform an *attest engagement* even if one of them is not a CPA. However, to be clear that a partnership no longer exists and to assure the *attest client* and others that both individuals performed the *attest engagement*, they should present their report on plain paper (that is, paper with no letterhead) that is signed in the following manner:

John Doe, Certified Public Accountant  
Richard Roe, Accountant

[Prior reference: paragraphs .271–.272 of ET section 591]

**Effective Date**

.02 The revisions to this interpretation are effective December 15, 2014.

**1.810.050 Alternative Practice Structures**

.01 The "Form of Organization and Name Rule" [1.800.001] states, "A *member* may practice public accounting only in a form of organization permitted by law or regulation whose characteristics conform to resolutions of *Council*." The *Council* resolution (appendix B) requires, among other things, that CPAs own a majority of the *financial interests* in a *firm* engaged to provide attest services (as defined therein) to the public. This interpretation explains the application of this rule to an alternative practice structure (APS) in which (a) the majority of the *financial interests* in the attest *firm* is owned by CPAs and (b) all or substantially all of the revenues are paid to another entity in return for services and the lease of employees, equipment, and *office* space.

.02 To protect the public interest, the overriding focus of the resolution is that CPAs remain responsible, financially and otherwise, for a *firm's* attest work. In addition to the provisions of the resolution, other requirements of the code and bylaws ensure responsibility for

- a. compliance with all aspects of applicable law or regulation,
- b. enrollment in an AICPA-approved practice monitoring program,
- c. compliance with the "Independence Rule" [1.200.001], and
- d. compliance with applicable standards promulgated by *Council*-designated bodies ("Compliance With Standards Rule" [1.310.001]) and all other provisions of the code, including "Structure and Application of the AICPA Code" [0.200].

.03 Given all the previously mentioned *safeguards* that protect the public interest, if the CPAs who own the attest *firm* remain financially responsible, under applicable law or regulation, for the *firm's* attest work, the *member* is considered to be in compliance with the financial interests provision of the resolution. [Prior reference: paragraph .04 of ET section 505]

## 1.820 Firm Name

### 1.820.010 Use of a Retired Partner's Name

.01 The "Form of Organization and Name Rule" [1.800.001] permits the use of the name(s) of former *partner(s)* in a *firm's* name. For example, if two *firms* merge, the newly formed *firm* may use in its *firm* name the name of retired or other *partners* in either or both of the merged *firms* without violating the "Form of Organization and Name Rule." [Prior reference: paragraphs .289–.290 of ET section 591]

### 1.820.020 A Practice With Non-CPA Partners

.01 Unless there are laws, rules, or regulations that are applicable to the *member* that conclude otherwise, a CPA *member* who is in a partnership with non-CPAs may sign reports in the *firm's* name and also affix the designation, "Certified Public Accountant," to the *member's* signature if it is clear that the partnership itself is not being held out as entirely comprising CPAs. [Prior reference: paragraphs .379–.380 of ET section 591]

### 1.820.030 Misleading Firm Names

.01 The "Form of Organization and Name Rule" [1.800.001] prohibits a *member* from practicing public accounting under a *firm* name that is misleading. If the *firm* name contains any representation that would be likely to cause a reasonable person to misunderstand, or be confused about, what the legal form of the *firm* is or who the owners or members of the *firm* are, the *firm* name would be misleading and the *member* would be in violation of the "Form of Organization and Name Rule." For example, the *member* should not refer to a type of organization or an abbreviation thereof that does not accurately reflect the form under which the *firm* is organized.

.02 In addition, the *member* should consider the rules and regulations of his or her state board(s) of accountancy concerning misleading *firm* names that may be more restrictive than the requirements in this interpretation. [Prior reference: paragraph .05 of ET section 505]

### 1.820.040 Use of a Common Brand Name in Firm Name

.01 *Firms* within a *network* sometimes share the use of a common brand or share common initials as part of the *firm* name. The sharing of a common brand name or common initials of a *network* as part of the *member's firm* name would not be considered misleading, provided the *firm* is a *network firm*.

.02 The sharing of a common brand name or common initials of a *network* as the entire name of the *member's firm* would not be considered misleading, if the *firm* is a *network firm* and shares one or more of the following characteristics with other *firms* in the *network*:

- a. Common *control* among the firms through ownership, management, or other means

- b. Profits or costs, excluding costs of operating the *network*; costs of developing audit methodologies, manuals, and training courses; and other costs that are immaterial to the *firm*
- c. Common business strategy that involves ongoing collaboration amongst the *firms* whereby the *firms* are responsible for implementing the *network's* strategy and are held accountable for performance pursuant to that strategy
- d. Significant part of professional resources
- e. Common quality control policies and procedures that *firms* are required to implement and that are monitored by the *network*

**.03** Refer to the "Network and Network Firms" interpretation [1.220.010] of the "Independence Rule" [1.200.001] for additional guidance. [Prior reference: paragraph .06 of ET section 505]

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## ET Part 2

***Members in Business***

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## 2.000 Introduction

.01 Part 2 of the Code of Professional Conduct (the code) applies to *members in business*. Accordingly, when the term *member* is used in part 2 of the code, the requirements apply only to *members in business*. When a *member in business* is also a *member in public practice* (for example, a *member* has a part-time tax practice), the *member* should also consult part 1 of the code, which applies to *members in public practice*. [No prior reference: new content]

### **Effective Date**

.02 Effective December 15, 2014.

## 2.000.010 Conceptual Framework for Members in Business

### **Introduction**

.01 *Members* may encounter various relationships or circumstances that create *threats* to the *member's* compliance with the rules. The rules and *interpretations* seek to address many situations; however, they cannot address all relationships or circumstances that may arise. Thus, in the absence of an *interpretation* that addresses a particular relationship or circumstance, a *member* should evaluate whether that relationship or circumstance would lead a reasonable and informed third party who is aware of the relevant information to conclude that there is a *threat* to the *member's* compliance with the rules that is not at an *acceptable level*. When making that evaluation, the *member* should apply the conceptual framework approach as outlined in this interpretation.

.02 The code specifies that in some circumstances, no *safeguards* can reduce a *threat* to an *acceptable level*. For example, the code specifies that a *member* may not subordinate the *member's* professional judgment to others without violating the "Integrity and Objectivity Rule" [2.100.001]. A *member* may not use the conceptual framework to overcome this or any other prohibition or requirement in the code.

### **Definitions Used in Applying the Conceptual Framework**

.03 **Acceptable level.** A level at which a reasonable and informed third party who is aware of the relevant information would be expected to conclude that a *member's* compliance with the rules is not compromised.

.04 **Safeguards.** Actions or other measures that may eliminate a *threat* or reduce a threat to an *acceptable level*.

.05 **Threat(s).** Relationships or circumstances that could compromise a *member's* compliance with the rules.

### **Conceptual Framework Approach**

.06 Under the conceptual framework approach, *members* should identify *threats* to compliance with the rules and evaluate the significance of those *threats*. *Members* should evaluate identified *threats* both individually and in the aggregate because *threats* can have a cumulative effect on a *member's* compliance with the rules. *Members* should perform three main steps in applying the conceptual framework approach:

- a. *Identify threats.* The relationships or circumstances that a *member* encounters in various engagements and work assignments or

positions will often create different *threats* to complying with the rules. When a *member* encounters a relationship or circumstance that is not specifically addressed by a rule or an *interpretation*, under this approach, the *member* should determine whether the relationship or circumstance creates one or more *threats*, such as those identified in paragraphs .09–.14 that follow. The existence of a *threat* does not mean that the *member* is in violation of the rules; however, the *member* should evaluate the significance of the *threat*.

- b. *Evaluate the significance of a threat.* In evaluating the significance of an identified *threat*, the *member* should determine whether a *threat* is at an *acceptable level*. A *threat* is at an *acceptable level* when a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the *threat* would not compromise the *member's* compliance with the rules. *Members* should consider both qualitative and quantitative factors when evaluating the significance of a *threat*, including the extent to which existing *safeguards* already reduce the *threat* to an *acceptable level*. If the *member* evaluates the *threat* and concludes that a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the *threat* does not compromise a *member's* compliance with the rules, the *threat* is at an *acceptable level* and the *member* is not required to evaluate the *threat* any further under this conceptual framework approach.
- c. *Identify and apply safeguards.* If, in evaluating the significance of an identified *threat*, the *member* concludes that the *threat* is not at an *acceptable level*, the *member* should apply *safeguards* to eliminate the *threat* or reduce it to an *acceptable level*. The *member* should apply judgment in determining the nature of the *safeguards* to be applied because the effectiveness of *safeguards* will vary depending on the circumstances. When identifying appropriate *safeguards* to apply, one *safeguard* may eliminate or reduce multiple *threats*. In some cases, the *member* should apply multiple *safeguards* to eliminate or reduce one *threat* to an *acceptable level*. In other cases, an identified *threat* may be so significant that no *safeguards* will eliminate the *threat* or reduce it to an *acceptable level*, or the *member* will be unable to implement effective *safeguards*. Under such circumstances, providing the specific *professional services* would compromise the *member's* compliance with the rules, and the *member* should determine whether to decline or discontinue the *professional services* or resign from the *employing organization*.

## Threats

**.07** Many *threats* fall into one or more of the following six broad categories: adverse interest, advocacy, familiarity, self-interest, self-review, and undue influence.

**.08** Examples of *threats* associated with a specific relationship or circumstance are identified in the *interpretations* of the code. Paragraphs .09–.14 of this section define and provide examples, which are not all inclusive, of each of these *threat* categories.

**.09** *Adverse interest threat.* The *threat* that a *member* will not act with objectivity because the *member's* interests are opposed to the interests of

the *employing organization*. Examples of adverse interest *threats* include the following:

- a. A *member* has charged, or expressed an intention to charge, the *employing organization* with violations of law.
- b. A *member* or the *member's immediate family* or *close relative* has a financial or another relationship with a vendor, customer, competitor, or potential acquisition of the *employing organization*.
- c. A *member* has sued or expressed an intention to sue the *employing organization* or its officers, directors, or employees.

**.10 Advocacy threat.** The *threat* that a *member* will promote an *employing organization's* interests or position to the point that his or her objectivity is compromised. Examples of advocacy *threats* include the following:

- a. Obtaining favorable financing or additional capital is dependent upon the information that the *member* includes in, or excludes from, a prospectus, an offering, a business plan, a financing application, or a regulatory filing.
- b. The *member* gives or fails to give information that the *member* knows will unduly influence the conclusions reached by an external service provider or other third party.

**.11 Familiarity threat.** The *threat* that, due to a long or close relationship with a person or an *employing organization*, a *member* will become too sympathetic to their interests or too accepting of the person's work or *employing organization's* product or service. Examples of familiarity *threats* include the following:

- a. A *member* uses an *immediate family's* or a *close relative's* company as a supplier to the *employing organization*.
- b. A *member* may accept an individual's work product with little or no review because the individual has been producing an acceptable work product for an extended period of time.
- c. A *member's immediate family* or *close relative* is employed as a *member's* subordinate.
- d. A *member* regularly accepts gifts or entertainment from a vendor or customer of the *employing organization*.

**.12 Self-interest threat.** The *threat* that a *member* could benefit, financially or otherwise, from an interest in, or relationship with, the *employing organization* or persons associated with the *employing organization*. Examples of self-interest *threats* include the following:

- a. A *member's immediate family* or *close relative* has a *financial interest* in the *employing organization*.
- b. A *member* holds a *financial interest* (for example, shares or share options) in the *employing organization*, and the value of that *financial interest* is directly affected by the *member's* decisions.
- c. A *member* is eligible for a profit or other performance-related bonus, and the value of that bonus is directly affected by the *member's* decisions.

**.13 Self-review threat.** The *threat* that a *member* will not appropriately evaluate the results of a previous judgment made or service performed or supervised by the *member*, or an individual in the *employing organization* and that the *member* will rely on that service in forming a judgment as part of another service. Examples of self-review *threats* include the following:

- a. When performing an internal audit procedure, an internal auditor accepts work that he or she previously performed in a different position.
- b. The *member* accepts the work previously performed by the *member*, alone or with others, that will be the basis for providing another *professional service*.

**.14** *Undue influence threat.* The *threat* that a *member* will subordinate his or her judgment to that of an individual associated with the *employing organization* or any relevant third party due to that individual's position, reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the *member*. Examples of undue influence *threats* include the following:

- a. A *member* is pressured to become associated with misleading information.
- b. A *member* is pressured to deviate from a company policy.
- c. A *member* is pressured to change a conclusion regarding an accounting or a tax position.
- d. A *member* is pressured to hire an unqualified individual.

### Safeguards

**.15** *Safeguards* may partially or completely eliminate a *threat* or diminish the potential influence of a *threat*. The nature and extent of the *safeguards* applied will depend on many factors. To be effective, *safeguards* should eliminate the *threat* or reduce it to an *acceptable level*.

**.16** *Safeguards* that may eliminate a *threat* or reduce it to an *acceptable level* fall into two broad categories:

- a. *Safeguards* created by the profession, legislation, or regulation
- b. *Safeguards* implemented by the *employing organization*

**.17** The effectiveness of a *safeguard* depends on many factors, including those listed here:

- a. The facts and circumstances specific to a particular situation
- b. The proper identification of *threats*
- c. Whether the *safeguard* is suitably designed to meet its objectives
- d. The party(ies) who will be subject to the *safeguard*
- e. How the *safeguard* is applied
- f. The consistency with which the *safeguard* is applied
- g. Who applies the *safeguard*
- h. How the *safeguard* interacts with a *safeguard* from another category
- i. Whether the *employing organization* is a *public interest entity*

**.18** Examples of *safeguards* within each category are presented in the following paragraphs. Because these are only examples and are not intended to be all inclusive, it is possible that *threats* may be sufficiently mitigated through the application of other *safeguards* not specifically identified herein.

**.19** The following are examples of *safeguards* created by the profession, legislation, or regulation:

- a. Education and training requirements on ethics and professional responsibilities

- b. Continuing education requirements on ethics
- c. Professional standards and the threat of discipline
- d. Legislation establishing prohibitions and requirements for entities and employees
- e. Competency and experience requirements for professional licensure
- f. Professional resources, such as hotlines, for consultation on ethical issues

**.20** Examples of *safeguards* implemented by the *employing organization* are as follows:

- a. A tone at the top emphasizing a commitment to fair financial reporting and compliance with applicable laws, rules, regulations, and corporate governance policies
- b. Policies and procedures addressing ethical conduct and compliance with laws, rules, and regulations
- c. Audit committee charter, including independent audit committee members
- d. Internal policies and procedures requiring disclosure of identified interests or relationships among the *employing organization*, its directors or officers, and vendors, suppliers, or customers
- e. Internal policies and procedures related to purchasing controls
- f. Internal policies and procedures related to customer acceptance or credit limits
- g. Dissemination of corporate ethical compliance policies and procedures, including whistle-blower hotlines, the reporting structure, dispute resolution, or other similar policies, to promote compliance with laws, rules, regulations, and other professional requirements
- h. Human resource policies and procedures *safeguarding* against discrimination or harassment, such as those concerning a worker's religion, sexual orientation, gender, or disability
- i. Human resource policies and procedures stressing the hiring and retention of technically competent employees
- j. Policies and procedures for implementing and monitoring ethical policies
- k. Assigning sufficient staff with the necessary competencies to projects and other tasks
- l. Policies segregating personal assets from company assets
- m. Staff training on applicable laws, rules, and regulations
- n. Regular monitoring of internal policies and procedures
- o. A reporting structure whereby the internal auditor does not report to the financial reporting group
- p. Policies and procedures that do not allow an internal auditor to monitor areas where the internal auditor has operational or functional responsibilities
- q. Policies for promotion, rewards, and enforcement of a culture of high ethics and integrity
- r. Use of third-party resources for consultation as needed on significant matters of professional judgment [No prior reference: new content]

**Effective Date**

.21 Effective December 15, 2015. Early implementation is allowed provided the member has implemented the revised code.

**2.000.020 Ethical Conflicts**

.01 An ethical conflict arises when a *member* encounters one or both of the following:

- a. Obstacles to following an appropriate course of action due to internal or external pressures
- b. Conflicts in applying relevant professional and legal standards.

For example, a *member* suspects a fraud may have occurred, but reporting the suspected fraud would violate the *member's* responsibility to maintain the confidentiality of his or her employer's confidential information.

.02 Once an ethical conflict is encountered, a *member* may be required to take steps to best achieve compliance with the rules and law. In weighing alternative courses of action, the *member* should consider factors such as the following:

- a. Relevant facts and circumstances, including applicable rules, laws, or regulations
- b. Ethical issues involved
- c. Established internal procedures

.03 The *member* should also be prepared to justify any departures that the *member* believes were appropriate in applying the relevant rules and law. If the *member* was unable to resolve the conflict in a way that permitted compliance with the applicable rules and law, the *member* may have to address the consequences of any violations.

.04 Before pursuing a course of action, the *member* should consider consulting with appropriate persons within the organization that employs the *member*.

.05 If a *member* decides not to consult with appropriate persons within the organization that employs the *member*, and the conflict remains unresolved after pursuing the selected course of action, the *member* should consider either consulting with other individuals for help in reaching a resolution or obtaining advice from an appropriate professional body or legal counsel. The *member* also should consider documenting the substance of the issue, the parties with whom the issue was discussed, details of any discussions held, and any decisions made concerning the issue.

.06 If the ethical conflict remains unresolved, the *member* will in all likelihood be in violation of one or more rules if he or she remains associated with the matter creating the conflict. Accordingly, the *member* should consider his or her continuing relationship with the specific assignment or employer. [No prior reference: new content]

**Effective Date**

.07 Effective December 15, 2014.

## 2.100 Integrity and Objectivity

### 2.100.001 Integrity and Objectivity Rule

.01 In the performance of any *professional service*, a *member* shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others. [Prior reference: paragraph .01 of ET section 102]

### Interpretations Under the Integrity and Objectivity Rule

#### 2.100.005 Application of the Conceptual Framework for Members in Business and Ethical Conflicts

.01 In the absence of an *interpretation* of the "Integrity and Objectivity Rule" [2.100.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Business" [2.000.010].

.02 A *member* would be considered in violation of the "Integrity and Objectivity Rule" [2.100.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

.03 A *member* should consider the guidance in "Ethical Conflicts" [2.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional and legal standards, or both. [No prior reference: new content]

#### **Effective Date**

.04 Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

## 2.110 Conflicts of Interest

### 2.110.010 Conflicts of Interest for Members in Business

.01 A *member* may be faced with a conflict of interest when undertaking a *professional service*. In determining whether a *professional service*, relationship, or matter would result in a conflict of interest, a *member* should use professional judgment, taking into account whether a reasonable and informed third party who is aware of the relevant information would conclude that a conflict of interest exists.

.02 A conflict of interest creates adverse interest and self-interest *threats* to the *member's* compliance with the "Integrity and Objectivity Rule" [2.100.001]. For example, *threats* may be created when

- a. a *member* undertakes a *professional service* related to a particular matter involving two or more parties whose interests with respect to that matter are in conflict, or

- b. the interests of a *member* with respect to a particular matter and the interests of a party for whom the *member* undertakes a *professional service* related to that matter are in conflict.

**.03** A party may include an *employing organization*, a vendor, a customer, a lender, a shareholder, or other party.

**.04** The following are examples of situations in which conflicts of interest may arise:

- a. Serving in a management or governance position for two *employing organizations* and acquiring confidential information from one *employing organization* that could be used by the *member* to the advantage or disadvantage of the other *employing organization*
- b. Undertaking a *professional service* for each of two parties in a partnership employing the *member* to assist in dissolving their partnership
- c. Preparing financial information for certain *members* of management of the *employing organization* who are seeking to undertake a management buy-out
- d. Being responsible for selecting a vendor for the *member's employing organization* when the *member* or his or her *immediate family member* could benefit financially from the transaction
- e. Serving in a governance capacity or influencing an *employing organization* that is approving certain investments for the company in which one of those specific investments will increase the value of the personal investment portfolio of the *member* or his or her *immediate family member*

### **Identification of a Conflict of Interest**

**.05** In identifying whether a conflict of interest exists or may be created, a *member* should take reasonable steps to determine

- a. the nature of the relevant interests and relationships between the parties involved and
- b. the nature of the services and its implication for relevant parties.

**.06** The nature of the relevant interests and relationships and the services may change over time. The *member* should remain alert to such changes for the purposes of identifying circumstances that might create a conflict of interest.

### **Evaluation of a Conflict of Interest**

**.07** When an actual conflict of interest has been identified, the *member* should evaluate the significance of the *threat* created by the conflict of interest to determine if the *threat* is at an *acceptable level*. *Members* should consider both qualitative and quantitative factors when evaluating the significance of the *threat*, including the extent to which existing *safeguards* already reduce the *threat* to an *acceptable level*.

**.08** In evaluating the significance of an identified *threat*, *members* should consider the following:

- a. The significance of relevant interests or relationships.
- b. The significance of the *threats* created by undertaking the *professional service* or services. In general, the more direct the connection between the *member* and the matter on which the parties'

interests are in conflict, the more significant the *threat* to compliance with the rule will be.

**.09** If the *member* concludes that the *threat* is not at an *acceptable level*, the *member* should apply *safeguards* to eliminate the *threat* or reduce it to an *acceptable level*. Examples of *safeguards* include the following:

- a. Restructuring or segregating certain responsibilities and duties
- b. Obtaining appropriate oversight
- c. Withdrawing from the decision making process related to the matter giving rise to the conflict of interest
- d. Consulting with third parties, such as a professional body, legal counsel, or another professional accountant

**.10** In cases where an identified *threat* may be so significant that no *safeguards* will eliminate the *threat* or reduce it to an *acceptable level*, or the *member* is unable to implement effective *safeguards*, the *member* should (a) decline to perform or discontinue the *professional services* that would result in the conflict of interest; or (b) terminate the relevant relationships or dispose of the relevant interests to eliminate the *threat* or reduce it to an *acceptable level*.

### ***Disclosure of a Conflict of Interest and Consent***

**.11** When a conflict of interest exists, the *member* should disclose the nature of the conflict to the relevant parties, including to the appropriate levels within the *employing organization* and obtain their consent to undertake the *professional service*. The *member* should disclose the conflict of interest and obtain consent even if the *member* concludes that *threats* are at an *acceptable level*.

**.12** The *member* is encouraged to document the nature of the circumstances giving rise to the conflict of interest, the *safeguards* applied to eliminate or reduce the *threats* to an *acceptable level*, and the consent obtained.

**.13** When addressing a conflict of interest, a *member* is encouraged to seek guidance from within the *employing organization* or from others, such as a professional body, legal counsel, or another professional accountant. When making disclosures and seeking guidance of third parties, the *member* should remain alert to the requirements of the "Confidential Information Obtained From Employment or Volunteer Activities" interpretation [2.400.070] of the "Acts Discreditable Rule" [2.400.001]. In addition, federal, state, or local statutes, or regulations concerning confidentiality of employer information may be more restrictive than the requirements contained in the Code of Professional Conduct.

**.14** A *member* may encounter other *threats* to compliance with the "Integrity and Objectivity Rule" [2.100.001]. This may occur, for example, when preparing or reporting financial information as a result of undue pressure from others within the *employing organization* or financial, business or personal relationships that *close relatives* or *immediate family* members of the *member* have with the *employing organization*. Guidance on managing such *threats* is covered by the "Knowing Misrepresentations in the Preparation of Financial Statements or Records" interpretation [2.130.010] and the "Subordination of Judgment" interpretation [2.130.020] under the "Integrity and Objectivity Rule."

[See Revision History Table.]

## 2.120 Gifts and Entertainment

### 2.120.010 Offering or Accepting Gifts or Entertainment

**.01** For purposes of this interpretation, a customer or vendor of the *member's* employer includes a representative of the customer or vendor.

**.02** When a *member* offers to, or accepts gifts or entertainment from, a customer or vendor of the *member's* employer, self-interest, familiarity, or undue influence *threats* to the *member's* compliance with the "Integrity and Objectivity Rule" [2.100.001] may exist.

**.03** *Threats* to compliance with the "Integrity and Objectivity Rule" [2.100.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*, and the *member* would be presumed to lack integrity in violation of the "Integrity and Objectivity Rule" in the following circumstances:

- a. The *member* offers to, or accepts gifts or entertainment from, a customer or vendor of the *member's* employer that violate applicable laws, rules, or regulations or the policies of the member's employer or the customer or vendor.
- b. The member knows of the violation or demonstrates recklessness in not knowing.

**.04** A *member* should evaluate the significance of any *threats* to determine if they are at an *acceptable level*. *Threats* are at an *acceptable level* when gifts or entertainment are reasonable in the circumstances. The *member* should exercise judgment in determining whether gifts or entertainment would be considered reasonable in the circumstances. The following are examples of relevant facts and circumstances:

- a. The nature of the gift or entertainment
- b. The occasion giving rise to the gift or entertainment
- c. The cost or value of the gift or entertainment
- d. The nature, frequency, and value of other gifts and entertainment offered or accepted
- e. Whether the entertainment was associated with the active conduct of business directly before, during, or after the entertainment
- f. Whether other customers or vendors also participated in the entertainment
- g. The individuals from the customer or vendor and a *member's* employer who participated in the entertainment

**.05** *Threats* to compliance with the "Integrity and Objectivity Rule" [2.100.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* through the application of *safeguards* if a *member* offers to, or accepts gifts or entertainment from, a customer or vendor of the *member's* employer that is not reasonable in the circumstances. The *member* would be considered to lack objectivity in violation of the "Integrity and Objectivity Rule," under these circumstances. [Prior reference: paragraphs .226–.227 of ET section 191]

A nonauthoritative basis-for-conclusions document summarizing considerations that were deemed significant in the development of this interpretation is available at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Gifts\\_Basis\\_Document.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Gifts_Basis_Document.pdf).

## 2.130 Preparing and Reporting Information

### 2.130.010 *Knowing Misrepresentations in the Preparation of Financial Statements or Records*

.01 *Threats* to compliance with the "Integrity and Objectivity Rule" [2.100.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*, and the *member* would be considered to have knowingly misrepresented facts in violation of the "Integrity and Objectivity Rule," if the *member*

- a. makes, or permits or directs another to make, materially false and misleading entries in an entity's *financial statements* or records;
- b. fails to correct an entity's *financial statements* or records that are materially false and misleading when the *member* has the authority to record the entries; or
- c. signs, or permits or directs another to sign, a document containing materially false and misleading information. [Prior reference: paragraph .02 of ET section 102]

### 2.130.020 *Subordination of Judgment*

.01 The "Integrity and Objectivity Rule" [2.100.001] prohibits a *member* from knowingly misrepresenting facts or subordinating his or her judgment when performing *professional services* for an employer or on a volunteer basis. This interpretation addresses differences of opinion between a member and his or her supervisor or any other person within the *member's* organization.

.02 Self-interest, familiarity, and undue influence *threats* to the *member's* compliance with the "Integrity and Objectivity Rule" [2.100.001] may exist when a *member* and his or her supervisor or any other person within the *member's* organization have a difference of opinion relating to the application of accounting principles; auditing standards; or other relevant professional standards, including standards applicable to tax and consulting services or applicable laws or regulations.

.03 A *member* should evaluate the significance of any *threats* to determine if they are at an *acceptable level*. *Threats* are at an *acceptable level* if the *member* concludes that the position taken does not result in a material misrepresentation of fact or a violation of applicable laws or regulations. If *threats* are not at an *acceptable level*, the *member* should apply the *safeguards* in paragraphs .06–.08 to eliminate or reduce the threat(s) to an *acceptable level* so that the *member* does not subordinate his or her judgment.

.04 In evaluating the significance of any identified *threats*, the *member* should determine, after appropriate research or consultation, whether the result of the position taken by the supervisor or other person

- a. fails to comply with professional standards, when applicable;

- b. creates a material misrepresentation of fact; or
- c. may violate applicable laws or regulations.

**.05** If the *member* concludes that *threats* are at an *acceptable level*, the *member* should discuss his or her conclusions with the person taking the position. No further action would be needed under this interpretation.

**.06** If the *member* concludes that the position results in a material misrepresentation of fact or a violation of applicable laws or regulations, then *threats* would not be at an *acceptable level*. In such circumstances, the *member* should discuss his or her concerns with the supervisor.

**.07** If the difference of opinion is not resolved after discussing the concerns with the supervisor, the *member* should discuss his or her concerns with the appropriate higher level(s) of management within the *member's* organization (for example, the supervisor's immediate superior, senior management, and *those charged with governance*).

**.08** If after discussing the concerns with the supervisor and appropriate higher level(s) of management within the *member's* organization, the *member* concludes that appropriate action was not taken, then the *member* should consider, in no specific order, the following *safeguards* to ensure that *threats* to the *member's* compliance with the "Integrity and Objectivity Rule" [2.100.001] are eliminated or reduced to an *acceptable level*:

- a. Determine whether the organization's internal policies and procedures have any additional requirements for reporting differences of opinion.
- b. Determine whether he or she is responsible for communicating to third parties, such as regulatory authorities or the organization's (former organization's) external accountant. In considering such communications, the *member* should be cognizant of his or her obligations under the "Confidential Information Obtained From Employment or Volunteer Activities" interpretation [2.400.070] of the "Acts Discreditable Rule" [2.400.001] and the "Obligation of a Member to His or Her Employer's External Accountant" interpretation [2.130.030] of the "Integrity and Objectivity Rule" [2.100.001].
- c. Consult with his or her legal counsel regarding his or her responsibilities.
- d. Document his or her understanding of the facts, the accounting principles, auditing standards, or other relevant professional standards involved or applicable laws or regulations and the conversations and parties with whom these matters were discussed.

**.09** If the *member* concludes that no *safeguards* can eliminate or reduce the *threats* to an *acceptable level* or if the *member* concludes that appropriate action was not taken, then he or she should consider the continuing relationship with the *member's* organization and take appropriate steps to eliminate his or her exposure to subordination of judgment.

**.10** Nothing in this interpretation precludes a *member* from resigning from the organization at any time. However, resignation may not relieve the

*member* of responsibilities in the situation, including any responsibility to disclose concerns to third parties, such as regulatory authorities or the employer's (former employer's) external accountant.

.11 A *member* should use professional judgment and apply similar *safeguards*, as appropriate, to other situations involving a difference of opinion as described in this interpretation so that the *member* does not subordinate his or her judgment. [Prior reference: paragraph .05 of ET section 102]

### **2.130.030 Obligation of a Member to His or Her Employer's External Accountant**

.01 The "Integrity and Objectivity Rule" [2.100.001] requires a *member* to maintain objectivity and integrity in the performance of a *professional service*. When dealing with an employer's external accountant, a *member* must be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts. This would include, for example, responding to specific inquiries for which the employer's external accountant requests written representation. [Prior reference: paragraph .04 of ET section 102]

## **2.160 Educational Services**

### **2.160.010 Educational Services**

.01 *Members* who perform educational services, such as teaching full or part time at a university, teaching a continuing professional education course, or engaging in research and scholarship, are performing *professional services* and, therefore, are subject to the "Integrity and Objectivity Rule" [2.100.001]. [Prior reference: paragraph .06 of ET section 102]

## **2.300 General Standards**

### **2.300.001 General Standards Rule**

.01 A *member* shall comply with the following standards and with any *interpretations* thereof by bodies designated by *Council*.

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

.02 See appendix A, "*Council* Resolution Designating Bodies to Promulgate Technical Standards." [Prior reference: paragraph .01 of ET section 201]

## Interpretations Under the General Standards Rule

### 2.300.005 Application of the Conceptual Framework for Members in Business and Ethical Conflicts

.01 In the absence of an *interpretation* of the "General Standards Rule" [2.300.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Business" [2.000.010].

.02 A *member* would be considered in violation of the "General Standards Rule" [2.300.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

.03 A *member* should consider the guidance in "Ethical Conflicts" [2.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional and legal standards, or both. [No prior reference: new content]

#### **Effective Date**

.04 Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

### 2.300.010 Competence

.01 Competence, in this context, means that the *member* or *member's* staff possesses the appropriate technical qualifications to perform *professional services* and, as required, supervises and evaluates the quality of work performed. Competence encompasses knowledge of the profession's standards, the techniques and technical subject matter involved, and the ability to exercise sound judgment in applying such knowledge in the performance of *professional services*.

.02 A *member's* agreement to perform *professional services* implies that the *member* has the necessary competence to complete those services according to professional standards and to apply the *member's* knowledge and skill with reasonable care and diligence. However, the *member* does not assume a responsibility for infallibility of knowledge or judgment.

.03 The *member* may have the knowledge required to complete the services in accordance with professional standards prior to performance. A normal part of providing professional services involves performing additional research or consulting with others to gain sufficient competence.

.04 If a *member* is unable to gain sufficient competence, the *member* should suggest the involvement of a competent person to perform the needed *professional service*, either independently or as an associate. [Prior reference: paragraph .02 of ET section 201]

### 2.300.030 Submission of Financial Statements

.01 When a *member* is a stockholder, a *partner*, a director, an officer, or an employee of an entity and, in this capacity, prepares or submits the entity's *financial statements* to third parties, the *member* should clearly communicate,

preferably in writing, the *member's* relationship to the entity and should not imply that the *member* is independent of the entity. In addition, if the communication states affirmatively that the *financial statements* are presented in conformity with the applicable financial reporting framework, the *member* should comply with the "Accounting Principles Rule" [2.320.001].

.02 Refer to the "Use of CPA Credential" interpretation [2.400.100] of the "Acts Discreditable Rule" [2.400.001] for additional guidance. [Prior reference: paragraphs .019–.020 of ET section 291]

## 2.310 Compliance With Standards

### 2.310.001 Compliance With Standards Rule

.01 A *member* who performs auditing, review, compilation, management consulting, tax, or other *professional services* shall comply with standards promulgated by bodies designated by *Council*.

.02 See appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards." [Prior reference: paragraph .01 of ET section 202]

## Interpretations Under the Compliance with Standards Rule

### 2.310.005 Application of the Conceptual Framework for Members in Business and Ethical Conflicts

.01 In the absence of an *interpretation* of the "Compliance With Standards Rule" [2.310.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Business" [2.000.010]

.02 A *member* would be considered in violation of the "Compliance With Standards Rule" [2.310.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

.03 A *member* should consider the guidance in "Ethical Conflicts" [2.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional or legal standards, or both. [No prior reference: new content]

### **Effective Date**

.04 Paragraphs .01 and .02 are effective December 15, 2015, and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

## 2.320 Accounting Principles

### 2.320.001 Accounting Principles Rule

.01 A *member* shall not (1) express an opinion or state affirmatively that the *financial statements* or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such

statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by *Council* to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the *member* can demonstrate that due to unusual circumstances the *financial statements* or data would otherwise have been misleading, the *member* can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

.02 See appendix A, "*Council* Resolution Designating Bodies to Promulgate Technical Standards." [Prior reference: paragraph .01 of ET section 203]

## Interpretations Under the Accounting Principles Rule

### 2.320.005 Application of the Conceptual Framework for Members in Business and Ethical Conflicts

.01 In the absence of an *interpretation* of the "Accounting Principles Rule" [2.320.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Business" [2.000.010].

.02 A *member* would be considered in violation of the "Accounting Principles Rule" [2.320.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

.03 A *member* should consider the guidance in "Ethical Conflicts" [2.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional or legal standards, or both. [No prior reference: new content]

#### **Effective Date**

.04 Paragraphs .01 and .02 are effective December 15, 2015 and early implementation is allowed provided the member has implemented the revised code. Paragraph .03 is effective December 15, 2014.

### 2.320.010 Responsibility for Affirming That Financial Statements Are in Conformity With the Applicable Financial Reporting Framework

.01 A *member* shall not state affirmatively that an entity's *financial statements* or other financial data are presented in conformity with generally accepted accounting principles (GAAP) if such statements or data contain any departure from an accounting principle promulgated by a body designated by *Council* to establish such principles. *Members* who affirm that *financial statements* or other financial data are presented in conformity with GAAP should comply with the "Accounting Principles Rule" [2.320.001]. A *member's* representation in a letter or other communication that an entity's *financial statements* are in conformity with GAAP may be considered an affirmative statement within the meaning of this rule with respect to the *member* who signed the letter or other communication (for example, the *member* signed a report to

a regulatory authority, a creditor, or an auditor). [Prior reference: paragraph .05 ET section 203]

### **2.320.020 Status of Financial Accounting Standards Board, Governmental Accounting Standards Board, Federal Accounting Standards Advisory Board, and International Accounting Standards Board Interpretations**

.01 The "Accounting Principles Rule" [2.320.001] authorizes *Council* to designate bodies to establish accounting principles. *Council* has designated the Financial Accounting Standards Board (FASB) as such a body and has resolved that FASB *Accounting Standards Codification* (ASC) constitutes accounting principles as contemplated in the rule. *Council* designated the Governmental Accounting Standards Board (GASB), with respect to Statements of Governmental Accounting Standards issued in July 1984 and thereafter, as the body to establish financial accounting principles for state and local governmental entities, pursuant to the "Accounting Principles Rule." *Council* designated the Federal Accounting Standards Advisory Board (FASAB), with respect to Statements of Federal Accounting Standards adopted and issued in March 1993 and subsequently, as the body to establish accounting principles for federal government entities, pursuant to the "Accounting Principles Rule." *Council* designated the International Accounting Standards Board (IASB) as an accounting body for purposes of establishing international financial accounting and reporting principles.

.02 Reference to GAAP in the "Accounting Principles Rule" [2.320.001] means those accounting principles promulgated by bodies designated by *Council*, which are listed in paragraph .01 and in appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards."

.03 The Professional Ethics Division will look to the codification or statements and any interpretations thereof issued by FASB, GASB, FASAB, or IASB in determining whether a *member* has departed from an accounting principle established by a designated accounting standard-setter in FASB ASC, a Statement of Governmental Accounting Standards, a Statement of Federal Accounting Standards, or International Financial Reporting Standards (IFRS). [Prior reference: paragraph .03 of ET section 203]

### **2.320.030 Departures From Generally Accepted Accounting Principles**

.01 It is difficult to anticipate all the circumstances in which accounting principles may be applied. However, there is a strong presumption that adherence to GAAP would, in nearly all instances, result in *financial statements* that are not misleading. The "Accounting Principles Rule" [2.320.001] recognizes that, upon occasion, there may be unusual circumstances when the literal application of GAAP would have the effect of rendering *financial statements* misleading. In such cases, the proper accounting treatment to apply is that which will not render the *financial statements* misleading.

.02 The question of what constitutes unusual circumstances, as referred to in the "Accounting Principles Rule" [2.320.001], is a matter of professional judgment involving the ability to support the position that adherence to a promulgated principle within GAAP would be regarded generally by reasonable persons as producing misleading *financial statements*.

.03 Examples of circumstances that may justify a departure from GAAP include new legislation or evolution of a new form of business transaction. Examples of circumstances that would not justify departures from GAAP include an unusual degree of materiality or conflicting industry practices. [Prior reference: paragraph .02 of ET section 203]

.04 If the statements or data contain such departures, see the "Accounting Principles Rule" [2.320.001] for further guidance.

## 2.320.040 Financial Statements Prepared Pursuant to Financial Reporting Frameworks Other Than GAAP

.01 Reference to GAAP in the "Accounting Principles Rule" [2.320.001] means those accounting principles promulgated by bodies designated by *Council*, which are listed in appendix A. The bodies designed by *Council* to promulgate accounting principles are

- a. FASAB,
- b. FASB,
- c. GASB, and
- d. IASB.

.02 *Financial statements* prepared pursuant to other accounting principles would be considered financial reporting frameworks other than GAAP within the context of the "Accounting Principles Rule" [2.320.001].

.03 However, the "Accounting Principles Rule" [2.320.001] does not preclude a *member* from preparing or reporting on *financial statements* that have been prepared pursuant to financial reporting frameworks other than GAAP, such as

- a. financial reporting frameworks generally accepted in another country, including jurisdictional variations of IFRS such that the entity's *financial statements* do not meet the requirements for full compliance with IFRS, as promulgated by the IASB;
- b. financial reporting frameworks prescribed by an agreement or a contract; or
- c. other special purpose frameworks, including statutory financial reporting provisions required by law or a U.S. or foreign governmental regulatory body to whose jurisdiction the entity is subject.

.04 In such circumstances, however, the *financial statements* or *member's* reports thereon should not purport that the *financial statements* are in accordance with GAAP and the *financial statements* or reports on those *financial statements*, or both, should clarify the financial reporting framework(s) used. [Prior reference: paragraph .06 of ET section 203]

## 2.400 Acts Discreditable

### 2.400.001 Acts Discreditable Rule

.01 A *member* shall not commit an act discreditable to the profession. [Prior reference: paragraph .01 of ET section 501]

## Interpretations Under the Acts Discreditable Rule

### 2.400.005 Application of the Conceptual Framework for Members in Business and Ethical Conflicts

.01 In the absence of an *interpretation* of the "Acts Discreditable Rule" [2.400.001] that addresses a particular relationship or circumstance, a *member* should apply the "Conceptual Framework for Members in Business" [2.000.010].

.02 A *member* would be considered in violation of the "Acts Discreditable Rule" [2.400.001] if the *member* cannot demonstrate that *safeguards* were applied that eliminated or reduced significant *threats* to an *acceptable level*.

.03 A *member* should consider the guidance in "Ethical Conflicts" [2.000.020] when addressing ethical conflicts that may arise when the *member* encounters obstacles to follow an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional standards or legal standards, or both. [No prior reference: new content]

#### **Effective Date**

.04 Paragraphs .01 and .02 are effective December 15, 2015 and early implementation is allowed. Paragraph .03 is effective December 15, 2014.

### 2.400.010 Discrimination and Harassment in Employment Practices

.01 A *member* would be presumed to have committed an act discreditable to the profession, in violation of the "Acts Discreditable Rule" [2.400.001] if a final determination, no longer subject to appeal, is made by a court or an administrative agency of competent jurisdiction that a *member* has violated any antidiscrimination laws of the United States, state, or municipality, including those related to sexual and other forms of harassment. [Prior reference: paragraph .03 of ET section 501]

### 2.400.020 Solicitation or Disclosure of CPA Examination Questions and Answers

.01 A *member* who solicits or knowingly discloses the Uniform CPA Examination question(s) or answer(s), or both, without the AICPA's written authorization shall be considered to have committed an act discreditable to the profession, in violation of the "Acts Discreditable Rule" [2.400.001]. [Prior reference: paragraph .07 of ET section 501]

### 2.400.030 Failure to File a Tax Return or Pay a Tax Liability

.01 A *member* who fails to comply with applicable federal, state, or local laws or regulations regarding (a) the timely filing of the *member's* personal tax returns or tax returns for the *member's* employer that the *member* has the authority to timely file or (b) the timely remittance of all payroll and other taxes collected on behalf of others may be considered to have committed an act discreditable to the profession, in violation of the "Acts Discreditable Rule" [2.400.001]. [Prior reference: paragraph .08 of ET section 501]

## 2.400.040 Negligence in the Preparation of Financial Statements or Records

.01 A *member* shall be considered in violation of the "Acts Discreditable Rule" [2.400.001] if the *member*, by virtue of his or her negligence, does any of the following:

- a. Makes, or permits or directs another to make, materially false and misleading entries in the *financial statements* or records of an entity.
- b. Fails to correct an entity's *financial statements* that are materially false and misleading when the *member* has the authority to record an entry.
- c. Signs, or permits or directs another to sign, a document containing materially false and misleading information. [Prior reference: paragraph .05 of ET section 501]

## 2.400.050 Governmental Bodies, Commissions, or Other Regulatory Agencies

.01 Many governmental bodies, commissions, or other regulatory agencies have established requirements, such as standards, guides, rules, and regulations, that *members* are required to follow in the preparation of *financial statements* or related information. For example, the SEC, the Federal Communications Commission, state insurance commissions, and other regulatory agencies have established such requirements.

.02 If a *member* prepares *financial statements* or related information (for example, management's discussion and analysis) for purposes of reporting to such bodies, commissions, or regulatory agencies, the *member* should follow the requirements of such organizations in addition to the applicable financial reporting framework.

.03 A *member's* material departure from such requirements would be considered a violation of the "Acts Discreditable Rule" [2.400.001] unless the *member* discloses in the *financial statements* or related information that such requirements were not followed and the applicable reasons. [Prior reference: paragraph .06 of ET section 501]

## 2.400.060 Indemnification and Limitation of Liability Provisions

.01 Certain governmental bodies, commissions, or other regulatory agencies (collectively, regulators) have established requirements through laws, regulations, or published interpretations that

- a. prohibit entities subject to their regulation (regulated entity) from including certain types of indemnification and limitation of liability provisions in agreements for the performance of audit or other attest services that are required by such regulators; or
- b. provide that the existence of such provisions disqualifies a *member* from rendering such services to these entities.

For example, federal banking regulators, state insurance commissions, and the SEC have established such requirements.

.02 If a *member* enters into, or directs or knowingly permits another individual to enter into, a contract for the performance of audit or other attest services that are subject to the requirements of these regulators, the *member* should not include, or knowingly permit or direct another individual to include,

an indemnification or limitation of liability provision that would cause the regulated entity or a *member* to be in violation of such requirements or disqualify a *member* from providing such services to the regulated entity. A *member* who enters into, or directs or knowingly permits another individual to enter into, such an agreement for the performance of audit or other attest services would be considered in violation of the "Acts Discreditable Rule" [2.400.001]. [Prior reference: paragraph .09 of ET section 501]

## 2.400.070 Confidential Information Obtained From Employment or Volunteer Activities

**.01** A *member* should maintain the confidentiality of his or her employer's confidential information and should not use or disclose any confidential employer information obtained as a result of an employment relationship, such as discussions with the employer's vendors, customers, or lenders (for example, any confidential information pertaining to a current or previous employer, subsidiary, affiliate, or parent thereof, as well as any entities for which the *member* is working in a volunteer capacity).

**.02** For purposes of this interpretation, confidential employer information is any proprietary information pertaining to the employer or any organization for whom the *member* may work in a volunteer capacity that is not known to be available to the public and is obtained as a result of such relationships.

**.03** A *member* should be alert to the possibility of inadvertent disclosure, particularly to a close business associate or *close relative* or *immediate family member*. The *member* should also take reasonable steps to ensure that staff under his or her control or others within the *employing organization* and persons from whom advice and assistance are obtained are aware of the confidential nature of the information.

**.04** When a *member* changes employment, a *member* should not use confidential employer information acquired as a result of a prior employment relationship to his or her personal advantage or the advantage of a third party, such as a current or prospective employer. The requirement to maintain the confidentiality of an employer's confidential information continues even after the end of the relationship between a *member* and the employer. However, the *member* is entitled to use experience and expertise gained through prior employment relationships.

**.05** A *member* would be considered in violation of the "Acts Discreditable Rule" [2.400.001] if the *member* discloses or uses any confidential employer information acquired as a result of employment or volunteer relationships without the proper authority or specific consent of the employer or organization for whom the *member* may work in a volunteer capacity, unless there is a legal or professional responsibility to use or disclose such information.

**.06** The following are examples of situations in which *members* are permitted or may be required to disclose confidential employer information or when such disclosure may be appropriate:

- a. Disclosure is permitted by law and authorized by the employer.
- b. Disclosure is required by law, for example, to
  - i. comply with a validly issued and enforceable subpoena or summons or
  - ii. inform the appropriate public authorities of violations of law that have been discovered.

- c. There is a professional responsibility or right to disclose information, when not prohibited by law, to
  - i. initiate a complaint with, or respond to any inquiry made by, the Professional Ethics Division or trial board of the AICPA or a duly constituted investigative or disciplinary body of a state CPA society, board of accountancy, or other regulatory body;
  - ii. protect the *member's* professional interests in legal proceedings;
  - iii. comply with professional standards and other ethics requirements; or
  - iv. report potential concerns regarding questionable accounting, auditing, or other matters to the employer's confidential complaint hotline or *those charged with governance*.
- d. Disclosure is permitted on behalf of the employer to
  - i. obtain financing with lenders;
  - ii. communicate with vendors, *clients*, and customers; or
  - iii. communicate with the employer's external accountant, attorneys, regulators, and other business professionals.

**.07** In deciding whether to disclose confidential employer information, relevant factors to consider include the following:

- a. Whether all the relevant information is known and substantiated to the extent that it is practicable. When the situation involves unsubstantiated facts, incomplete information, or unsubstantiated conclusions, the member should use professional judgment in determining the type of disclosure to be made, if any.
- b. Whether the parties to whom the communication may be addressed are appropriate recipients.

**.08** A *member* may wish to consult with his or her legal counsel prior to disclosing, or determining whether to disclose, confidential employer information.

**.09** Refer to the "Subordination of Judgment" interpretation [2.130.020] of the "Integrity and Objectivity Rule" [2.100.001] for additional guidance. [Prior reference: paragraph .10 of ET section 501]

## **2.400.090 False, Misleading, or Deceptive Acts in Promoting or Marketing Professional Services**

**.01** A *member* would be in violation of the "Acts Discreditable Rule" [2.400.001] if the *member* promotes or markets the *member's* abilities to provide *professional services* or makes claims about the *member's* experience or qualifications in a manner that is false, misleading, or deceptive.

**.02** Promotional efforts would be false, misleading, or deceptive if they contain any claim or representation that would likely cause a reasonable person to be misled or deceived. This includes any representation about CPA licensure or any other professional certification or accreditation that is not in compliance with the requirements of the relevant licensing authority or designating body. [Prior reference: paragraph .11 of ET section 501]

## 2.400.100 Use of the CPA Credential

.01 A *member* should refer to applicable state accountancy laws and board of accountancy rules and regulations for guidance regarding the use of the CPA credential. A *member* who fails to follow the accountancy laws, rules, and regulations on use of the CPA credential in any of the jurisdictions in which the CPA practices would be considered to have used the CPA credential in a manner that is false, misleading, or deceptive and in violation of the "Acts Discreditable Rule" [2.400.001]. [Prior reference: paragraph .12 of ET section 501].

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## ET Part 3

*Other Members*

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## 3.000 Introduction

.01 Part 3 of the Code of Professional Conduct (the code) applies to *members* who are not in *public practice* and are not *members in business*. Accordingly, when the term *member* is used in part 3 of the code, the requirements apply only to such *members*. [No prior reference: new content]

### **Effective Date**

.02 Effective December 15, 2014.

## 3.000.030 Applicability

.01 Part 3 of the code applies to *members* who are neither *members in public practice* nor *members in business*, for example *members* who are retired or not currently employed. These *members* are subject to the "Acts Discreditable Rule" [3.400.001]. [No prior reference: new content]

### **Effective Date**

.02 Effective December 15, 2014.

## 3.400 Acts Discreditable

### 3.400.001 Acts Discreditable Rule

.01 A *member* shall not commit an act discreditable to the profession. [Prior reference: paragraph .01 of ET section 501]

## Interpretations Under the Acts Discreditable Rule

### 3.400.010 Discrimination and Harassment in Employment Practices

.01 A *member* would be presumed to have committed an act discreditable to the profession, in violation of the "Acts Discreditable Rule" [3.400.001] if a final determination, no longer subject to appeal, is made by a court or an administrative agency of competent jurisdiction that a *member* has violated any antidiscrimination laws of the United States, state, or municipality, including those related to sexual and other forms of harassment. [Prior reference: paragraph .03 of ET section 501]

### 3.400.020 Solicitation or Disclosure of CPA Examination Questions and Answers

.01 A *member* who solicits or knowingly discloses the Uniform CPA Examination question(s) or answer(s), or both, without the AICPA's written authorization shall be considered to have committed an act discreditable to the profession, in violation of the "Acts Discreditable Rule" [3.400.001]. [Prior reference: paragraph .07 of ET section 501]

### 3.400.030 Failure to File a Tax Return or Pay a Tax Liability

.01 A *member* who fails to comply with applicable federal, state, or local laws or regulations regarding (a) the timely filing of the *member's* personal tax returns or (b) the timely remittance of all payroll and other taxes collected on behalf of others may be considered to have committed an act discreditable to

the profession, in violation of the "Acts Discreditable Rule" [3.400.001]. [Prior reference: paragraph .08 of ET section 501]

### **3.400.070 Confidential Information Obtained From Former Employment or Previous Volunteer Activities**

**.01** A *member* should maintain the confidentiality of his or her former employer's confidential information and should not use or disclose any confidential employer information obtained as a result of an employment relationship, such as discussions with the employer's vendors, customers, or lenders (for example, any confidential information pertaining to a previous employer, subsidiary, affiliate, or parent thereof, as well as any entities for which the *member* worked in a volunteer capacity).

**.02** For purposes of this interpretation, confidential employer information is any proprietary information pertaining to the former employer or any organization for whom the *member* may have worked in a volunteer capacity that is not known to be available to the public and is obtained as a result of such relationships.

**.03** A *member* should be alert to the possibility of inadvertent disclosure, particularly to a close business associate or *close relative* or *immediate family member*.

**.04** A *member* should not use confidential employer information acquired as a result of a prior employment relationship to his or her personal advantage or the advantage of a third party, such as a current or prospective employer. The requirement to maintain the confidentiality of an employer's confidential information continues even after the end of the relationship between a *member* and the employer. However, the *member* is entitled to use experience and expertise gained through prior employment relationships.

**.05** A *member* would be considered in violation of the "Acts Discreditable Rule" [3.400.001] if the *member* discloses or uses any confidential employer information acquired as a result of former employment or volunteer relationships without the proper authority or specific consent of the former employer or organization for whom the *member* may work in a volunteer capacity, unless there is a legal or professional responsibility to use or disclose such information.

**.06** The following are examples of situations in which *members* are permitted or may be required to disclose confidential employer information or when such disclosure may be appropriate:

- a. Disclosure is permitted by law and authorized by the former employer.
- b. Disclosure is required by law, for example, to
  - i. comply with a validly issued and enforceable subpoena or summons or
  - ii. inform the appropriate public authorities of violations of law that have been discovered.
- c. There is a professional responsibility or right to disclose information, when not prohibited by law, to
  - i. initiate a complaint with, or respond to any inquiry made by, the Professional Ethics Division or trial board of the AICPA or a duly constituted investigative or disciplinary body of a state CPA society, board of accountancy, or other regulatory body;

- ii. protect the *member's* professional interests in legal proceedings;
  - iii. comply with professional standards and other ethics requirements; or
  - iv. report potential concerns regarding questionable accounting, auditing, or other matters to the former employer's confidential complaint hotline or *those charged with governance*.
- d. Disclosure is permitted on behalf of the former employer to
- i. obtain financing with lenders;
  - ii. communicate with vendors, *clients*, and customers; or
  - iii. communicate with the former employer's external accountant, attorneys, regulators, and other business professionals.

**.07** In deciding whether to disclose confidential employer information, relevant factors to consider include the following:

- a. Whether all the relevant information is known and substantiated to the extent that it is practicable. When the situation involves unsubstantiated facts, incomplete information, or unsubstantiated conclusions, the member should use professional judgment in determining the type of disclosure to be made, if any.
- b. Whether the parties to whom the communication may be addressed are appropriate recipients.

**.08** A *member* may wish to consult with his or her legal counsel prior to disclosing, or determining whether to disclose, confidential employer information. [Prior reference: paragraph .10 of ET section 501]

### **3.400.090 False, Misleading, or Deceptive Acts in Promoting or Marketing Services**

**.01** A *member* would be in violation of the "Acts Discreditable Rule" [3.400.001] if the *member* promotes or markets the *member's* abilities to provide services or makes claims about the *member's* experience or qualifications in a manner that is false, misleading, or deceptive.

**.02** Promotional efforts would be false, misleading, or deceptive if they contain any claim or representation that would likely cause a reasonable person to be misled or deceived. This includes any representation about CPA licensure or any other professional certification or accreditation that is not in compliance with the requirements of the relevant licensing authority or designating body. [No prior reference: new content]

#### ***Effective Date***

**.03** Effective December 15, 2014.

### **3.400.100 Use of the CPA Credential**

**.01** A *member* should refer to applicable state accountancy laws and board of accountancy rules and regulations for guidance regarding the use of the

CPA credential. A *member* who fails to follow the accountancy laws, rules, and regulations on use of the CPA credential in any of the jurisdictions in which the CPA practices would be considered to have used the CPA credential in a manner that is false, misleading, or deceptive and in violation of the "Acts Discreditable Rule" [3.400.001]. [Prior reference: paragraph .12 of ET section 501]

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**ET****APPENDIXES**

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## ET Appendix A

# ***Council Resolution Designating Bodies to Promulgate Technical Standards***

[As amended January 12, 1988; Revised April 1992, October 1999, May 2004, October 2007, May 2008, October 2012 and May 2013.]

## **Federal Accounting Standards Advisory Board**

RESOLVED: That the Federal Accounting Standards Advisory Board, with respect to its statements of federal accounting standards and concepts adopted and issued in March of 1993 and subsequently, in accordance with its rules of procedure, the memorandum of understanding, and public notice designating FASAB's standards and concepts as having substantial authoritative support, be, and hereby is, designated by the Council of the American Institute of Certified Public Accountants as the body to establish financial accounting principles for federal governmental entities pursuant to the "Accounting Principles Rule" (AICPA, *Professional Standards*, ET sec. 1.320.001 and 2.320.001) of the Code.<sup>1</sup>

[Added by *Council* October 1999.]

## **Financial Accounting Standards Board**

WHEREAS: In 1959 the *Council* designated the Accounting Principles Board to establish accounting principles, and

WHEREAS: The *Council* is advised that the Financial Accounting Standards Board (FASB) has become operational, it is

RESOLVED: That as of the date hereof the FASB, in respect of statements of financial accounting standards finally adopted by such board in accordance with its rules of procedure and the bylaws of the Financial Accounting Foundation, be, and hereby is, designated by this *Council* as the body to establish accounting principles pursuant to the "Accounting Principles Rule," (AICPA, *Professional Standards*, ET sec. 1.320.001 and 2.320.001) and standards on disclosure of financial information for such entities outside *financial statements* in published financial reports containing *financial statements* under the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001 and 2.310.001) of the Code of Professional Conduct of the American Institute of Certified Public Accountants provided, however, any accounting research bulletins, or opinions of the accounting principles board issued or approved for exposure by the accounting principles board prior to April 1, 1973, and finally adopted by such board on or before June 30, 1973, shall constitute statements of accounting principles promulgated by a body designated by *Council* as contemplated in the "Accounting Principles Rule" (AICPA, *Professional Standards*, ET sec. 1.320.001 and 2.320.001) of the Code unless and until such time as they are expressly superseded by action of the FASB.<sup>1</sup>

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<sup>1</sup> The changes to this appendix as of December 15, 2014 are administrative changes that were made to conform to the reformatted Code of Professional Conduct.

## Governmental Accounting Standards Board

WHEREAS: The Governmental Accounting Standards Board (GASB) has been established by the board of trustees of the Financial Accounting Foundation (FAF) to issue standards of financial accounting and reporting with respect to activities and transactions of state and local governmental entities, and

WHEREAS: The American Institute of Certified Public Accountants is a signatory to the agreement creating the GASB as an arm of the FAF and has supported the GASB professionally and financially, it is

RESOLVED: That as of the date hereof, the GASB, with respect to statements of governmental accounting standards adopted and issued in July 1984 and subsequently, in accordance with its rules of procedure and the bylaws of the FAF, be, and hereby is, designated by the Council of the American Institute of Certified Public Accountants as the body to establish financial accounting principles for state and local governmental entities, pursuant to the "Accounting Principles Rule" (AICPA, *Professional Standards*, ET sec. 1.320.001 and 2.320.001) of the Code of Professional Conduct, and standards on disclosure of financial information for such entities outside *financial statements* in published financial reports containing *financial statements* under the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001 and 2.310.001) of the Code of Professional Conduct.<sup>1</sup>

## Public Company Accounting Oversight Board

WHEREAS: The Public Company Accounting Oversight Board (PCAOB) has been established pursuant to the Sarbanes-Oxley Act of 2002 (the Act), and

WHEREAS: The PCAOB has authority under the Act to establish or adopt, or both, by PCAOB rule, auditing and related attestation standards, quality control, ethics, *independence* and other standards relating to the preparation and issuance of audit reports for issuers as defined in the Act.

RESOLVED: That the PCAOB be, and hereby is, designated by the Council of the American Institute of Certified Public Accountants as the body to establish standards relating to the preparation and issuance of audit reports for entities within its jurisdiction as defined by the Act pursuant to the "General Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.300.001) and the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001) of the Code of Professional Conduct.<sup>1</sup>

[Added by *Council* May 2004.]

## International Accounting Standards Board

RESOLVED: That the International Accounting Standards Board (IASB) is hereby designated as the body to establish professional standards with respect to international financial accounting and reporting principles pursuant to the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001 and 2.310.001) and the "Accounting Principles Rule" (AICPA, *Professional Standards*, ET sec. 1.320.001 and 2.320.001) of the Code of Professional Conduct; and

BE IT FURTHER RESOLVED: That the *Council* shall reassess, no sooner than three years but no later than five years after the effective date of this

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<sup>1</sup> The changes to this appendix as of December 15, 2014 are administrative changes that were made to conform to the reformatted Code of Professional Conduct.

resolution, whether continued recognition of the IASB as the body designated to establish professional standards with respect to international financial accounting and reporting principles under the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001 and 2.310.001) and the "Accounting Principles Rule" (AICPA, *Professional Standards*, ET sec. 1.320.001 and 2.320.001) of the Code of Professional Conduct is appropriate.<sup>1</sup>

[Added by *Council* May 18, 2008; readopted by Council, May 19, 2013.]

## AICPA COMMITTEES AND BOARDS

WHEREAS: The membership of the *Institute* has adopted the "General Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.300.001 and 2.300.001) of the Code of Professional Conduct, which authorizes the Council to designate bodies to promulgate technical standards with which members must comply, and therefore it is<sup>1</sup>

### Accounting and Review Services Committee

RESOLVED: That the AICPA accounting and review services committee is hereby designated to promulgate standards under the "General Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.300.001) and the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001) of the Code of Professional Conduct with respect to unaudited *financial statements* or other unaudited financial information of an entity that is not required to file *financial statements* with a regulatory agency in connection with the sale or trading of its securities in a public market.<sup>1</sup>

### Auditing Standards Board

RESOLVED: That, with respect to standards relating to the preparation and issuance of audit reports not included within the resolution on the Public Company Accounting Oversight Board, the AICPA auditing standards board is hereby designated as the body authorized under the "General Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.300.001) and the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001) of the Code of Professional Conduct to promulgate auditing, attestation, and quality control standards and procedures.

RESOLVED: That the auditing standards board shall establish under statements on auditing standards, the responsibilities of *members* with respect to standards for disclosure of financial information outside of the *financial statements* in published financial reports containing *financial statements*.<sup>1</sup>

[Revised May 2004.]

### Management Consulting Services Executive Committee

RESOLVED: That the AICPA management consulting services executive committee is hereby designated to promulgate standards under the "General Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.300.001 and 2.300.001) and the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001 and 2.310.001) of the Code of Professional Conduct with respect to the offering of management consulting services, provided, however, that such standards do not deal with the broad question of what, if any, services should be proscribed.

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<sup>1</sup> The changes to this appendix as of December 15, 2014 are administrative changes that were made to conform to the reformatted Code of Professional Conduct.

AND FURTHER RESOLVED: That any *Institute* committee or board now or in the future authorized by the *Council* to issue enforceable standards under the "General Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.300.001 and 2.300.001) and the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001 and 2.310.001) of the Code of Professional Conduct must observe an exposure process seeking comment from other affected committees and boards, as well as the general membership.<sup>1</sup>

[Revised April 1992.]

### **Attestation Standards**

RESOLVED: That the AICPA accounting and review services committee, auditing standards board, and management consulting services executive committee are hereby designated as bodies authorized under the "General Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.300.001) and the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001) of the Code of Professional Conduct to promulgate attestation standards in their respective areas of responsibility.<sup>1</sup>

[Added by *Council*, May 1988; revised April 1992.]

### **Tax Executive Committee**

RESOLVED: That the Tax Executive Committee is hereby designated as the body authorized under the "General Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.300.001 and 2.300.001) and the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001 and 2.310.001) of the Code of Professional Conduct to promulgate professional practice standards with respect to tax services.<sup>1</sup>

[Added by *Council*, October 1999.]

### **Forensic and Valuation Services Executive Committee**

RESOLVED: That the Forensic and Valuation Services Executive Committee is hereby designated as the body to promulgate professional standards with respect to forensic and valuation services under the "General Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.300.001 and 2.300.001) and the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001 and 2.310.001) of the Code of Professional Conduct.<sup>1</sup>

[Added by *Council*, October 2007.]

### **Personal Financial Planning Executive Committee**

RESOLVED: That the Personal Financial Planning Executive Committee is hereby designated as the body to promulgate professional standards with respect to personal financial planning services under the "General Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.300.001 and 2.310.001) and the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001 and 2.310.001) of the Code of Professional Conduct.<sup>1</sup>

[Added by *Council*, October 2012.]

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<sup>1</sup> The changes to this appendix as of December 15, 2014 are administrative changes that were made to conform to the reformatted Code of Professional Conduct.

## ET Appendix B

# Council Resolution Concerning the Form of Organization and Name Rule

[As adopted May 23, 1994; revised May 7, 1997, May 15, 2000, May 22, 2006 August 2011, and October 19, 2014.]

- A. RESOLVED: That with respect to a *member* engaged in *public practice* in a *firm* or organization which performs (1) any audit or other engagement performed in accordance with the Statements on Auditing Standards, (2) any review of a *financial statement* performed in accordance with the Statements on Standards for Accounting and Review Services, (3) any examination of prospective financial information performed in accordance with the Statements on Standards for Attestation Engagements, (4) any engagement to be performed in accordance with the standards of the Public Company Accounting Oversight Board (PCAOB), or (5) any examination, review, or agreed upon procedures engagement to be performed in accordance with the SSAE, other than an examination described in subsection (A) (3), or which holds itself out as a *firm* of certified public accountants or uses the term "certified public accountant(s)" or the designation "CPA" in connection with its name, the characteristics of such a *firm* or organization under the "Form of Organization and Name Rule" (AICPA, *Professional Standards*, ET sec. 1.800.001) of the Code of Professional Conduct are as set forth below:
1. A majority of the ownership of the *member's firm* in terms of financial interests and voting rights must belong to CPAs. Any non-CPA owner would have to be actively engaged as a member of the *firm* or its affiliates. Ownership by investors or commercial enterprises not actively engaged as members of the *firm* or its affiliates is against the public interest and continues to be prohibited.
  2. There must be a CPA who has ultimate responsibility for all the services described in A above, compilation services and other engagements governed by Statements on Auditing Standards or Statements on Standards for Accounting and Review Services, and non-CPA owners could not assume ultimate responsibility for any such services or engagements.
  3. Non-CPA owners would be permitted to use the title "principal," "owner," "officer," "member" or "shareholder" or any other title permitted by state law, but not hold themselves out to be CPAs.
  4. A *member* shall not knowingly permit a person, whom the *member* has the authority or capacity to control, to carry out on his or her behalf, either with or without compensation, acts which, if carried out by the *member*, would place the *member* in violation of the rules. Further, a *member*

may be held responsible for the acts of all persons associated with him or her in the *public practice* whom the *member* has the authority or capacity to control.

5. Owners shall at all times own their equity in their own right and shall be the beneficial owners of the equity capital ascribed to them. Provision would have to be made for the ownership to be transferred, within a reasonable period of time, to the *firm* or to other qualified owners if the owner ceases to be actively engaged in the *firm* or its affiliates.
  6. Non-CPA owners would not be eligible for regular membership in the AICPA, unless they meet the requirements in BL section 2.2.1.
- B. RESOLVED: The characteristics of all other *firms* or organizations are deemed to be whatever is legally permissible under applicable law or regulation, except as otherwise provided in paragraph C below.
- C. RESOLVED: That with respect to a *member* engaged in *public practice* in a *firm* or organization which is not within the description of a *firm* or organization set forth in paragraph A above, but who performs compilations of *financial statements* performed in accordance with the Statements on Standards for Accounting and Review Services, the characteristics of such a *firm* or organization under the "Form of Organization and Name Rule" of the Code are as set forth below.
1. There must be a CPA who has ultimate responsibility for any *financial statement* compilation services provided by the *firm* and by each business unit performing such compilation services and non-CPA owners could not assume ultimate responsibility for any such services.
  2. Any compilation report must be signed individually by a CPA, and may not be signed in the name of the *firm* or organization.
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## ET Appendix C

### *Revision History Table*

Revisions made to the Code of Professional Conduct subsequent to June 1, 2014, appear below in the Revision History Table. In addition to identifying the numeric citation for the change, the effective date is identified and a link to the marked version of the content is provided when available. If the revision changes guidance that is already authoritative, the action taken (see "Action" column) will be identified as "revised." If the revision is new guidance, the action taken will be identified as "added."

The "New and Revised Interpretations and Other Guidance" [0.600.010] section and the "Pending Interpretations and Other Guidance" [0.600.020] section provide a listing of current activity.

<i>Appendix C Revision History</i>			
<b>Citation</b>	<b>Action</b>	<b>Effective Date</b>	<b>Official Release</b>
1.275.025 paragraphs .01–.06	Revised April 2015	April 30, 2015	<a href="http://www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2015/2015AprilOfficialReleases.pdf">www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2015/2015AprilOfficialReleases.pdf</a>
1.224.010 paragraphs .05–.09	Revised April 2015	April 30, 2015	<a href="http://www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2015/2015AprilOfficialReleases.pdf">www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2015/2015AprilOfficialReleases.pdf</a>
0.400.03	Revised April 2015	April 30, 2015	<a href="http://www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2015/2015AprilOfficialReleases.pdf">www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2015/2015AprilOfficialReleases.pdf</a>
1.298.010	Added January 2015	March 31, 2016, early implementation allowed	<a href="http://www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2015/2015MarchOfficialReleases.pdf">www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2015/2015MarchOfficialReleases.pdf</a>
1.298	Added January 2015	March 31, 2016, early implementation allowed	<a href="http://www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2015/2015MarchOfficialReleases.pdf">www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2015/2015MarchOfficialReleases.pdf</a>
0.200.020.06–.07	Revised January 2015	March 31, 2016, early implementation allowed	<a href="http://www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2015/2015MarchOfficialReleases.pdf">www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2015/2015MarchOfficialReleases.pdf</a>
Appendix B	Revised October 2014	October 19, 2014	<a href="http://aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2014/2014October19OfficialRelease.pdf">http://aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2014/2014October19OfficialRelease.pdf</a>

(continued)

<b>Appendix C Revision History</b>			
<b>Citation</b>	<b>Action</b>	<b>Effective Date</b>	<b>Official Release</b>
2.110.010	Revised June 2014	September 30, 2014	<a href="http://aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2014/2014AugustOfficialReleases.pdf">http://aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2014/2014AugustOfficialReleases.pdf</a>
1.110.010	Revised June 2014	September 30, 2014	<a href="http://aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2014/2014AugustOfficialReleases.pdf">http://aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2014/2014AugustOfficialReleases.pdf</a>
0.200.020	Revised June 2014	September 30, 2014	<a href="http://aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2014/2014AugustOfficialReleases.pdf">http://aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2014/2014AugustOfficialReleases.pdf</a>

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## ET Appendix D

### *Mapping Document*

[As of December 31, 2013]

On June 1, 2014, the AICPA issued a codification of the code's principles, rules, *interpretations* and rulings (revised code). To assist users in understanding where the content from the prior code appears in the revised code, this mapping document was created. The first two columns identify the citation and title where the content resided in the prior code and the second two columns identify the citation and title where the content now resides *in the revised code*. The "Prior Code Citations" box *has been left blank where* the content did not exist in the prior code and is new to the revised code. "New Titles" that appear in regular roman text are effective December 15, 2014, in bold italic December 15, 2015, and in italic have components that are effective both December 15, 2014, and December 15, 2015.

<i>Prior Code Citations</i>	<i>Title in Prior Code</i>	<i>New Citation</i>	<i>New Title</i>
		0.100	Overview of the Code of Professional Conduct
Introduction	Composition, Applicability, and Compliance	0.100.010	Principles and Rules of Conduct
Introduction	Other Guidance	0.100.020	Interpretations and Other Guidance
		0.200.010	Structure of the AICPA Code
		0.200.020.01	Application of the AICPA Code
ET section 91	Applicability	0.200.020.02–.05	Application of the AICPA Code
		0.200.030	Citations
		0.200.040	Transition Provisions
		0.200.050	Drafting Conventions
ET section 51	Preamble	0.300.010	Preamble
ET section 52	Article I—Responsibilities	0.300.020	Responsibilities
ET section 53	Article II—The Public Interest	0.300.030	The Public Interest
ET section 54	Article III—Integrity	0.300.040	Integrity
ET section 55	Article IV—Objectivity and Independence	0.300.050	Objectivity and Independence

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<b><i>Prior Code Citations</i></b>	<b><i>Title in Prior Code</i></b>	<b><i>New Citation</i></b>	<b><i>New Title</i></b>
ET section 56	Article V—Due Care	0.300.060	Due Care
ET section 57	Article VI—Scope and Nature of Services	0.300.070	Scope and Nature of Services
ET section 92	Definitions	0.400	Definitions
ET section 100-1	Conceptual Framework for AICPA Independence Standards— Introduction	0.400.01	Acceptable level
		0.400.01	Acceptable level
ET section 101.20	Application of the Independence Rules to Affiliates— Definitions	0.400.02	Affiliate
		0.400.03	Attest Client
ET section 92.01	Attest engagement	0.400.04	Attest Engagement
ET section 92.02	Attest engagement team	0.400.05	Attest Engagement Team
ET section 101.17	Financial Relationships— Definitions	0.400.06	Beneficially Owned
ET section 92.03	Client	0.400.07	Client
ET section 92.04	Close relative	0.400.08	Close Relative
ET section 92.05	Confidential Client Information	0.400.09	Confidential Client Information
Various locations		0.400.10	Control (s) (led)
ET section 92.06	Council	0.400.11	Council
ET section 92.07	Covered Member	0.400.12	Covered Member
ET section 101.17	Financial Relationships— Definitions	0.400.13	Direct financial interest
		0.400.14	Employing organization
ET section 101.17	Financial Relationships— Definitions	0.400.15	Financial interest
ET section 101.20	Application of the Independence Rules to Affiliates— Definitions	0.400.16	Financial statement attest client
ET section 92.10	Financial statements	0.400.17	Financial statements
ET section 92.11	Firm	0.400.18	Firm
ET section 92.13	Immediate family	0.400.19	Immediate family
ET section 100-1 paragraph .09	Conceptual Framework for AICPA Independence Standards— Definitions	0.400.20	Impair(ed)(ing)

<b><i>Prior Code Citations</i></b>	<b><i>Title in Prior Code</i></b>	<b><i>New Citation</i></b>	<b><i>New Title</i></b>
ET section 100-1 paragraphs .06–.08	Conceptual Framework for AICPA Independence Standards—Definitions	0.400.21	Independence
ET section 101.17	Financial Relationships—Definitions	0.400.22	Indirect financial interest
ET section 92.14	Individual in a position to influence the attest engagement	0.400.23	Individual in a position to influence the attest engagement
ET section 92.15	Institute	0.400.24	Institute
ET section 92.16	Interpretation of a rules of conduct	0.400.25	Interpretation
ET section 92.17	Joint closely held investment	0.400.26	Joint Closely-Held Investments
ET section 92.18	Key position	0.400.27	Key position
ET section 92.09	Financial institution	0.400.28	Lending institution
ET section 92.19	Loan	0.400.29	Loan
ET section 92.20	Manager	0.400.30	Manager
ET section 92.21	Member	0.400.31	Member
ET section 92.22	Member in business	0.400.32	Member in business
ET section 92.23	Network	0.400.33	Network
ET section 92.24	Network Firm	0.400.34	Network Firm
ET section 92.25	Normal Lending Procedures, Terms, and Requirements	0.400.35	Normal lending procedures, terms, and requirements
ET section 92.26	Office	0.400.36	Office
ET section 92.27	Partner	0.400.37	Partner
ET section 92.28	Partner Equivalents	0.400.38	Partner Equivalents
ET section 92.29	Period of the professional engagement	0.400.39	Period of the professional engagement
ET section 92.31	Professional services	0.400.40	Professional Services
ET section 100-1 paragraph .20	Conceptual Framework for AICPA Independence Standards—Definitions	0.400.41	Public interest entities
ET section 92.30	Practice of public accounting	0.400.42	Public Practice (also referred to as the practice of public accounting)
ET section 100-1 paragraph .20	Conceptual Framework for AICPA Independence Standards—Definitions	0.400.43	Safeguards

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<i>Prior Code Citations</i>	<i>Title in Prior Code</i>	<i>New Citation</i>	<i>New Title</i>
ET section 101.02	Interpretation of Rule 101— Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated with a Client	0.400.44	Share-based compensation arrangements
ET section 92.32	Significant influence	0.400.45	Significant influence
ET section 101.05	Performance of nonattest services— Management Responsibilities	0.400.46	Source Documents
ET section 191.224–.225	Use of a Third-Party Service Provider to Assist a Member in Providing Professional Services	0.400.47	Third-party service provider
ET section 291.023–.024	Applicability of General and Technical Standards When Using a Third-Party Service Provider	0.400.47	Third-party service provider
ET section 391.001–.002	Use of a Third-Party Service Provider to Provide Professional Services to Clients or Administrative Support Services to the Member	0.400.47	Third-party service provider
ET section 92.33	Those Charged with Governance	0.400.48	Those Charged With Governance
		0.400.49	Threats
		0.500	Nonauthoritative Guidance
		0.600.010	New and Revised Interpretations and Other Guidance
		0.600.020	Pending Interpretations and Other Guidance
		0.700	Deleted Interpretations and Other Guidance
		1.000	Members in Public Practice— Introduction
		1.000.010	<b><i>Conceptual Framework for Members in Public Practice</i></b>

<b><i>Prior Code Citations</i></b>	<b><i>Title in Prior Code</i></b>	<b><i>New Citation</i></b>	<b><i>New Title</i></b>
		1.000.020	Members in Public Practice—Ethical Conflicts
ET section 102.01	Integrity and Objectivity	1.100.001	Integrity and Objectivity Rule
		1.100.005	<i>Integrity and Objectivity Rule—Application of the Conceptual Framework for Members in Public Practice and the Ethical Conflicts</i>
ET section 102.03	Conflicts of Interest	1.110.010	Conflicts of Interest
ET section 191.186–.187	Service on Board of Directors of Federated Fund-Raising Organization	1.110.010.01j	Conflicts of Interest
ET section 191.198–.199	Member Providing Services for Company Executives	1.110.010.01k	Conflicts of Interest
ET section 191.220–.221	Member is Connected With an Entity That has a Loan to or From a Client	1.110.010.01l	Conflicts of Interest
ET section 191.170–.171	Bank Director	1.110.020	Director Positions
ET section 191.226–.227	Acceptance or Offering of Gifts or Entertainment	1.120.010	Offering or Accepting Gifts or Entertainment
ET section 102.02	Knowing misrepresentations in the preparation of financial statements or records	1.130.010	Knowing Misrepresentations in the Preparation of Financial Statements or Records
ET section 102.05	Subordination of judgment by a member	1.130.020	Subordination of Judgment
ET section 102.07	Professional Services involving client advocacy	1.140.010	Client Advocacy
ET section 191.224–.225	Use of a Third-Party Service Provider to Assist a Member in Providing Professional Services	1.150.040	Use of a Third-Party Service Provider
ET section 101.01	Rule 101—Independence	1.200.001	Independence Rule

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<b><i>Prior Code Citations</i></b>	<b><i>Title in Prior Code</i></b>	<b><i>New Citation</i></b>	<b><i>New Title</i></b>
ET section 101.02	Interpretation of Rule 101—Other Considerations	1.200.005.01–.02	Application of the Conceptual Framework for Independence and Ethical Conflicts Interpretation
		1.200.005.03	Application of the Conceptual Framework for Independence and Ethical Conflicts Interpretation
ET section 101.02	Interpretation of Rule 101—Other Considerations	1.210.010.01	Conceptual Framework for Independence
ET section 100-1	Conceptual Framework for AICPA Independence Standards—Introduction	1.210.010.02–.08	Conceptual Framework for Independence
ET section 101.02	Interpretation of Rule 101—Other Considerations	1.210.010.09	Conceptual Framework for Independence
ET section 100-1	Conceptual Framework for AICPA Independence Standards—Introduction	1.210.010.10–.21	Conceptual Framework for Independence
ET section 101.19	Network and network firms	1.220.010.01–.05	Network and Network Firms
ET section 101.19	Network and network firms—Characteristics of a Network	1.220.010.06–.19	Characteristics of a Network
ET section 101.16	The effect of alternative practice structures on the applicability of independence rules	1.220.020	Alternative Practice Structures
ET section 191.142–.143	Use of Nonindependent CPA Firm on an Engagement	1.220.030	Use of a Nonindependent CPA Firm on an Engagement
ET section 101.20	Application of the Independence Rules to Affiliates	1.224.010	Client Affiliates
ET section 101.12	The effect of independence of relationships with entities included in the governmental financial statements	1.224.020	Entities Included in State and Local Government Financial Statements
ET section 191.200–.201	Actions Permitted When Independence is Impaired	1.226.010	Consenting to the Use of a Previously Issued Report

<b><i>Prior Code Citations</i></b>	<b><i>Title in Prior Code</i></b>	<b><i>New Citation</i></b>	<b><i>New Title</i></b>
ET section 191.188–.189	Indemnification Clause in Engagement Letters	1.228.010	Indemnification of a Covered Member
ET section 191.204–.205	Indemnification of a Client	1.228.020	Indemnification of an Attest Client
ET section 191.190–.191	Agreement with Attest Client to Use ADR Techniques	1.228.030.01–.02	Alternative Dispute Resolution
ET section 191.192–.193	Commencement of ADR Proceeding	1.228.030.03	Alternative Dispute Resolution
New		1.230.010.01	Unpaid Fees
ET section 191.103–.104	Unpaid Fees	1.230.010.02–.03	Unpaid Fees
New		1.230.020	Fees and Other Types of Remuneration
ET section 101.02(A)(1)	Interpretation of Rule 101-A1	1.240.010.01–.02	Overview of Financial Interests
ET section 101.17	Financial Relationships—Financial Interests	1.240.010.01–.02	Overview of Financial Interests
ET section 101.02(B)	Interpretation of Rule 101-B	1.240.010.03	Overview of Financial Interests
ET section 101.17	Financial Relationships—Unsolicited Financial Interest	1.240.020	Unsolicited Financial Interests
ET section 101.17	Financial Relationships—Mutual Funds	1.240.030	Mutual Funds
ET section 101.17	Financial Relationships—Retirement, Savings, Compensation, or Similar Plans	1.240.040	Retirement, Savings, Compensation, or Similar Plans
ET section 101.17	Financial Relationships—Partnerships	1.240.050	Partnerships
ET section 101.17	Financial Relationships—Limited Liability Companies	1.240.060	Limited Liability Companies
ET section 101.17	Financial Relationships—Section 529 Plans	1.240.070	Section 529 Plans
ET section 191.021–.022	Member Designated to Serve as Executor or Trustee	1.245.010.01	Trustee or Executor
ET section 101.02(A)(2)	Interpretation of Rule 101-A2	1.245.010.02	Trustee or Executor

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<i>Prior Code Citations</i>	<i>Title in Prior Code</i>	<i>New Citation</i>	<i>New Title</i>
ET section 101.17	Financial Relationships—Trust Investments	1.245.020	Trust Investments
ET section 191.214–.215	Participation in Employee Benefit Plan Sponsored by Client	1.250.010.01	Plan is an Attest Client or is Sponsored by an Attest Client
ET section 101.17	Financial Relationships—Retirement, Savings, Compensation, or Similar Plans	1.250.010.02	Plan is an Attest Client or is Sponsored by an Attest Client
ET section 101.04	Employment or Association with Attest Clients	1.250.020	Former Partners and Professional Employees Participation in a Firm-Sponsored Plan
ET section 191.140–.141	Member's Depository Relationship With Client Financial Institution	1.255.010	Depository Accounts
ET section 191.081–.082	Financial Services Company Client Has Custody of a Member's Assets	1.255.020	Brokerage and Other Accounts
ET section 101.17	Financial Relationships—Insurance Products	1.257.010	Insurance Policies with No Investment Option
ET section 101.17	Financial Relationships—Insurance Products	1.257.020	Insurance Policies with Investment Options
ET section 101.17	Financial Relationships—Insurance Products	1.257.030	Insurer Undergoes Demutualization
ET section 101.02(A)(4)	Interpretation of Rule 101-A4	1.260.010	Loans
ET section 101.07	Loans from financial institution clients and related terminology	1.260.020	Loans and Leases with Lending Institutions
ET section 191.150–.151	Membership in Client Credit Union	1.260.020	Loans and Leases with Lending Institutions
ET section 191.134–.135	Servicing of Loan	1.260.030	Servicing of a Loan
ET section 191.182–.183	Member Leasing Property to or From Client	1.260.040	Leases
ET section 191.220–.221	Member is Connected With an Entity That has a Loan to or From a Client	1.260.050	Association with an Entity that has a Loan To or From an Attest Client

<b><i>Prior Code Citations</i></b>	<b><i>Title in Prior Code</i></b>	<b><i>New Citation</i></b>	<b><i>New Title</i></b>
ET section 101.14	Independence and cooperative arrangements with clients	1.265.010	Cooperative Arrangements with Attest Clients
ET section 101.02(A)(3)	Interpretation of Rule 101-A3	1.265.020.01	Joint Closely-Held Investments
ET section 191.184-.185	Joint Interest in Vacation Home	1.265.020.02	Joint Closely-Held Investments
ET section 101.02	Interpretation of Rule 101— Application of the Independence Rules to a Covered Member's Immediate Family	1.270.010	Immediate Family Members
ET section 101.02	Interpretation of Rule 101—Application of the Independence Rules to a Covered Member's Immediate Family—Permitted Employment	1.270.020.01-.03	Immediate Family Member is Employed by the Attest Client
ET section 101.02	Interpretation of Rule 101—Grandfathered Employment Relationships	1.270.020.04	Immediate Family Member is Employed by the Attest Client
ET section 101.02	Interpretation of Rule 101—Application of the Independence Rules to a Covered Member's Immediate Family— Employee Benefits Plans Other Than Certain Share-Based Arrangements or Nonqualified Deferred Compensation Plans	1.270.030	Immediate Family Member Participation in an Employee Benefit Plan That Is an Attest Client or Is Sponsored by an Attest Client (Other than Certain Share-Based Arrangements or Nonqualified Deferred Compensation Plans)
ET section 101.02	Interpretation of Rule 101— Application of the Independence Rules to a Covered Member's Immediate Family—Employee Benefits Plans Other Than Certain Share-Based Arrangements or Nonqualified Deferred Compensation Plans	1.270.040	Immediate Family Member Participation in an Employee Benefit Plan With Financial Interests in an Attest Client

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<b><i>Prior Code Citations</i></b>	<b><i>Title in Prior Code</i></b>	<b><i>New Citation</i></b>	<b><i>New Title</i></b>
ET section 101.02	Interpretation of Rule 101— Application of the Independence Rules to a Covered Member's Immediate Family— Share-Based Compensation Arrangements Resulting in Beneficial Financial Interests in Attest Clients	1.270.050	Immediate Family Member Participation in Share-Based Compensation Arrangements Resulting in Beneficially Owned Financial Interests in Attest Clients
ET section 101.02	Interpretation of Rule 101— Application of the Independence Rules to a Covered Member's Immediate Family— Share-Based Compensation Arrangements Resulting in Rights to Acquire Shares in an Attest Client	1.270.060	Immediate Family Member Participation in Share-Based Compensation Arrangements Resulting in Rights to Acquire Shares in an Attest Client
ET section 101.02	Interpretation of Rule 101— Application of the Independence Rules to a Covered Member's Immediate Family— Share-Based Compensation Arrangements Based Upon Stock Appreciation	1.270.070	Immediate Family Member Participation in Share-Based Compensation Arrangements Based Upon Stock Appreciation
ET section 101.02	Interpretation of Rule 101— Application of the Independence Rules to a Covered Member's Immediate Family— Nonqualified Deferred Compensation Plans	1.270.080	Immediate Family Member Participation in a Nonqualified Deferred Compensation Plan
ET section 101.02	Interpretation of Rule 101— Application of the Independence Rules to a Close Relatives	1.270.100.01– .03	Close Relatives

<b><i>Prior Code Citations</i></b>	<b><i>Title in Prior Code</i></b>	<b><i>New Citation</i></b>	<b><i>New Title</i></b>
ET section 101.02	Interpretation of Rule 101—Grandfathered Employment Relationships	1.270.100.04	Close Relatives
ET section 101.02(C)	Interpretation of Rule 101-C	1.275.005.01–.02	Simultaneous Employment or Association with an Attest Client
ET section 101.21	Permitted Employment With Client Educational Institution	1.275.005.03	Simultaneous Employment or Association with an Attest Client
ET section 101.06	Honorary directorships and trusteeships of not-for-profit organization	1.275.010	Honorary Director or Trustee of a Not-for-Profit Organization
ET section 191.144–.145	Member on Advisory Board of Client	1.275.015	Member of Advisory Board
ET section 191.039–.040	Member Serving on Governmental Advisory Unit	1.275.020	Member of Governmental Advisory Committee
ET section 191.164–.165	Campaign Treasurer	1.275.025	Campaign Treasurer
ET section 191.027–.028	Member on Board of Federated Fund-Raising Organization	1.275.030	Member of Federated Fund-Raising Organization
ET section 191.128–.129	Member Serves on Board of Organization for Which Client Raises Funds	1.275.035	Member of Organization that Receives Funds From Fund-Raising Organization
ET section 101.02	Interpretation of Rule 101—Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated with a Client	1.277.010	Former Employment or Association with an Attest Client
ET section 101.04	Employment or Association with Attest Clients—Considering Employment or Association with the Client	1.279.010	Considering Employment or Association with an Attest Client

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<i><b>Prior Code Citations</b></i>	<i><b>Title in Prior Code</b></i>	<i><b>New Citation</b></i>	<i><b>New Title</b></i>
ET section 101.04	Employment or Association with Attest Clients	1.279.020	Subsequent Employment or Association with an Attest Client
ET section 191.033–.034	Member of Social Club	1.280.010	Member of a Social Club
ET section 191.003–.004	Association Membership	1.280.020	Member of a Trade Association
ET section 191.061–.062	Performance of Services for CIRAs, Including Cooperatives, Condominium Associations, Planned Unit Developments, Homeowners Associations, and Timeshare Developments	1.280.030	Member of a Common Interest Realty Association
ET section 191.150–.151	Membership in Client Credit Union	1.280.040	Member of a Credit Union
ET section 191.228–.229	Acceptance or Offering of Gifts and Entertainment to or From an Attest Client	1.285.010	Offering or Accepting Gifts or Entertainment
ET section 101.08	The effect of actual or threatened litigation on independence	1.290.010	Actual or Threatened Litigation
ET section 101.05	Performance of nonattest services— Introduction and Engagements Subject to Independence Rules of Certain Regulatory Bodies	1.295.010	Scope and Applicability of Nonattest Services
ET section 101.05	Cumulative Effect Providing Multiple Nonattest Services	1.295.020	Cumulative Effect on Independence When Providing Multiple Nonattest Services
ET section 101.05	Performance of nonattest services— Management Responsibilities	1.295.030	Management Responsibilities
ET section 101.05	Performance of nonattest services— General Requirements	1.295.040	General Requirements for Performing Nonattest Services
ET section 101.05	Performance of nonattest services— General Requirements	1.295.050	Documentation Requirements When Providing Nonattest Services

<b><i>Prior Code Citations</i></b>	<b><i>Title in Prior Code</i></b>	<b><i>New Citation</i></b>	<b><i>New Title</i></b>
ET section 101.05	Performance of nonattest services— Management Responsibilities	1.295.105	Advisory Services
ET section 191.015–.016	Member Providing Advisory Services	1.295.105	Advisory Services
ET section 101.05	Performance of nonattest services— Appraisal, Valuation and Actuarial Services	1.295.110	Appraisal, Valuation, and Actuarial Services
ET section 101.05	Performance of nonattest services— Benefit Plan Administration	1.295.115	Benefit Plan Administration
ET section 101.05	Performance of nonattest services— Bookkeeping	1.295.120	Bookkeeping, Payroll, and Other Disbursements
ET section 101.05	Performance of nonattest services— Nontax Disbursements	1.295.120	Bookkeeping, Payroll, and Other Disbursements
ET section 101.05	Performance of nonattest services— Business Risk Consulting	1.295.125	Business Risk Consulting
ET section 101.05	Performance of nonattest services— Corporate Finance— Consulting or Advisory	1.295.130	Corporate Finance Consulting
ET section 101.05	Performance of nonattest services— Executive or employee search	1.295.135	Executive or Employee Recruiting
ET section 101.05	Performance of nonattest services— Forensic Accounting Services	1.295.140	Forensic Accounting
ET section 101.05	Performance of nonattest services— Information Systems—Design, Installation or integration	1.295.145	Information Systems Design, Implementation, or Integration
ET section 101.05	Performance of nonattest services— Internal Audit Assistance Services	1.295.150	Internal Audit
ET section 101.05	Performance of nonattest services— Investment— Advisory or Management	1.295.155	Investment Advisory or Management

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<b>Prior Code Citations</b>	<b>Title in Prior Code</b>	<b>New Citation</b>	<b>New Title</b>
ET section 101.05	Performance of nonattest services—Tax Compliance Services	1.295.160.01–.05, .07	Tax Services
		1.295.160.06	Tax Services—Power of Attorney
ET section 101.13	Modified Application of Rule 101 for Engagements Performed in Accordance with Statements on Standards for Attestations Engagements	1.297.010	Application of the Independence Rule to Engagements Performed in Accordance with Statements on Standards for Attestation Engagements
ET section 101.13	Modified Application of Rule 101 for Engagements Performed in Accordance with Statements on Standards for Attestations Engagements—AUP Engagements	1.297.020	Agreed-Upon Procedure Engagements Performed in Accordance with SSAEs
ET section 101.13	Modified Application of Rule 101 for Engagements Performed in Accordance with Statements on Standards for Attestations Engagements	1.297.030	Engagements, Other Than AUPs, Performed in Accordance with SSAEs
ET section 201.01	General Standards	1.300.001	General Standards Rule
New		1.300.005	<i>General Standards Rule—Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts</i>
ET section 201.02	Competence	1.300.010	Competence
ET section 291.017–.018	Supervision of Technical Specialist on Management Consulting Services Engagements	1.300.020	Supervision of a Specialist on Consulting Engagements
ET section 291.019–.020	Submission of Financial Statements by a Member in Public Practice	1.300.030	Submission of Financial Statements

<b>Prior Code Citations</b>	<b>Title in Prior Code</b>	<b>New Citation</b>	<b>New Title</b>
ET section 291.015--016	Subcontractor Selection for Management Consulting Service Engagements	1.300.040	Use of a Third-Party Service Provider
ET section 291.023--024	Applicability of General and Technical Standards When Using a Third-Party Service Provider	1.300.040	Use of a Third-Party Service Provider
ET section 202.01	Compliance with Standards	1.310.001	Compliance with Standards Rule
		1.310.005	<i>Compliance with Standards Rule—Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts</i>
ET section 203.01	Accounting Principles	1.320.001	Accounting Principles Rule
		1.320.005	<i>Accounting Principles Rule—Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts</i>
ET section 203.05	Responsibility of employees for the preparation of financial statements in conformity with GAAP	1.320.010	Responsibility for Affirming that Financial Statements Are in Conformity With the Applicable Financial Reporting Framework
ET section 203.03	Status of FASB, GASB and FASAB interpretations	1.320.020	Status of Financial Accounting Standards Board, Governmental Accounting Standards Board, Federal Accounting Standards Advisory Board, and International Accounting Standards Board Interpretations
ET section 203.02	Departures from Generally Accepted Accounting Principles	1.320.030	Departures From Generally Accepted Accounting Principles

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<b>Prior Code Citations</b>	<b>Title in Prior Code</b>	<b>New Citation</b>	<b>New Title</b>
ET section 203.06	Financial Statements Prepared Pursuant to Financial Reporting Frameworks Other than GAAP	1.320.040	Financial Statements Prepared Pursuant to Financial Reporting Frameworks Other than GAAP
ET section 501.01	Acts Discreditable	1.400.001	Acts Discreditable Rule
		1.400.005	<i>Acts Discreditable Rule—Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts</i>
ET section 501.03	Discrimination and Harassment in Employment Practices	1.400.010	Discrimination and Harassment in Employment Practices
ET section 501.07	Solicitation or disclosure of CPA examination questions and answers	1.400.020	Solicitation or Disclosure of CPA Examination Questions and Answers
ET section 501.08	Failure to file tax returns or pay tax liability	1.400.030	Failure to File a Tax Return or Pay a Tax Liability
ET section 501.05	Negligence in the preparation of financial statements or records	1.400.040	Negligence in the Preparation of Financial Statements or Records
ET section 501.06	Failure to follow requirements of governmental bodies, commissions, or other regulatory agencies	1.400.050	Governmental Bodies, Commissions, or Other Regulatory Agencies
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**LITIGATION SERVICES**

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# Bylaws of the American Institute of Certified Public Accountants

As Amended October 28, 1997, unless otherwise indicated

## DEFINITIONS

As used in these bylaws, implementing resolutions of Council thereunder, or the Code of Professional Conduct, masculine terms shall be understood to include the feminine; "state" shall be understood to include the District of Columbia, Puerto Rico, and the territories, or territorial possessions of the United States of America; "firm" shall be understood to mean any organization permitted by law or regulation; "owner" shall be understood to include partners, partner equivalents, shareholders, or other owners of a firm; "official records of the Institute" shall be understood to mean the records of the membership department; and "committee" shall be understood to include any board (except the AICPA Board of Directors), division, task force, or any subdivision thereof.

[As revised May 15, 2000; revised November 6, 2007.]

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# BL Section 100

## 1. NAME AND PURPOSE

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**BL Section 101*****Name and Purpose***

**As amended  
January 12, 1988**

**.01** The name of this organization shall be the American Institute of Certified Public Accountants. In keeping with the Institute's certificate of incorporation, its objectives shall be to unite certified public accountants in the United States; to promote and maintain high professional standards of practice; to assist in the maintenance of standards for entry to the profession; to promote the interests of CPAs; to develop and improve accounting education; and to encourage cordial relations between CPAs and professional accountants in other countries.

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**BL Section 200****2. ADMISSION TO, AND RETENTION OF,  
MEMBERSHIP AND ASSOCIATION**

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## BL Section 210

### *2.1 Members*

**As amended  
January 12, 1988**

**.01** Members of the Institute shall be

**2.1.1** Members of the Institute at the effective date of these bylaws,  
and

**2.1.2** Persons who shall qualify for admission as provided in section 2.2  
of this article and who shall be admitted under procedures adopted by the  
Board of Directors.

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## BL Section 220

# 2.2 Requirements for Admission to Membership

As amended  
January 12, 1988,  
unless otherwise  
indicated

**.01** Persons may qualify for admission as members of the Institute if they satisfy the criteria listed below:

**2.2.1** They are in possession of a valid and unrevoked certified public accountant certificate issued by a legally constituted authority, or at any time possessed the certificate described herein and the certificate was not revoked as a result of a disciplinary action, or meet the education, examination, and experience requirements set out in the Uniform Accountancy Act and who are of good moral character and have never been granted a right to practice,

**2.2.2** They have passed an examination in accounting and other related subjects satisfactory to the Board of Directors, and

**2.2.3** With respect to those persons who are engaged in the practice of public accounting as an owner or as an employee who has been licensed as a CPA for more than two years, either they are practicing in a firm that is enrolled in an Institute-approved practice-monitoring program if the services performed by such a firm are within the scope of the AICPA's practice-monitoring standards and the firm issues reports purporting to be in accordance with AICPA professional standards, or if authorized by Council, are themselves enrolled in such a program.

[As amended October 28, 1997, May 15, 2000, and October 8, 2010.]

(See section 220R.)

**2.2.4** With respect to persons who first become eligible to take the examination required by section 2.2.2 after the year 2012, they shall have obtained 150 semester hours of education at an accredited college or university including a bachelor's degree or its equivalent. After 2012, a person who does not meet the educational requirement set out in this section shall, nonetheless, be eligible for membership upon enactment (regardless of the effective date) of the education requirement set out in this section by the state which grants the certificate required under section 2.2.1.

[As revised May 15, 2000; revised November 6, 2007.]



**BL Section 220R*****Implementing Resolution Under Section 2.2  
Requirements for Admission to Membership***

As amended  
October 24, 1994,  
unless otherwise  
indicated

**Under Sections 2.2.3 and 2.3.4 to Implement the  
Practice-Monitoring Requirement*****Resolved:***

.01 That the Board of Directors is authorized to establish within the Institute a peer review division governed by an executive committee named the "peer review board" having senior status with authority to carry out the activities of the division. The primary activities of the division will be to establish and conduct, in cooperation with state CPA societies, practice-monitoring programs for AICPA and state society members engaged in the practice of public accounting. Such activities shall not conflict with the policies and standards of the AICPA and shall be subject to the oversight of the Board of Directors. The nominees to serve on the peer review board shall be selected by the AICPA nominations committee and elected by Council.

[As revised by Council May 15, 2000.]

***Further Resolved:***

.02 A firm within the description of subparagraph A of Council Resolution Concerning the Form of Organization and Name Rule shall be required to enroll in an Institute-approved practice-monitoring program. An individual engaged in the practice of public accounting in a firm not within the description of Subparagraph A of Council Resolution Concerning the Form of Organization and Name Rule, but who performs compilations of financial statements in accordance with the Statements on Standards for Accounting and Review Services shall be enrolled in an Institute-approved practice-monitoring program. A firm or individual enrolled in a practice-monitoring program established herein shall be deemed to be enrolled in an approved practice-monitoring program under sections 2.2.3 and 2.3.4 of the bylaws. A firm or individual which is dropped for disciplinary reasons from enrollment in a practice-monitoring program established herein is ineligible to enroll in another Institute-approved practice-monitoring program until the cause of the disciplinary action is removed.

[As amended by Council October 28, 1997; revised May 15, 2000; revised November 6, 2007.]

***Further Resolved:***

[.03] [Deleted May 15, 2000.]



**BL Section 230****2.3 Requirements for Retention of Membership**

**As amended  
January 8, 1990,  
unless otherwise  
indicated**

**.01** Members of the Institute shall

**2.3.1** Pay dues as established by Council.

**2.3.2** Conform with these bylaws and the Rules of the Code of Professional Conduct.

**2.3.3** Complete continuing professional education requirements established by Council.

(See section 230R.)

**2.3.4** Engage in the practice of public accounting with a firm that is enrolled in an Institute-approved practice-monitoring program if the services performed by such a firm are within the scope of the AICPA's practice-monitoring standards and the firm issues reports purporting to be in accordance with AICPA professional standards or, if authorized by Council, themselves enroll in such a program.

[As amended October 28, 1997; revised May 15, 2000.]

(See section 220R, as amended October 24, 1994.)

**2.3.5**

[Deleted November 6, 2007.]

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## BL Section 230R

### ***Implementing Resolutions Under Section 2.3 Requirements for Retention of Membership***

As amended  
January 12, 1988,  
unless otherwise indicated

#### **Under Sections 2.2.3 and 2.3.4 to Implement the Practice-Monitoring Requirement**

[.01-.03] [Deleted March 1995. See section 220R.]

#### **Under Section 2.3.3 Continuing Professional Education for Members**

***Resolved:***

.04 That pursuant to section 2.3.3 of the bylaws the continuing professional education requirement for membership in the American Institute of Certified Public Accountants shall be as follows:

From January 1, 2001, forward and for each three-year reporting period thereafter, all AICPA members shall complete 120 hours, or its equivalent, of continuing professional education. Compliance can be achieved either by a formal program of education or by any other means, however measured, that would be reasonably expected to maintain professional competencies in the member's area of practice or employment. Members shall report compliance with such requirement to the AICPA each year and shall keep appropriate records and submit copies of such on request of the Institute.

[As amended by Council September 23, 1989 and May 7, 1997.]

[.05-.06] [Deleted January 1, 2001.]

***Further Resolved:***

.07 That the Board of Directors, or a body designated or appointed by it, shall have the power and authority to

- a. Identify and accept methods of learning to meet and measure this continuing professional education requirement.
- b. Grant exceptions for reasons such as retirement, inactive dues status, health, military service, foreign residency, or any other reason it deems appropriate.

[As amended by Council May 7, 1997.]

#### **Under Section 2.3.5, Definition of "SEC Client"**

[.08] [Deleted November 6, 2007.]



**BL Section 240*****2.4 Certificate of Membership***

**As amended  
January 12, 1988**

**.01** Upon admission each member shall be entitled to a certificate setting forth that the person is a member of the Institute, but no certificate shall be issued until receipt of dues for the current year. Certificates of membership shall be returned upon the demand of the secretary of the Institute in the event of suspension or termination of membership.

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**BL Section 250*****2.5 Right of Members to Describe  
Themselves as Such***

**As amended  
January 12, 1988,  
unless otherwise  
indicated**

**.01** A member of the Institute shall be entitled to use the designation "Member of the American Institute of Certified Public Accountants." A firm shall be entitled to use the designation "Members of the American Institute of Certified Public Accountants" only if all of its CPA owners are members.

[As revised May 15, 2000.]

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**BL Section 260*****2.6 International Associates***

**As amended  
January 12, 1988,  
unless otherwise  
indicated**

**.01** International associates shall include those who were international associates on or before January 12, 1988. Thereafter, citizens of other countries who shall satisfy such requirements as the Council may prescribe may be admitted as international associates. The Council shall adopt rules governing such association and indications thereof.

[As revised May 15, 2000.]

(See section 260R.)

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**BL Section 260R*****Implementing Resolution Under Section 2.6  
International Associates***

**As adopted  
May 7, 1997,  
unless otherwise indicated**

***Resolved:***

**.01** That membership in the nonvoting international associate category created pursuant to bylaw section 2.6 shall be available to any individual who holds a valid non-U.S. accounting credential from a professional organization, governmental entity, or similar accountancy body with which the AICPA Board of Directors has approved a recognition agreement, and who is of good moral character and does not hold a CPA certificate issued by a U.S. jurisdiction and who meets either the CPE requirement for a CPA or its equivalent in the individual's home country or for an AICPA member. If reasonably practicable and appropriate, all member benefits will be made available to international associates, except for voting, eligibility for a seat on Council and as a nonpublic member of the Board of Directors.

[As revised by Council May 24, 2010.]

***Further Resolved:***

**.02** That any individual who was an international associate as of May 25, 2010, shall be eligible to continue as a member of the international associate category.

[As adopted by Council May 24, 2010.]

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**BL Section 300****3. ORGANIZATION AND PROCEDURE**

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## BL Section 310

### 3.1 General

**As amended  
January 12, 1988,  
unless otherwise  
indicated**

**.01** The organization of the Institute shall include the members, the Council, the Board of Directors, officers, and committees.

**.02** The Board of Directors may from time to time organize the committees and staff of the Institute into divisions and, subject to section 3.6, may adopt rules of procedure and operating policies for such divisions.

#### **3.1.1 Communications With Members**

Any communication, notification or other action required by these by-laws to be provided or undertaken by mail or in writing, to or from the members, may be provided or undertaken by any means including but not limited to electronic or telephonic means, as authorized by Council. Except for determining a member's residence for voting purposes under section 3.2.3, a member's mailing address for purposes of these bylaws may be an electronic or other form of address, in lieu of a postal address.

[As adopted May 15, 2000.]

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## BL Section 320

### 3.2 Membership

As amended  
June 17, 1996,  
unless otherwise  
indicated

.01 The rights and powers of the membership of the Institute shall be as defined herein.

#### 3.2.1 Attendance at Meetings

Every member and international associate of the Institute shall be entitled to attend all meetings of the Institute.

#### 3.2.2 Voting Rights

Every member, but no international associate, shall be entitled to vote in person, when in attendance, upon all questions brought before duly called meetings of the Institute, and by mail ballot for the election of Council members pursuant to sections 6.1 through 6.1.6, on proposed amendments to these bylaws or to the Code of Professional Conduct as provided in article 8, and upon proposed resolutions of the membership as provided in section 5.1.4.

#### 3.2.3 Residence for Voting Purposes

The state from which a member may vote shall be that indicated by the member's mailing address as carried in the official records of the Institute, and may be either the state in which the member resides or that in which the member's office is located.

#### 3.2.4 Resolutions of the Membership

As provided in section 5.1.4, the members by mail ballot may enact resolutions of the membership, not inconsistent with these bylaws, which shall be binding upon the membership, the Council, the Board of Directors, officers, committees, and staff.

#### 3.2.5 Certain Positions to Be Held Only by Members

With the exceptions noted below, only members of the Institute, as defined in section 2.1, may serve as members of the Council, the Board of Directors, or any committee or board designated as "senior" by the Council (see section 3.6.1) or as "permanent" by these bylaws (see section 3.6.2). Exceptions to this rule are as follows:

1. Three representatives of the public, none of whom shall be members of the Institute, shall be members of the Board of Directors and Council.
2. Council may authorize the appointment of persons who are not Institute members to any senior or permanent committee or board provided the non-Institute members do not constitute more than twenty-five percent of its membership.

[As revised May 15, 2000.]



## BL Section 320R

# *Implementing Resolution Under Section 3.2 Membership*

As adopted  
May 15, 2000,  
unless otherwise  
indicated

### **Under Section 3.2.5 Certain Positions to Be Held Only by Members**

***Resolved:***

**.01** That pursuant to bylaw section 3.2.5, persons who are not Institute members may be appointed to the following senior or permanent committees or boards:

- Board of Examiners
- Professional Ethics Executive Committee
- Auditing Standards Board
- Financial Reporting Executive Committee
- Center for Audit Quality Governing Board
- Peer Review Board
- Personal Financial Planning Executive Committee
- Information Management and Technology Assurance Executive Committee
- Forensic and Valuation Services Executive Committee
- National Accreditation Commission

[As revised by Council October 21, 2003; revised October 24, 2005; revised May 21, 2006; revised May 24, 2010; revised May 20, 2013.]

***Further Resolved:***

**.02** That except as otherwise provided by Council, and except for committees of the Board of Directors, such as the Committee on Audit, no public member on a senior or permanent committee or board may serve as its chair.

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## BL Section 330

### 3.3 Council

As amended  
January 12, 1988

.01 The governing body of the Institute shall be the Council.

#### **3.3.1 Composition**

The Council shall be composed of

**3.3.1.1** Members of the Institute directly elected by the membership in each state in accordance with sections 6.1.1 through 6.1.6;

**3.3.1.2** Representatives of the recognized state societies of certified public accountants selected in accordance with section 6.2;

**3.3.1.3** Twenty-one members-at-large selected in accordance with section 6.3;

**3.3.1.4** All members of the Board of Directors of the Institute;

**3.3.1.5** All past presidents of the American Institute of Certified Public Accountants who served prior to December 31, 1973, and are members of the Institute;

**3.3.1.6** All past chairmen of the board of the American Institute of Certified Public Accountants who are members of the Institute.

#### **3.3.2 Powers**

The Council may exercise all powers requisite for the purposes of the Institute, not inconsistent with these bylaws or with duly enacted resolutions of the membership, including but not limited to the authority to prescribe the policies and procedures of the Institute and to enact resolutions binding upon the Board of Directors, the officers, committees, and staff.

#### **3.3.3 Reports to Membership**

The actions of the Council shall be reported to the membership at least annually.

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## BL Section 340

### *3.4 Board of Directors*

**As amended  
January 12, 1988**

**.01** Between meetings of the Council, the activities of the Institute shall be directed by the Board of Directors, the composition of which shall be prescribed by the Council.

(See section 340R.)

#### **3.4.1 Powers**

The Board of Directors shall act as the executive committee of Council between meetings of Council, shall control and manage the property, business, and activities of the Institute, and shall take whatever action it deems desirable including the establishment of policies for the conduct of the affairs of the Institute consistent with the provisions of these bylaws, resolutions of the membership, or actions of the Council.

#### **3.4.2 Reports to Council**

The actions of the Board of Directors shall be reported to the Council at least semiannually.

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**BL Section 340R*****Implementing Resolution Under Section 3.4  
Board of Directors***

**As amended  
May 23, 1994**

***Resolved:***

- .01** That the Board of Directors shall be composed of
- (a) The chairman, the vice chairman, and the immediate past chairman of the Board of Directors;
  - (b) The president of the Institute;
  - (c) Sixteen present or former members of the Council elected pursuant to section 6.3 to serve for three years or until the election of their successors; and
  - (d) Three representatives of the public, who are not members of the Institute.
-



**BL Section 350*****3.5 Officers Elected by Council***

**As amended  
June 17, 1996**

.01 The officers of the Institute elected by the Council shall be a chairman of the Board of Directors and a vice chairman of the board, who shall be the chairman of the board nominee, both of whom shall be members possessing valid and unrevoked certified public accountant certificates. The chairman and the vice chairman of the board shall have such terms of office, powers, and privileges as the Council may prescribe.

(See section 350R.)

**3.5.1 Officers Appointed by the Board of Directors**

The officers of the Institute appointed by the Board of Directors shall be a president, who shall be a full-time employee of the Institute and who shall be a member possessing a valid and unrevoked certified public accountant certificate, and a secretary, who shall be a full-time employee of the Institute, but need not be a member of the Institute. The president and the secretary shall have such terms of office, powers, and privileges as the Board of Directors may prescribe. The Board of Directors may also appoint staff vice presidents who shall be neither members of the board nor of the Council and who shall perform such duties as may be assigned to them by the president.

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**BL Section 350R*****Implementing Resolution Under Section  
3.5 Officers Elected by Council***

As amended  
January 14, 1992

***Resolved:*****Term of Office**

.01 That the chairman and the vice chairman of the Board of Directors shall each be elected annually by the Council for a term of one year or until the election of that person's successor. Neither may succeed oneself in the same office after serving a full term of one year. The term of the president and the secretary shall be determined by the Board of Directors.

**Chairman of the Board**

.02 That the chairman of the Board of Directors shall preside at meetings of members of the Institute, the Council, and the Board of Directors. The chairman shall appoint committees and boards as provided in section 3.6 of the bylaws. The chairman shall act as a spokesperson for the Institute and appear on its behalf before other organizations.

**Vice Chairman of the Board**

.03 That the vice chairman shall be chairman-nominee of the Board of Directors and shall preside in the absence of the chairman at meetings of the Institute, the Council, and the Board of Directors. The vice chairman shall familiarize oneself with the duties of the office of chairman and shall perform such other related duties as may be assigned to the vice chairman by the chairman.

**President**

.04 That the president shall have full responsibility for the execution of the policies and programs of the Institute, act as a spokesperson for the Institute, and perform such other services as may be assigned to the president by the Council and the Board of Directors.

**Secretary**

.05 That the secretary of the Institute shall have the usual duties of a corporate secretary and shall perform such other related duties as may be assigned to the secretary by the president. An assistant secretary to serve in the secretary's absence, who need not be a member of the Institute, may be appointed by the Board of Directors.

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## BL Section 360

### 3.6 Committees

**As amended  
June 17, 1996,  
unless otherwise indicated**

**.01** Except as otherwise provided by these bylaws or the Council (see section 3.6.1), the chairman of the Board of Directors, or the chairman's delegate, may appoint committees and boards with such duties, powers, responsibilities, and procedures as the chairman may prescribe. The chairman of the board and the president shall have the privilege of the floor at meetings of all committees.

(See section 360R.)

#### **3.6.1 Senior Committees**

The Council may designate any committee as a "senior" committee. The appointment by the chairman of the Board of Directors of members and any appointed pursuant to bylaw 3.2.5, to senior committees shall require the approval of the Board of Directors. The scope of responsibility of senior committees shall be as the Council may prescribe consistent with the specific provisions of these bylaws. The Board of Directors shall prescribe the duties, powers, and procedures of such committees.

[As revised November 6, 2007.]

(See section 360R.)

#### **3.6.2 Permanent Committees, Boards, and Divisions**

The following shall be permanent committees, boards, or divisions of the Institute: the nominations committee (see section 3.6.2.1); the professional ethics division (see section 3.6.2.2); the trial board (see section 3.6.2.3); and the board of examiners (see section 3.6.2.4).

(See section 360R.)

##### **3.6.2.1 Nominations Committee**

There shall be a nominations committee composed of eleven persons, including any appointed pursuant to bylaw 3.2.5 and members of the Institute, elected by the Council in such manner as the Council shall prescribe. It shall be the responsibility of the committee to make nominations for the offices of chairman of the Board of Directors, vice chairman of the Board of Directors, the elected members of the Board of Directors, the joint trial board, the peer review board, and the Council, as elsewhere provided in these bylaws, and to apportion among the states directly elected Council seats pursuant to section 6.1.2.

(See section 360R.)

##### **3.6.2.2 Professional Ethics Division**

The executive committee of the professional ethics division, including any appointed pursuant to bylaw 3.2.5, shall serve as the ethics committee of the Institute, and there shall be such other committees

within the division as the Board of Directors shall authorize. The executive committee shall (1) subject to amendment, suspension, or revocation by the Board of Directors, adopt rules governing procedures consistent with these bylaws or actions of Council to investigate potential disciplinary matters involving members, (2) arrange for presentation of a case before the trial board where the committee finds prima facie evidence of infraction of these bylaws or of the Code of Professional Conduct, (3) interpret the Code of Professional Conduct, (4) propose amendments thereto, and (5) perform such related services as the Council may prescribe.

(See section 360R.)

### **3.6.2.3 Joint Trial Board**

There shall be a trial board that, in addition to any appointed pursuant to bylaw 3.2.5, shall consist of members possessing a valid and unrevoked certified public accountant certificate, each of whom shall have been a member for at least five consecutive years prior to that person's appointment to the joint trial board, to adjudicate disciplinary charges against members of the Institute pursuant to section 7.4. Members of the trial board shall be elected by the Council for such terms as the Council may prescribe.

The trial board is empowered to adopt rules, consistent with these bylaws or actions of the Council, governing procedure in cases heard by any hearing panel, and in connection with any application for review of a decision of a hearing panel.

Decisions of any hearing panel shall be subject to review only by the trial board.

(See section 360R.)

### **3.6.2.4 Board of Examiners**

There shall be a board of examiners, that, in addition to any appointed pursuant to bylaw 3.2.5, shall consist of persons who have passed the Uniform CPA Examination and who possess valid and unrevoked certified public accountant certificates, appointed by the chairman of the Board of Directors subject to the approval of the Board of Directors. It shall supervise the preparation of a uniform examination which may be adopted by the legally constituted authorities of the states in examining candidates for the certified public accountant certificate and the conduct of the grading service offered by the Institute. The board of examiners shall formulate the necessary rules and regulations for the conduct of its work, but all such rules and regulations may be amended, suspended, or revoked by the Board of Directors. The board of examiners may delegate to members of the Institute's staff or other duly qualified persons the preparation of examination questions and the operation of the grading service conducted by the Institute.

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**BL Section 360R*****Implementing Resolutions Under  
Section 3.6 Committees***

**As amended  
January 12, 1988,  
unless otherwise  
indicated**

***Resolved:***

- .01** (1) That the following be designated as senior committees and boards:\*
- Accounting and review services committee\*
  - Assurance services executive committee\*
  - Auditing standards board\*
  - Board of examiners
  - Center for audit quality governing board\*
  - Employee benefit plans audit quality center executive committee
  - Financial reporting executive committee\*
  - Forensic and valuation services executive committee\*
  - Government audit quality center executive committee
  - Information management and technology assurance executive committee
  - Management consulting services executive committee\*
  - National Accreditation Commission
  - Peer review board\*
  - Personal financial planning executive committee\*
  - Private companies practice executive committee\*
  - Professional ethics executive committee\*
  - Tax executive committee\*

[As amended by Council May 1988 and May 1991; revised April 1992; amended October 1994; revised June 1996; revised May 1997; revised October 21, 2003; revised October 24, 2005; revised October 2007; revised May 24, 2010; revised October 2012.]

**[.02]**

[As amended by Council May 1988 and May 1991; revised April 1992; amended October 24, 1994; revised May 1997; revised October 21, 2003; revised October 24, 2005; deleted October 2007.]

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\* Note: \* Indicates a senior committee which is authorized to make statements, without clearance with the Council or the Board of Directors, in matters related to its area of practice.

## Under Section 3.6.2.1 Nominations Committee

### *Resolved:*

**.03** That the nominations committee shall be chaired by the immediate past chairman of the Board and shall consist of ten additional members serving two-year terms. At the Council meeting held in conjunction with the annual meeting, the Board of Directors, after having considered at least ten candidates, shall recommend five members for election to the nominations committee, each for a two-year term. At any one time, no more than seven members shall be members of Council, and none except the chairman shall be a member of the Board of Directors. Other nominations from the floor shall be permitted. Voting shall be by voice vote of the incoming Council, or, if requested by a majority of those present, by written ballot. A majority vote shall elect. With the exception of its chairman, no member, having served on the nominations committee, shall be eligible again to serve on the nominations committee until the passage of five years.

[As amended by Council May 1991; revised May 15, 2000.]

### *Further Resolved:*

**.04** That the nominations committee shall not select any of its members for positions to be filled by the committee.

## Under Section 3.6.2.2 Professional Ethics Division

### *Resolved:*

**.05** That in cases where the professional ethics executive committee concludes that a prima facie violation of the Code of Professional Conduct or by-laws is not of sufficient gravity to warrant further formal action, the committee may direct the member or members concerned to complete specified continuing professional education courses, or to take other remedial or corrective action, provided, however, that there will be no publication of such action in the Institute's principal membership periodical and the member concerned is notified of the member's right to reject such direction. In the case of such a rejection, the professional ethics executive committee shall determine whether to bring the matter to a hearing panel of the trial board for a hearing.

### *Further Resolved:*

**.06** That in cases where there is prima facie evidence of one or more actions by or with respect to a member as described in subparagraphs 7.4.1 through and including 7.4.6 of bylaw section 7.4, the professional ethics executive committee may decide to offer the member or members concerned the opportunity to avoid further investigation and a possible hearing before the trial board by entering into a settlement agreement under such terms and conditions as the committee deems appropriate including but not limited to agreement by the member or members (a) to resign from membership or (b) to complete specified continuing professional education courses and/or to submit to independent preissuance review of some or all financial statements and accountant's reports and/or submit to an accelerated practice-monitoring review, and/or to perform other remedial or corrective action as the committee may determine and/or (c) to submit to disciplinary action with publication by the Institute as provided in Council resolutions under bylaw section 7.6. The committee shall monitor compliance with the settlement agreement and may initiate an investigation where it finds there has been noncompliance.

[As revised by Council April 28, 2003; revised November 6, 2007.]

.07 A member's rejection of the terms and conditions of a proposed settlement agreement will not in any way affect the rights of a member under the bylaws and implementing resolutions in any subsequent investigation by the professional ethics executive committee in a hearing before the trial board.

[As adopted by Council May 26, 1993.]

### Under Section 3.6.2.3 Joint Trial Board

***Resolved:***

.08 That the joint trial board shall consist of at least thirty-six members elected for a three-year term by Council on a staggered basis on nomination of the nominations committee. No member shall serve more than two full successive terms. The size of the trial board shall be determined by the Board of Directors. No member of the Institute's professional ethics division, of a state society ethics committee, or of a state board of accountancy shall be a member of the trial board.

[As revised by Council June 17, 1996.]

.09 The trial board shall elect from its membership a chairman and a vice chairman, the vice chairman to serve as chairman during any period of unavailability of the chairman. It shall also elect a secretary who need not be a member.

.10 The chairman or vice chairman, when acting as chairman, pursuant to the trial board rules of practice and procedure, may appoint from the members of the trial board a panel consisting of not less than three members, which may, but need not, include the chairman to sit as a hearing panel and hear and adjudicate charges against members, or an ad hoc committee consisting of not less than three members of the trial board to consider requests for nonapplication of sections 7.2 and 7.3. Decisions of hearing panels shall be reviewable by the trial board under the conditions and procedures as provided for in Council resolution under section 7.4 of the bylaws.

[As revised by Council May 15, 2000.]

***Resolved:***

.11 That the trial board is authorized to receive and act on petitions requesting review of a decision of the peer review board terminating a firm's or an individual's enrollment in the practice-monitoring program or of an AICPA peer review committee's decision terminating a firm's or an individual's enrollment in another Institute-approved practice-monitoring program. Following such review, the trial board may affirm, modify, or reverse all or any part of the peer review board's or an AICPA peer review committee's decision, but it may not increase the severity of the peer review board's or an AICPA peer review committee's sanction.

[As revised by Council June 17, 1996; revised October 24, 2005; revised November 6, 2007.]

***Resolved:***

.12 That the trial board is authorized to receive and act on petitions requesting review of a decision by the Center for Audit Quality Governing Board which imposed a sanction upon, or denied a reinstatement request by, a member or associate member of the Center for Audit Quality. Following such review, the trial board may affirm or reverse the Board's decision.

[As adopted by Council October 24, 2005.]

***Resolved:***

**.13** That the trial board may hear and adjudicate charges involving alleged violations of a state CPA society's bylaws or code of professional conduct when there is in force a written agreement for such procedure between the Institute and the state CPA society concerned.

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**BL Section 400****4. FINANCIAL MANAGEMENT AND CONTROLS**

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## BL Section 401

# *Financial Management and Controls*

**As amended  
January 12, 1988**

**.01** The Council shall have authority to prescribe such procedures as it deems appropriate to assure adequate budgetary and financial controls. Budgets shall be prepared and presented as the Council shall prescribe.

(See section 401R.)

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**BL Section 401R*****Implementing Resolution Under Article 4  
Financial Management and Controls***

**As amended  
January 12, 1988,  
unless otherwise  
indicated**

***Resolved:***

**.01** That annual budget of revenues and expenditures for the succeeding fiscal year shall be prepared by the Institute's staff, reviewed and approved by the Board of Directors, and presented to Council for approval; such budgets shall be in a form indicating the costs of the principal programs and activities of the Institute; material variations from the annual budget shall be reported to the Council by the Board of Directors; receipt of such report without rejection shall constitute authority to continue expenditures for purposes indicated in the annual budget, as modified and presented to Council, until a new budget for the following fiscal year is approved by the Council. However, the Board of Directors may, between meetings of Council, authorize additional expenditures in total not to exceed 5 percent of budgeted revenues from all sources.

[As revised by Council May 15, 2000.]

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## BL Section 410

### *4.1 Audit*

**As amended  
January 12, 1988**

**.01** The Council shall, for each fiscal year, appoint a certified public accountant or certified public accountants to express an opinion on the financial statements of the Institute and its affiliated organizations. The financial statements of the Institute and the report of the auditor or auditors for each fiscal year shall be published for the information of the membership.

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**BL Section 420*****4.2 Committee on Audit***

**As amended  
January 12, 1988,  
unless otherwise  
indicated**

**.01** The chairman of the board shall appoint from among the members of the Board of Directors, other than the officers, a committee on audit to make arrangements with the auditor or auditors for their examination, to review the audit report, and to perform such other duties appropriate for such a committee as directed by the Board of Directors.

[As revised May 15, 2000.]

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**BL Section 430*****4.3 Execution of Instruments on Behalf  
of the Institute***

**As amended  
January 12, 1988**

**.01** All checks, drafts, deeds, mortgages, bonds, contracts, reports, proxies, and other instruments may be executed on behalf of the Institute by such officers or employees as the Council or the Board of Directors may from time to time designate, either generally or in specific instances.

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**BL Section 440****4.4 Indemnification**

**As amended  
January 12, 1988**

**.01** The Institute shall indemnify to the full extent authorized by law for the good faith exercise of judgment in the performance of assigned duties any person made or threatened to be made a party to any action, suit, or proceeding, whether criminal, civil, administrative, or investigative, by reason of the fact that the person, the person's testator, or intestate is or was a member of Council, the Board of Directors, or any committee, trustee, officer, employee, or agent of the Institute or any affiliated entity or serves or served any other enterprise as a director, trustee, officer, employee, or agent at the request of the Institute.

**.02** Without limiting the generality of the foregoing, the Institute may contract for insurance against all or a portion of any liabilities and expenses, if any, resulting from the indemnification of any of the foregoing persons pursuant to this section or otherwise as permitted by law, and may also contract for companion insurance directly insuring any or all of such persons against liabilities and expenses.

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## BL Section 450

### *4.5 Dues*

**As amended  
January 14, 1992**

**.01** The Council shall determine the annual dues which shall be paid by each member and international associate in accordance with such classifications as it deems appropriate, and may require dues of a different amount for each class so created.

**.02** Dues shall be payable on or before the first day of each fiscal year of the Institute or in such other manner as the Council shall prescribe. For new members or international associates, dues shall be apportioned to the end of the fiscal year.

**.03** No dues shall be paid by members or international associates of the Institute while they are engaged in military service of the United States or its allies during war. Individual members or international associates may be excused from payment of dues for reasonable cause by the chairman of the Finance Committee.

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## **BL Section 460**

### ***4.6 Fiscal Year***

**As amended  
January 12, 1988**

**.01** The fiscal year of the Institute shall be as the Council shall prescribe.

(See section 460R.)

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**BL Section 460R**

***Implementing Resolution Under Section 4.6  
Fiscal Year***

**As amended  
January 12, 1988**

***Resolved:***

**.01** That the fiscal year of the Institute shall be the twelve months beginning August 1 and ending July 31.

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**BL Section 500****5. MEETINGS OF THE INSTITUTE AND  
THE COUNCIL**

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## BL Section 501

# *Meetings of the Institute and the Council*

As amended  
January 12, 1988

.01 This article shall govern meetings of the Institute and of the Council. The Board of Directors shall determine the dates of meetings of Council and the matters to be presented for action.

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## BL Section 510

### *5.1 Meetings of the Institute*

As amended  
January 12, 1988

.01 The membership shall meet pursuant to sections 5.1.1 through 5.1.3, conduct its business pursuant to section 5.1.3, and may adopt resolutions pursuant to section 5.1.4. Meetings of the membership shall be known as meetings of the Institute.

#### **5.1.1 Regular Meetings of the Institute**

There shall be a regular meeting of the Institute within three months after the close of the fiscal year, on a date to be fixed by the Board of Directors. This meeting shall also be known as the annual meeting of the Institute.

#### **5.1.2 Special Meetings of the Institute**

The chairman of the board shall call special meetings of the Institute when so requested by the Council or the Board of Directors, or upon the written request of at least 5 percent of the membership of the Institute or any thirty members of Council. Special meetings of the Institute shall be held at places designated by the Board of Directors. No business shall be transacted at a special meeting of the Institute other than that for which the meeting shall have been convened.

#### **5.1.3 Notice of Meetings of the Institute**

Notice of each meeting of the Institute, whether regular or special, shall be mailed to each member of the Institute, at the member's mailing address as shown on the official records of the Institute, at least thirty days prior to the date of such meeting.

#### **5.1.4 Resolution of the Membership by Mail Ballot**

A majority of the members of the Institute, assembled at any duly called corporate meeting of the Institute at which a quorum is present, may direct that the chairman of the board submit any question to the entire membership for a vote by mail. Any resolution enacted in such a mail ballot by two-thirds of the members voting shall be declared by the chairman of the board a resolution of the membership and shall be binding, if consistent with these bylaws, upon the Council, the Board of Directors, committees, officers, and staff. Mail ballots shall be valid and counted only if received within sixty days after the date of the mailing of ballot forms.

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## BL Section 520

### *5.2 Meetings of Council*

As amended  
January 12, 1988,  
unless otherwise  
indicated

.01 Meetings of the Council shall be governed by sections 5.2.1 through 5.2.5, section 5.3, and section 6.6.

#### **5.2.1 Regular Meetings of Council**

A regular meeting of the Council shall be held in conjunction with the annual meeting of the Institute and on such other dates as the Council or the Board of Directors may designate.

[As revised May 15, 2000.]

#### **5.2.2 Special Meetings of Council**

The chairman of the board shall call special meetings of the Council when requested to do so by the Board of Directors or when requested in writing by at least thirty members of the Council. Special meetings of the Council shall be held at places designated by the Board of Directors.

#### **5.2.3 Mail Ballot in Lieu of Special Meeting of Council**

In lieu of a special meeting of the Council, the chairman of the board, with the approval of the Board of Directors, may submit any question to the Council for a vote by mail, and any action therein approved in writing by not less than two-thirds of those voting shall be declared by the chairman of the board an act of the Council and shall be recorded in the minutes of the Council provided, however, that at least a majority of the Council must have cast ballots on the question.

[As revised November 6, 2007.]

#### **5.2.4 Notice**

Notice of each meeting of the Council shall be sent to each member of the Council, at the member's mailing address as shown in the official records of the Institute, at least twenty-one days before such meeting. Such notice, as far as practicable, shall contain a statement of the business to be transacted.

#### **5.2.5 Minutes**

A copy of the minutes of each meeting of the Council shall be forwarded to each member of the Council within forty-five days after such meeting.



**BL Section 530****5.3 General Provisions Governing Meetings**

**As amended  
January 12, 1988**

**.01** The following general provisions shall govern quorum and parliamentary procedure.

**5.3.1 Meetings—Quorum**

Five hundred members of the Institute shall constitute a quorum for the transaction of any business duly presented at any meeting of the Institute. Thirty members of Council shall constitute a quorum of the Council at any duly called meeting of the Council. Eleven members of the Board of Directors shall constitute a quorum of the board.

**5.3.2 Meetings—Rules of Parliamentary Procedure Applicable**

The rules of parliamentary procedure contained in *Robert's Rules of Order Revised* shall govern all meetings of the Institute and of the Council.

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**BL Section 600**

**6. ELECTION OF COUNCIL, BOARD OF DIRECTORS, AND OFFICERS OF THE INSTITUTE**

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## **BL Section 601**

# ***Election of Council, Board of Directors, and Officers of the Institute***

**As amended  
January 12, 1988**

**.01** Except for ex officio members of Council (see sections 3.3.1.4 through 3.3.1.6), the election of members of the Council, the Board of Directors, and officers of the Institute shall be in accordance with the provisions of this article.

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## BL Section 610

### ***6.1 Members of Council Directly Elected by Members of the Institute***

As amended  
June 17, 1996,  
unless otherwise  
indicated

**.01** Members of Council directly elected by the membership in the respective states (see section 3.3.1.1) shall be elected in accordance with sections 6.1.1 through 6.1.6 as supplemented by Council resolution.

#### **6.1.1 At Least One Member of Council Directly Elected by Membership of Each State**

There shall be at least one member of Council directly elected by the members of the Institute in each state having one or more persons enrolled upon the membership lists of the Institute.

#### **6.1.2 Number and Allocation of Directly Elected Council Seats Among the States**

The total number of directly elected members of Council, in addition to those provided for by section 6.1.1, shall be eighty-five except as modified by section 6.1.2.1. The number of seats, excluding those extended by section 6.1.2.1, shall be equitably allocated among the states in direct proportion to the number of Institute members enrolled from each state.

##### **6.1.2.1 Unexpired Terms Unaffected by Reduced Allocation**

No member of Council directly elected by the membership in any state shall lose the member's seat for the term the member then serves should the allocation of that state be diminished by virtue of section 6.1.2; but, no state's allocation of directly elected Council seats shall be extended by this section beyond the natural expiration of a seat's full term or its vacation by the member filling it, whichever first occurs.

##### **6.1.2.2 Allocation to Be Made by Nominations Committee**

The nominations committee shall make the allocation provided in section 6.1.2. It shall be made at five-year intervals, at least nine months prior to annual meetings to be held each calendar year which ends in one and in six, and shall govern the five annual elections immediately following. It shall be based upon the membership figures and addresses carried on the books of the Institute the last day of the fiscal year immediately preceding the date of such determination.

If a state gains an additional seat from such allocation, the state society may request the nominations committee to authorize election for an initial term of less than three years in order to promote orderly rotation of Council members from that state. Upon receipt of such request, the nominations committee may authorize such shortened term. Following the expiration of such shortened term, subsequent terms for the seat shall be for three years, as provided in section 6.1.3.

In the event that a state has three or more directly elected members whose terms are not evenly staggered over a three-year cycle, the state society may request the nominations committee, for the election following the year these bylaws are adopted and thereafter in calendar years ending in one and in six, to approve the election of a nominee to fill a vacancy for a term of less than three years in order to effect a more orderly rotation of the Council members from that state. The nominations committee may authorize such shortened term. Subsequent terms for such a seat shall be three years, as provided in section 6.1.3.

### **6.1.3 Term of Office**

Except as specified by this section 6.1.3, the term of office of a directly elected member of the Council shall commence when the member's election is announced by the chairman of the Board of Directors at the meeting of the Council held in conjunction with the annual meeting of the Institute, as prescribed by section 6.6, and shall run until the announcement of the election of new directly elected members of the Council at the meeting of the Council held in conjunction with the annual meeting of the Institute three years after the member's election. If any such member of the Council shall not serve that member's full term, the vacancy so created may be filled pursuant to section 6.5. The term of office of any member directly elected by the members in that member's state to fill such vacancy shall be the remainder of the three-year term with respect to which the vacancy occurred.

No member having served for two consecutive full terms as a directly elected member of the Council shall be eligible to serve another such term until at least one year after the completion of the member's second consecutive full term.

### **6.1.4 Number of Council Seats to Be Filled by Election**

The number of Council seats to be filled in a state's quota of directly elected members of the Council for any given year shall be the number of its allocation of directly elected Council seats less the number of members of the Council from that state filling such seats for terms running through that year.

### **6.1.5 Nominations**

At least eight months prior to the annual meeting of the Institute, the nominations committee shall request, from the recognized society of certified public accountants in each state for which any vacancies (see section 6.1.4) will arise in the coming year, the names of suggested candidates from the state represented by such society to fill each such vacancy. The committee shall give due consideration to the names so submitted, but shall not be required to select its nominees from among such names. In the absence of a satisfactory response from any such state society, the nominations committee shall select the nominees from such state.

The nominations committee shall make its nominations for directly elected members of the Council at least six months prior to the annual meeting of the Institute. Notice of such nominations shall be published to the membership by the secretary at least five months prior to the annual meeting of the Institute. Five percent, but in no event less than twenty members of the Institute from any given state for which a vacancy shall arise, may submit to the secretary independent nominations for directly

elected members of the Council from that state provided that such nominations be filed with the secretary at least four months prior to the annual meeting of the Institute.

[As revised November 6, 2007.]

#### **6.1.6 Election**

The nominees of the nominations committee for directly elected seats on Council shall be declared elected by the secretary if no independent nominations are filed for such seats as required by section 6.1.5.

If independent nominations are received, the secretary shall mail to all members of the Institute in each state in which there is a contest for a directly elected seat on Council, at least ninety days prior to the annual meeting of the Institute, mail ballots containing the names and relevant background information of nominees from that state nominated by the nominations committee and the names and relevant background information of nominees independently nominated. Each ballot shall contain an announcement that votes will be counted only if received by the secretary at least forty-five days before the annual meeting of the Institute. Election to contested seats on Council shall be determined by a plurality of the votes received from each jurisdiction by that date. Mail ballots shall be counted by the secretary, who shall certify the results for publication to the membership. Newly elected members shall be notified promptly and advised to attend the meeting of Council held in conjunction with the annual meeting of the Institute. They shall take office as provided in section 6.6.

[As revised May 15, 2000; revised November 6, 2007]

(See section 610R.)

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## **BL Section 610R**

# ***Implementing Resolution Under Section 6.1 Members of Council Directly Elected by Members of the Institute***

As amended  
January 12, 1988

## **Under Section 6.1.6 Election**

### ***Resolved:***

**.01** That the withdrawal of a nomination for whatever reason after the balloting has commenced will not be acted upon until the certification of election has been completed. Vacancies then arising will be filled in accordance with section 6.5 of the bylaws, except that in states where the number of nominees exceeds the number of vacancies, the vacancy created by any withdrawal will be filled by that nominee having the highest number of votes after all other vacancies have been filled.

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**BL Section 620*****6.2 Selection of Members of Council to Represent State Societies***

**As amended  
June 17, 1996,  
unless otherwise  
indicated**

**.01** Each recognized state society of certified public accountants shall designate, in a manner it deems appropriate, an Institute member to represent it on the Council. The term of each member of the Council so designated shall commence at the meeting of Council held in conjunction with the annual meeting of the Institute after notification to the secretary by the society designating the member. The term shall run for one year or until the commencement of the successor's term, provided that no such member of the Council shall represent a state society for more than six consecutive years.

[As revised May 15, 2000.]

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**BL Section 630****6.3 Election of Members-at-Large of Council,  
Board of Directors, Chairman of the Board,  
and Vice Chairman of the Board**

As amended  
January 14, 1992,  
unless otherwise  
indicated

.01 At the meeting of the Council held in conjunction with the annual meeting of the Institute, following the completion of such other business as the Council may transact, seven Institute members, without regard to the states in which they reside, shall be elected annually by the Council as members-at-large of the Council. This election shall occur prior to the installation of the members of the Council newly elected under section 6.1. The at-large members shall serve for a term of three years or until the election of their successors. At the same meeting, but after all newly elected and designated Council members have been installed, the Council shall elect the chairman of the board, the vice chairman of the board, one-third (or as near to one-third as mathematically possible) of the elected members of the Board of Directors. The elected members of the Board of Directors shall serve for a term of three years or until election of their successors. The Council shall also elect one representative of the public, who is not a member of the Institute, to the Board of Directors for a term of three years, or until election of a successor. Nominations for all these positions on the Board of Directors shall be made by the nominations committee at least six months prior to the annual meeting of the Institute. Notice of those nominations shall be published to the membership of the Institute at least five months prior to such annual meeting. Independent nominations may be made by any twenty members of the Council if filed with the secretary at least four months prior to the annual meeting of the Institute. No nominations from the floor will be recognized. A majority of votes shall elect. Nominees may be invited to the meeting at which the election is to be held, and those elected shall take office as prescribed in section 6.6.

[As amended June 17, 1996; revised May 15, 2000.]

.02 No member having served for two consecutive full terms as a member-at-large of the Council shall be eligible to serve another such term until at least one year after the completion of the member's second consecutive full term.

**6.3.1. Re-election to Board of Directors**

No elected member of the Board of Directors who has served a full three-year term shall be eligible for re-election to such a term until the meeting of the Council one year after the completion of the member's full three-year term, provided, however, that a public member may be elected to serve a second three-year term.



## **BL Section 640**

### ***6.4 Forfeiture of Office for Nonattendance***

**As amended  
January 12, 1988**

**.01** Any directly elected member or member-at-large of Council who shall be absent from three consecutive meetings shall forfeit that member's seat.

[Section renumbered as a result of the deletion of the former sections 640 and 640R on June 17, 1996.]

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## BL Section 650

### 6.5 Vacancies

**As amended  
June 17, 1996**

**.01** Vacancies in the membership of Council, or in the Board of Directors, or in any of the offices of the Institute elected by the Council, occurring between annual meetings of the Institute, may be filled by election of replacements by the Council, either at a meeting of Council or by mail ballot, under such conditions as the Council may prescribe. If the Council should so replace a directly elected member of the Council, such interim appointment will run only until the member's seat is filled by direct election of the membership of that member's state as provided in these bylaws.

**.02** Pending action by the Council to fill a vacancy among any of the officers of the Institute who are elected by the Council, the Board of Directors may appoint a temporary successor to act in the capacity indicated.

(See section 650R.)

[Section renumbered as a result of the deletion of the former sections 640 and 640R on June 17, 1996.]

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**BL Section 650R*****Implementing Resolution Under Section 6.5  
Vacancies***

**As amended  
June 17, 1996**

***Resolved:***

**.01** That if a vacancy occurs in the membership of Council, or in the Board of Directors, or in any of the offices of the Institute elected by the Council between annual meetings of the Institute, the Board of Directors shall recommend replacements for election by Council. Voting on such replacement may be conducted by mail ballot, in which case provision shall be made for write-in votes, or at the next meeting of Council, as may appear most desirable in the circumstances. If the voting takes place at a Council meeting, nominations from the floor shall be permitted; voting may be by voice vote, or, at the request of a majority of those present, by written ballot. A majority vote shall elect. In any event, persons elected to fill vacancies in the Board of Directors, in the Council, or in any of the offices of the Institute elected by the Council shall serve only for the remainder of the unexpired term of the previous incumbent or until a successor is elected.

[Section renumbered as a result of the deletion of the former sections 640 and 640R on June 17, 1996.]

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**BL Section 660*****6.6 Election Meeting of Council***

**As amended  
June 17, 1996,  
unless otherwise  
indicated**

**.01** New members-at-large of Council elected pursuant to section 6.3 shall take office as soon as their election is completed, replacing those members-at-large whose terms shall have expired. Then the presiding officer shall announce the installation of members of the Council newly elected under section 6.1, at which time they shall take office, replacing those directly elected members of Council whose terms shall have expired. Election of officers who are elected by the Council, new members of the Board of Directors, and others shall then be held, and each officer or member of the Board of Directors so elected shall replace that person's predecessor upon such election, provided, however, that the retiring chairman of the board shall continue in office through the end of the annual meeting of the Institute.

[Section renumbered as a result of the deletion of the former sections 640 and 640R on June 17, 1996; as revised May 15, 2000.]

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## BL Section 670

### ***6.7 Term Limit***

**As adopted  
November 6, 2007**

**.01** Regardless of whether a member has served as a designated, directly elected, or at-large member of Council, no Council member who has served in any, or all, of the foregoing categories may serve more than seven consecutive years. A member who has served seven consecutive years shall not be eligible to serve on Council as a designated, directly elected, or at-large member of the Council until at least one year after the seventh consecutive year the member last served on the Council. Notwithstanding anything to the contrary in any section of these bylaws, any period during which an individual served as an ex officio Council member, such as president or a member of the Board of Directors, shall not be included in any determination of eligibility under this section.

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**BL Section 700**

**7. TERMINATION OF MEMBERSHIP AND DISCIPLINARY SANCTIONS**

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**BL Section 701*****Termination of Membership and Disciplinary Sanctions***

**As amended  
January 12, 1988**

**.01** This article shall govern the termination or suspension of membership in the Institute, whether imposed as a matter of discipline or voluntarily sought, and the imposition of any other disciplinary sanction, or administrative reprimand, whether public or private, or imposition of conditions for retention of membership.

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## BL Section 710

### *7.1 Resignation of Membership*

**As amended  
January 12, 1988,  
unless otherwise indicated**

**.01** Resignations of members shall be in writing and may be offered at any time. Actions on such resignations and applications for reinstatement of resigned members shall be taken by the Board of Directors under such provisions as the Council may prescribe. Council may make separate provision for action on resignations of members not in good standing or against whom disciplinary proceedings or investigations are pending or as to whom or to whose firm a practice-monitoring review has begun but has not been completed, and the resignation or resignations would make the firm or member ineligible to enroll in an Institute-approved practice-monitoring program, and on applications for reinstatement of persons whose resignation was accepted when in such classification.

[As revised November 6, 2007]

(See section 710R.)

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**BL Section 710R*****Implementing Resolution Under Section 7.1  
Resignation of Membership***

**As amended,  
January 12, 1988,  
unless otherwise indicated**

***Resolved:***

.01 That the Board of Directors shall act upon resignation of members, which shall become effective on the date of acceptance, but no action shall be taken on the resignation of a member with respect to whom charges are under investigation by the professional ethics division, or against whom a complaint is pending before the trial board, or as to whom or whose firm a practice-monitoring review has begun but has not been completed, and the resignation or resignations would make the firm or member ineligible to enroll in an Institute-approved practice-monitoring program unless the division, the trial board, or the Peer Review Board or peer review committee, as the case may be, recommends that such resignation be accepted. If a person whose resignation was accepted when that person was under investigation or the object of a complaint or during the pendency of a practice-monitoring review when that resignation or resignations would make the firm or member ineligible to enroll in an Institute-approved practice-monitoring program, should subsequently apply for reinstatement, the Board of Directors shall not reinstate such person without the consent of the division or the trial board, or the Peer Review Board or committee as the case may be.

[As revised November 6, 2007.]

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**BL Section 720*****7.2 Termination of Membership for Nonpayment of Financial Obligation or for Failure to Comply With Membership-Retention Requirements***

**As amended  
January 12, 1988,  
unless otherwise  
indicated**

**.01** The Board of Directors may, in its discretion, terminate the membership of a member who fails to pay dues or any other obligation to the Institute within five months after such debt has become due and terminate the membership of a member who fails to comply with the practice-monitoring or continuing education membership-retention requirements. The Council shall provide for consideration and disposition by the trial board, with or without hearing, of a timely written petition that membership should not be terminated pursuant to this section. Any membership so terminated may be reinstated by the Board of Directors, under such conditions and procedures as the Council may prescribe.

(See section 720R.)

**7.2.1 Termination of Association of International Associate**

The Board of Directors may terminate the affiliation of an international associate at its discretion.

[As revised May 15, 2000.]

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**BL Section 720R*****Implementing Resolution Under  
Section 7.2 Termination of Membership  
for Nonpayment of Financial Obligation  
or for Failure to Comply With  
Membership-Retention Requirements***

As amended  
January 12, 1988

***Resolved:***

**.01** That if a person whose membership has terminated for nonpayment of dues or other financial obligation shall apply for reinstatement, the Board of Directors, in its discretion, may reinstate the member, provided that all dues and other obligations owing to the Institute at the time membership was terminated shall have been paid.

***Further Resolved:***

**.02** That if a person whose membership has terminated for failure to comply with membership-retention requirements relating to CPE or practice-monitoring shall apply for reinstatement, the Board of Directors, in its discretion, may reinstate the person as a member provided the person shall have satisfactorily demonstrated that the failure to comply with the CPE or practice-monitoring requirements has been rectified.

***Further Resolved:***

**.03** That no person shall be considered to have resigned in good standing if at the time of resignation the person was in debt to the Institute for dues or other obligations. A member submitting a resignation after the beginning of the fiscal year, but before expiration of the time limit for payment of dues or other obligations, may attain good standing by paying dues prorated according to the portion of the fiscal year which has elapsed, provided obligations other than dues shall have been paid in full.

**.04** A member who has resigned or whose membership has terminated in any manner may not file a new application for admission but may apply for reinstatement under this resolution or applicable provisions of the bylaws.

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**BL Section 730****7.3 Disciplinary Action Without a Hearing**

As amended  
January 12, 1988,  
unless otherwise indicated

.01 Membership in the Institute shall be suspended or terminated without a hearing for disciplinary purposes, or a member may be subjected to other disciplinary actions, as provided in sections 7.3.1 and 7.3.2, under such conditions and by such procedure as shall be prescribed by the Council.

[As revised October 18, 2003.]

(See section 730R.)

**7.3.1 Criminal Conviction of Member**

Membership in the Institute shall be suspended without a hearing should there be filed with the secretary of the Institute a judgment of conviction imposed upon any member for

**7.3.1.1** A crime punishable by imprisonment for more than one year;

**7.3.1.2** The willful failure to file any income tax return which the member, as an individual taxpayer, is required by law to file;

**7.3.1.3** The filing of a false or fraudulent income tax return on the member's or a client's behalf; or

**7.3.1.4** The willful aiding in the preparation and presentation of a false and fraudulent income tax return of a client; and

shall be terminated in like manner upon the similar filing of a final judgment of conviction; however, the Council shall provide for the consideration and disposition by the trial board, with or without hearing, of a timely written petition of any member that the member's membership should not be suspended or terminated pursuant to section 7.3.1.1, herein.

**7.3.2 Other Disciplinary Action**

**7.3.2.1** Membership in the Institute shall be suspended without a hearing should a member's certificate as a certified public accountant or license or permit to practice as such or to practice public accounting be suspended as a disciplinary measure; however, such suspension of membership shall terminate upon reinstatement of the certificate, license or permit. Membership in the Institute shall be terminated without a hearing should such certificate, license, or permit be revoked, withdrawn, surrendered, indefinitely suspended, or cancelled as a disciplinary measure or in connection therewith.

[As revised October 18, 2003.]

**7.3.2.2** The professional ethics executive committee and the Board of Directors may jointly approve certain governmental agencies and other organizations whose disciplinary actions against a member will permit the Institute to take disciplinary action against that member without a hearing. To be eligible for approval, the governmental

agency must be one which has the authority to prohibit a member from either practicing before it or serving as a director, officer or trustee of an entity. To be eligible for approval, an organization other than a governmental agency must be one which has been granted the authority by statute or regulation to regulate accountants. If such approved governmental agency or organization temporarily suspends, prohibits or restricts a member from practicing before it or another governmental agency, or from serving as a director, officer or trustee of any entity, the member's membership in the Institute shall be suspended; however, such suspension of membership shall terminate upon such agency's or organization's termination of the suspension, prohibition or restriction. If such approved governmental agency or organization bars or permanently or indefinitely suspends, prohibits or restricts a member from practicing before it or another governmental agency, or from serving as a director, officer or trustee of any entity, the member's membership in the Institute shall be terminated.

[As adopted October 18, 2003.]

**7.3.2.3** A member who has been subjected to any sanction as a disciplinary measure other than or in addition to those sanctions addressed above, by an authority covered in section 7.3.2.1 or section 7.3.2.2, may also be subjected to discipline by the Institute without a hearing pursuant to guidelines established by the professional ethics executive committee and approved by the Board of Directors.

[As adopted October 18, 2003.]

**7.3.2.4** Council shall permit the trial board, with or without a hearing, to consider a timely written petition by the professional ethics executive committee or the member that the member should not be disciplined pursuant to this section 7.3.2.

[As revised October 18, 2003.]

### **7.3.3 Trial Board Disciplining Not Precluded**

Application of the provisions of section 7.3.1 and section 7.3.2 shall not preclude the summoning of the member concerned to appear before a hearing panel of the trial board pursuant to section 7.4.

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**BL Section 730R****Implementing Resolution Under Section 7.3  
Disciplinary Action Without a Hearing**

As amended  
January 12, 1988,  
unless otherwise  
indicated

***Resolved:***

**.01** (1) That the membership of a member who is convicted by a court of any of the criminal offenses enumerated in section 7.3.1 of the bylaws shall become automatically suspended upon the mailing of a notice of such suspension, as provided in paragraph (6) of this resolution. Such notice shall be mailed within a reasonable time after a certified copy of a judgment of conviction of such criminal offense has been filed with the secretary of the Institute.

[As revised by Council October 18, 2003.]

**.02** (2) That the membership of a member who has been convicted by a court of any of the offenses enumerated in section 7.3.1 of the bylaws, and which conviction has become final, shall become automatically terminated upon the mailing of a notice of such termination, as provided in paragraph (6) of this resolution. Such notice shall be mailed within a reasonable time after a certified copy of such conviction and evidence that it has become final has been filed with the secretary of the Institute.

[As revised by Council October 18, 2003.]

**.03** (3) That the membership of a member (a) whose certificate, license or permit to practice public accounting or as a certified public accountant has been suspended as a disciplinary measure or (b) who is subject to a temporary suspension, prohibition or restriction by an approved governmental agency or organization covered in section 7.3.2 as a disciplinary measure shall, except as provided in paragraph (7) of this resolution, become automatically suspended upon the expiration of thirty days after the mailing of a notice of such suspension, as provided in paragraph (6) of this resolution. Such notice shall be mailed within a reasonable time after a statement by such authority showing the suspension, prohibition or restriction and specifying the cause and duration of such authority's action has been filed with the secretary of the Institute. Such automatic suspension shall cease upon the expiration of the period of suspension, prohibition or restriction so specified.

[As revised by Council October 18, 2003.]

**.04** (4) That the membership of a member (a) whose certificate, license or permit to practice public accounting or as a certified public accountant has been revoked, withdrawn, indefinitely suspended, surrendered or cancelled as a disciplinary measure, or (b) who has been subjected to a bar, to a permanent or indefinite suspension, prohibition or restriction by an approved governmental agency or organization covered in section 7.3.2 shall, except as provided in paragraph (7) of this resolution, become automatically terminated upon the expiration of thirty days after the mailing of a notice of such termination, as provided in paragraph (6) of this resolution. Such notice shall be mailed within

a reasonable time after a statement by such authority showing the revocation, withdrawal, surrender, cancellation, bar, permanent or indefinite suspension, prohibition or restriction and specifying the cause of such authority's action, has been filed with the secretary of the Institute.

[As revised by Council October 18, 2003.]

**.05** (5) That, if a member has been subjected to any sanction as a disciplinary measure, other than or in addition to those set out in paragraph (1), (2), (3) or (4), the member shall, except as provided in paragraph (7), have their membership suspended or terminated or be otherwise disciplined upon the expiration of thirty days after the mailing of a notice of such disciplinary action taken pursuant to guidelines developed by the professional ethics executive committee and approved by the Board of Directors, under section 7.3.2.

[As adopted by Council October 18, 2003.]

**.06** (6) That notices of disciplinary action pursuant to paragraph (1), (2), (3), (4) or (5) of this resolution shall be signed by the secretary of the Institute and mailed by registered or certified mail, postage prepaid, addressed to the member concerned at the member's last known address according to the official records of the Institute, which are the records of the membership department.

[As revised by Council June 17, 1996; revised October 18, 2003.]

**.07** (7) That the operation of paragraph (1), (2), (3), (4) or (5) of this resolution shall become postponed if, before the expiration of thirty days after mailing the notice of disciplinary action, the secretary of the Institute receives a written petition from either the member concerned or the professional ethics executive committee that the pertinent provision not become operative. The petition shall state briefly the facts and reasons relied upon. All such petitions shall be referred to the trial board for action thereon by a panel of the trial board consisting of at least three members appointed by the chairman of the trial board or vice chairman, when acting as chairman. If the petition is denied, the disciplinary action shall become effective upon such denial, and the party that made the petition shall be so notified in writing by the secretary of the Institute. No appeal shall be allowable with respect to a denial of such a petition. If the petition is granted, the disciplinary action shall not become effective. In such event, the secretary shall transmit the matter to the professional ethics division to take whatever action it considers proper in the circumstances. A determination that paragraph (1), (2), (3), (4) or (5) of this resolution shall not become operative shall be made only when it clearly appears that, because of exceptional or unusual circumstances, it would be inequitable to permit such automatic disciplinary action.

[As revised by Council May 15, 2000; revised October 18, 2003.]

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**BL Section 740****7.4 Disciplining of Member by Trial Board**

**As amended  
January 12, 1988,  
unless otherwise  
indicated**

**.01** Under such conditions and by such procedure as the Council may prescribe, a hearing panel of the trial board, by a two-thirds vote of the members present and voting, may expel a member (except as otherwise provided in section 7.4.3), or by a majority vote of the members present and voting, may suspend a member for a period not to exceed two years not counting any suspension imposed under sections 7.3.1 and 7.3.2, or may impose such lesser sanctions as the Council may prescribe on any member if the member

**7.4.1** Infringes any of these bylaws or any rule of the Code of Professional Conduct;

**7.4.2** Is declared by a court of competent jurisdiction to have committed any fraud;

**7.4.3** Is held by a hearing panel of the trial board to have been guilty of an act discreditable to the profession, or to have been convicted of a criminal offense which tends to discredit the profession; provided that should a hearing panel of the trial board find by a majority vote that the member has been convicted by a criminal court of an offense involving moral turpitude, or any of the offenses enumerated in section 7.3.1, the penalty shall be expulsion;

**7.4.4** Is declared by any competent court to be insane or otherwise incompetent;

**7.4.5** Is subject to a disciplinary action by an authority covered in section 7.3.2 that could result in automatic discipline under section 7.3.2; or

[As revised October 18, 2003.]

**7.4.6** Fails to cooperate with the professional ethics division in any disciplinary investigation of the member, owner or employee of the firm by not making a substantive response to interrogatories or a request for documents from a committee of the professional ethics division or by not complying with the educational and remedial or corrective action determined to be necessary by the professional ethics executive committee, within thirty days after the posting of notice of such interrogatories, or a request for documents, or directive to take CPE or corrective action by registered or certified mail, postage prepaid, to the member at the member's last known address shown in the official records of the Institute.

[As revised May 15, 2000.]

**.02** With respect to a member residing in a state in which the state society has entered into an agreement approved by the Institute's Board of Directors

**2734**      **Termination of Membership and Disciplinary Sanctions**

to deal with complaints against society members in cooperation with the professional ethics division, disciplinary hearings shall be conducted before a hearing panel of the joint trial board.

(See section 740R.)

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**BL Section 740R*****Implementing Resolution Under Section 7.4  
Disciplining of Member by Trial Board***

**As amended  
January 12, 1988,  
unless otherwise  
indicated**

***Resolved:***

**.01** (1) Any complaint preferred against a member under section 7.4 of the bylaws shall be submitted to the professional ethics division, which in turn may refer the complaint for investigation and recommendation to an ethics committee (or its equivalent) of a state society of certified public accountants that has made an agreement with the Institute of the type authorized in section 7.4 of the bylaws. If, upon consideration of the complaint, investigation and/or recommendation thereon, it appears that a prima facie case is established showing a violation of any applicable bylaws or any rule of the Code of Professional Conduct of the Institute or any state society making an agreement with the Institute referred to above or showing any conduct discreditable to a certified public accountant, the professional ethics division or the ethics committee of such state society, except as provided in the implementing resolution under section 3.6.2.2 of the bylaws, shall report the matter to the secretary of the joint trial board who shall summon the member involved to respond to the charges preferred against the member, which response may include the entering of a plea of guilty without a hearing, in accordance with rules established by the trial board, provided, however, that with respect to a case in which the trial board has granted a petition that automatic discipline shall not become operative under the provisions of paragraph (7) in the implementing resolution under section 7.3.2 of the bylaws, the division or such state society ethics committee shall have discretion as to whether and when to report the matter to the secretary for such summoning.

[As revised by Council October 18, 2003.]

**.02** (2)

- (a) If the professional ethics division or state society ethics committee dismisses any complaint preferred against a member or shall fail to initiate its inquiry within ninety days after such complaint is presented to it in writing, the member preferring the complaint may present the complaint in writing to the trial board, provided, however, that this provision shall not apply to a case falling within the scope of section 7.3.
- (b) The chairman of the trial board shall cause such investigation to be made of the matter as the chairman may deem necessary, and shall either dismiss the complaint or refer it to the secretary of the trial board who shall summon the member to answer the complaint in accordance with the provisions in paragraph (1) hereof.
- (c) Prior to causing the investigation referred to in paragraph (b), the chairman of the trial board shall designate six members of the trial

board who shall not be involved in such investigation in order that not less than three of them may be appointed to an independent hearing panel if necessary. The chairman shall report the names of such members to the secretary of the trial board prior to any action under paragraph (b).

[As revised by Council May 15, 2000.]

**.03** (3) For the purpose of adjudicating charges against members of the Institute, as provided in the foregoing paragraphs of this resolution, the following must take place:

- (a) The secretary shall mail to the member concerned, at least thirty days prior to the proposed meeting of a panel appointed to hear the case, written notice of the charges to be adjudicated. Such notice, when mailed by registered or certified mail, postage prepaid, addressed to the member concerned at the member's last known address according to the official records of the Institute, which are the records of the membership department, shall be deemed properly served.
- (b) After considering the evidence presented by the professional ethics division or other complainant and by the defense, the panel hearing the case, a quorum present, by vote of the members present and voting, may, in a manner consistent with section 7.4 of the bylaws, admonish, suspend for a period of not more than two years, or expel the member against whom the complaint is made and take such other disciplinary, remedial or corrective action as the panel deems appropriate.
- (c) In a case decided by a panel, the member concerned may request a review by the trial board of the decision of the panel, provided such a request for review is filed with the secretary of the trial board within thirty days after the decision of the panel, and that such information as may be required by the rules of the trial board shall be filed with such request. Such a review shall not be a matter of right. Each such request for a review shall be considered by an ad hoc committee to be appointed by the chairman of the trial board, or its vice chairman in the event of the chairman's unavailability, and to consist of not less than three members of the trial board who did not participate in the prior proceedings in the case. The ad hoc committee shall have power to decide whether such request for review by the trial board shall be granted, and such committee's decision that such request shall not be granted shall be final and subject to no further review. A quorum of such ad hoc committee shall consist of a majority of the appointed. If such request for review is granted, the trial board shall review the decision of the panel in accordance with its rules of practice and procedure. On review of such decision, the trial board may affirm, modify, or reverse all or any part of such decision or make such other disposition of the case as it deems appropriate. The trial board may, by general rule, indicate the character of reasons that may be considered to be of sufficient importance to warrant an ad hoc committee granting a request for review of a decision of a panel.

[As revised by Council May 15, 2000.]

- (d) Any decision of the trial board, including any decision reviewing a decision of a panel, shall become effective when made, unless the trial board's decision indicates otherwise, in which latter event it shall become effective at the time determined by the trial board. Any decision of a panel shall become effective as follows:
- (i) Upon the expiration of thirty days after it is made, if no request for review is properly filed within such thirty-day period.
  - (ii) Upon the denial of a request for review, if such request has been properly filed within such thirty-day period and is denied by an ad hoc committee.
  - (iii) Upon the date of a decision of a review panel affirming the decision of a hearing panel in cases where a review has been granted by an ad hoc committee.
- (e) A plea of guilty, if it conforms to the rules and procedures of the trial board, shall become effective upon acceptance by the trial board.

[As revised by Council June 17, 1996.]

**.04** (4) In the case of a settlement agreement between a member and the professional ethics executive committee that provides for disciplinary action pursuant to the Council resolution implementing bylaw section 3.6.2.2, the matter shall be referred to a panel of the trial board which, upon finding that there has been a waiver of the member's rights under Article 7.4, shall recognize such settlement agreement and arrange for publication of such disciplinary action under section 7.6 of the bylaws.

[As revised by Council May 26, 1993; revised April 28, 2003.]

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## **BL Section 750**

### ***7.5 Reinstatement***

**As amended  
January 12, 1988**

**.01** The Council may prescribe the conditions and procedures under which members suspended or terminated under sections 7.3 and 7.4 may be reinstated.

(See section 750R.)

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**BL Section 750R*****Implementing Resolution Under  
Section 7.5 Reinstatement***

**As amended  
January 12, 1988,  
unless otherwise  
indicated**

***Resolved:***

**.01** (1) That at any time after the publication by the Institute of a statement of a case and decision, including cases in which a guilty plea was entered without a hearing, on application of the member concerned to the secretary of the trial board, the appropriate panel of the trial board that last heard the case and whose decision provided the basis for the publication or, where the original panel cannot be reappointed, or in the case of a guilty plea, a newly formed panel, may, by a two-thirds vote of the members present and voting, rescind or modify such decision. Any such action shall be published by the Institute. The denial of an application under this section shall not be published and shall not prevent the member concerned from applying for reinstatement under section (2) hereof.

[As revised by Council May 26, 1993; revised May 15, 2000.]

**.02** (2) That

- (a) Should an order, judgment of conviction, decision or action on which the suspension or termination of membership was based under section 7.3 of the bylaws be reversed or otherwise set aside or invalidated, such suspension shall terminate or such member shall become reinstated when a certified copy of the order reversing or otherwise setting aside or invalidating such order, conviction, decision or action is filed with the secretary of the joint trial board, who shall refer the matter to the professional ethics division for whatever action it deems appropriate.

[As revised by Council October 18, 2003.]

- (b) A member who has been suspended or expelled by the trial board pursuant to section 7.4 of the bylaws may request that the suspension terminate or may request reinstatement if an order, judgment of conviction, decision or action on which the suspension or termination was based has been reversed or otherwise set aside or invalidated. Such request shall be referred to the trial board whereupon a hearing panel composed of five members designated by the chairman of the trial board may, after investigating all related circumstances, terminate the suspension or reinstate the member concerned by a majority vote of the members present and entitled to vote.

[As revised by Council October 18, 2003.]

- (c) Except as provided in subparagraphs (a) and (b) of this paragraph (2), a member whose membership has been automatically terminated

**Termination of Membership and Disciplinary Sanctions**

under section 7.3, or who has been expelled by or had the member's resignation accepted by a panel of the trial board may, at any time after three years from the effective date of such termination, expulsion, or acceptance of resignation, request reinstatement of their membership. Such request shall be referred to the trial board, whereupon the chairman shall designate five members of the board to a hearing panel which may, after investigation, reinstate such member on such terms and conditions as it shall determine to be appropriate. If an application for reinstatement under this subparagraph is denied, the member concerned may again apply for reinstatement at any time after two years from the date of such denial.

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**BL Section 760*****7.6 Publication of Disciplinary Action***

**As amended  
January 12, 1988,  
unless otherwise  
indicated**

**.01** Notice of disciplinary action pursuant to section 7.3 or 7.4 or of termination of enrollment of a member or a member's firm in an Institute-approved practice-monitoring program, together with a statement of the reasons therefore, shall be published in such form and manner as the Council may prescribe. Council also may prescribe any additional disclosures regarding any matter within the jurisdiction of the professional ethics executive committee.

[As revised May 15, 2000; revised October 18, 2003; revised November 6, 2007.]

(See section 760R.)

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**BL Section 760R*****Implementing Resolution Under Section 7.6  
Publication of Disciplinary Action***

**As amended  
May 26, 1993,  
unless otherwise  
indicated**

***Resolved:***

**.01** That notice of disciplinary action taken under section 7.3 or 7.4 of the bylaws or of termination of enrollment of a member or a member's firm in an Institute-approved practice monitoring program, and the basis therefore shall be published by the Institute and that the professional ethics division, the Peer Review Board or peer review committee as appropriate shall maintain a record of such information and disclose that information upon request. In the case of disciplinary action pursuant to section 7.3 of the bylaws, such notice shall be in a form approved by the chairman of the trial board and consistent with this Council resolution. In any action pursuant to section 7.4 of the bylaws in which the member is found guilty or has entered into a settlement agreement with the professional ethics executive committee, the trial board or panel hearing the case shall decide on the form of the notice of the case and the decision to be published. All notices shall disclose, at least, the name of the member involved and, when appropriate, the terms and conditions of any settlement agreement and the nature of the violation. The statement and decision, as released by the chairman, trial board, or hearing panel, shall be published by the Institute. No such publication shall be made until such decision has become effective. The professional ethics executive committee may inform the complainant of the outcome of its investigation without regard to whether the action taken results in publication under section 7.6 of the bylaws.

[As revised by Council May 15, 2000; revised October 18, 2003; revised November 6, 2007.]

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**BL Section 770*****7.7 Disciplinary Sections Not to Be Applied Retroactively***

**As amended  
January 12, 1988**

**.01** Sections 7.3 and 7.4 shall not be applied to offenses of wrongful conduct occurring prior to their effective dates, but such offenses shall be subject to discipline under the bylaws of the Institute in effect at the time of their occurrence.

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**BL Section 800**  
**8. AMENDMENTS**

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## **BL Section 801**

### ***Amendments***

**As amended  
January 12, 1988**

**.01** Amendments to these bylaws and the Code of Professional Conduct shall be accomplished in a manner consistent with this article.

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## BL Section 810

### *8.1 Proposals to Amend the Bylaws*

**As amended  
June 17, 1996**

**.01** Proposals to amend the bylaws may be made by any thirty members of the Council, by any two hundred or more members of the Institute in good standing, by the Board of Directors, or by petition of 5 percent of the membership as of the end of the prior fiscal year. Any such petition shall include the member's name (typed or printed), membership number and the date it is signed, and the signature of a member on such a petition shall be valid for one year from the date thereof. The changes to this provision will not apply to petitions, regardless of when they are signed, submitted pursuant to efforts to gather such petitions which were ongoing as of July 13, 1995.

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**BL Section 820*****8.2 Proposals to Amend the Code of Professional Conduct*****As amended  
June 17, 1996**

**.01** Proposals to amend the Code of Professional Conduct may be made by any thirty members of the Council, by any two hundred or more members of the Institute in good standing, by the Board of Directors, by the professional ethics division, or by petition of 5 percent of the membership as of the end of the prior fiscal year. Any such petition shall include the member's name (typed or printed), membership number and the date it is signed, and the signature of a member on such a petition shall be valid for one year from the date thereof. The changes to this provision will not apply to petitions, regardless of when they are signed, submitted pursuant to efforts to gather such petitions which were ongoing as of July 13, 1995.

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**BL Section 830*****8.3 Submission to Council via  
Board of Directors***

**As amended  
January 12, 1988**

**.01** All such proposals to amend the bylaws or the Code of Professional Conduct, unless made at a meeting of the Council or the Board of Directors, shall be submitted in writing to the Board of Directors. The Board of Directors shall submit all such proposals, accompanied by its recommendation, to the Council for action.

**8.3.1 Proposals Not Requiring Council Approval**

Following discussion at a meeting of the Council, proposals sponsored by at least 5 percent of the membership shall be submitted to the membership of the Institute for vote by mail ballot pursuant to section 8.4.

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**BL Section 840*****8.4 Submission to Membership by Mail Ballot***

**As amended  
January 12, 1988,  
unless otherwise  
indicated**

**.01** Amendments proposed under section 8.3.1 and those authorized by the Council under section 8.3 shall be submitted to all of the members of the Institute for a vote by mail ballot no later than 180 days following discussion or authorization by the Council. If at least two-thirds of those voting approve such proposal, it shall become effective as an amendment to the bylaws or to the Code of Professional Conduct, as applicable. Mail ballots shall be considered valid and counted only if received as instructed by the Institute for the return of such votes within sixty days from the date of mailing the ballots to the members.

[As revised May 15, 2000; revised November 6, 2007.]

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# BL Section 900

## GENERAL

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## BL Section 911

### ***AICPA Mission Statement***\*

.01 The American Institute of Certified Public Accountants is the national professional organization for all Certified Public Accountants. Its mission is to provide members with the resources, information, and leadership that enable them to provide valuable services in the highest professional manner to benefit the public as well as employers and clients.

In fulfilling its mission, the AICPA works with state CPA organizations and gives priority to those areas where public reliance on CPA skills is most significant.

To achieve its mission, the Institute:

#### *Advocacy*

- Serves as the national representative of CPAs before governments, regulatory bodies and other organizations in protecting and promoting members' interests.

#### *Certification and Licensing*

- Seeks the highest possible level of uniform certification and licensing standards and promotes and protects the CPA designation.

#### *Communications*

- Promotes public awareness and confidence in the integrity, objectivity, competence, and professionalism of CPAs and monitors the needs and views of CPAs.

#### *Recruiting and Education*

- Encourages highly qualified individuals to become CPAs and supports the development and outstanding academic programs.

#### *Standards and Performance*

- Establishes professional standards; assists members in continually improving their professional conduct, performance, and expertise; and monitors such performance to enforce current standards and requirements.

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\* **Note:** The Mission Statement, developed in 1986 by the Mission of AICPA Special Committee, was revised by the Strategic Planning Committee and approved by Council in May 1991. The Strategic Objectives were revised in November 1993 and again in November 1995.



## BL Section 921

# *A Description of the Professional Practice of Certified Public Accountants*

- .01** Certified public accountants practice in the broad field of accounting.
- .02** Accounting is a discipline which provides financial and other information essential to the efficient conduct and evaluation of the activities of any organization.
- .03** The information which accounting provides is essential for (1) effective planning, control, and decision-making by management, and (2) discharging the accountability of organizations to investors, creditors, government agencies, taxing authorities, association members, contributors to welfare institutions, and others.
- .04** Accounting includes the development and analysis of data, the testing of their validity and relevance, and the interpretation and communication of the resulting information to intended users. The data may be expressed in monetary or other quantitative terms, or in symbolic or verbal forms.
- .05** Some of the data with which accounting is concerned are not precisely measurable, but necessarily involve assumptions and estimates as to the present effect of future events and other uncertainties. Accordingly, accounting requires not only technical knowledge and skill, but even more important, disciplined judgment, perception, and objectivity.
- .06** Within this broad field of accounting, certified public accountants are the identified professional accountants. They provide leadership in accounting research and education. In the practice of public accounting CPAs bring competence of professional quality, independence, and a strong concern for the usefulness of the information and advice they provide, but they do not make management decisions.
- .07** The professional quality of their services is based upon experience and the requirements for the CPA certificate—education and examination—and upon the ethical and technical standards established and enforced by their profession.
- .08** CPAs have a distinctive role in auditing financial statements submitted to investors, creditors, and other interested parties, and in expressing independent opinions on the fairness of such statements. This distinctive role has inevitably encouraged a demand for the opinions of CPAs on a wide variety of other representations, such as compliance with rules and regulations of government agencies, sales statistics under lease and royalty agreements, and adherence to covenants in indentures. [Revised, July 1997, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 58.]
- .09** The audit of financial statements requires CPAs to review many aspects of an organization's activities and procedures. Consequently they can advise clients of needed improvements in internal control and make constructive suggestions on financial, tax, and other operating matters. [Revised, July 1997, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 58.]

**.10** In addition to furnishing advice in conjunction with their independent audits of financial statements, CPAs are engaged to provide objective advice and consultation on various management problems. Many of these involve information and control systems and techniques, such as budgeting, cost control, profit planning, internal reporting, automatic data processing, and quantitative analysis. CPAs also assist in the development and implementation of programs approved by management. [Revised, July 1997, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 58.]

**.11** Among the major management problems depending on the accounting function is compliance with tax requirements. An important part of the practice of CPAs includes tax planning and advice, preparation of tax returns, and representation of clients before government agencies.

**.12** CPAs also participate in conferences with government agencies such as the Securities and Exchange Commission, and with other interested parties, such as bankers.

**.13** Like other professionals, CPAs are often consulted on business, civic, and other problems on which their judgment, experience, and professional standards permit them to provide helpful advice and assistance.

**.14** The complexities of an industrial society encourage a high degree of specialization in all professions. The accounting profession is no exception. Its scope is so wide and varied that many individual CPAs choose to specialize in particular types of service.

**.15** Although their activities may be diverse, all CPAs have demonstrated basic competence of professional quality in the discipline of accounting. It is this which unites them as members of one profession, and provides a foundation for extension of their services into new areas.

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- Election Meetings ..... 660.01
- Election of Members ..... 601.01
- Execution of Instruments ..... 430.01
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- Organization of Institute ..... 310.01
- Powers of Council ..... 330.01
- President—See President of Institute
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- Disciplinary Action ..... 760.01
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- Disciplinary Sanctions ..... 220R.02
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- Appointed by Board of Directors ..... 350.01
- Duties of President ..... 350R.04
- Powers Prescribed by Board of Directors ..... 350.01
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- Authority to Make Public Statements ..... 360R.01
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## Select PCAOB Releases

The full text of the releases issued by the PCAOB can be found in the AICPA's *PCAOB Standards and Related Rules*.

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## VS Section

# STATEMENTS ON STANDARDS FOR VALUATION SERVICES

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## VS Section 100

# ***Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset***

Source: Statement on Standards for Valuation Services No. 1

June 2007

## Foreword

### Why Issued

Valuations of businesses, business ownership interests, securities, or intangible assets (hereinafter collectively referred to in this Foreword as *business valuations*) may be performed for a wide variety of purposes including the following:

1. Transactions (or potential transactions), such as acquisitions, mergers, leveraged buyouts, initial public offerings, employee stock ownership plans and other share based plans, partner and shareholder buy-ins or buyouts, and stock redemptions
2. Litigation (or pending litigation) relating to matters such as marital dissolution, bankruptcy, contractual disputes, owner disputes, dissenting shareholder and minority ownership oppression cases, and employment and intellectual property disputes
3. Compliance-oriented engagements, including (a) financial reporting and (b) tax matters such as corporate reorganizations; S corporation conversions; income, estate, and gift tax compliance; purchase price allocations; and charitable contributions
4. Planning oriented engagements for income tax, estate tax, gift tax, mergers and acquisitions, and personal financial planning

In recent years, the need for business valuations has increased significantly. Performing an engagement to estimate value involves special knowledge and skill.

Given the increasing number of members of the AICPA who are performing business valuation engagements or some aspect thereof, the AICPA Consulting Services Executive Committee has written this standard to improve the consistency and quality of practice among AICPA members performing business valuations. AICPA members will be required to follow this standard when they perform engagements to estimate value that culminate in the expression of a conclusion of value or a calculated value.

The Consulting Services Executive Committee is a body designated by AICPA Council to promulgate professional standards under the "General Standards Rule" (ET sec. 1.300.001 and 2.300.001) and the "Compliance with Standards Rule" (ET sec. 1.310.001 and 2.310.001) of the AICPA Code of Professional Conduct (the code).

## Introduction and Scope

.01 This statement establishes standards for AICPA members (hereinafter referred to in this statement as *members*) who are engaged to, or, as part of

another engagement, estimate the value of a **business**,<sup>1</sup> *business ownership interest, security, or intangible asset* (hereinafter collectively referred to in this statement as **subject interest**). For purposes of this statement, the definition of a business includes not-for-profit entities or activities.

**.02** As described in this statement, the term **engagement to estimate value** refers to an engagement or any part of an engagement (for example, a tax, litigation, or acquisition-related engagement) that involves estimating the value of a subject interest. An engagement to estimate value culminates in the expression of either a **conclusion of value** or a **calculated value** (see paragraph .21). A member who performs an engagement to estimate value is referred to, in this statement, as a **valuation analyst**.

**.03** Valuation analysts should be aware of any governmental regulations and other professional standards applicable to the engagement, including the code and the Statement on Standards for Consulting Services (SSCS) No. 1, *Consulting Services: Definitions and Standards* (CS sec. 100), and the extent to which they apply to engagements to estimate value. Compliance is the responsibility of the valuation analyst.

**.04** In the process of estimating value as part of an engagement, the valuation analyst applies **valuation approaches** and **valuation methods**, as described in this statement, and uses professional judgment. The use of professional judgment is an essential component of estimating value.

## Exceptions From This Statement

**.05** This statement is not applicable to a member who participates in estimating the value of a subject interest as part of performing an attest engagement defined by the "Independence Rule" of the code (ET sec. 1.200.001) (for example, as part of an audit, review, or compilation engagement).

**.06** This statement is not applicable when the value of a subject interest is provided to the member by the client or a third party, and the member does not apply valuation approaches and methods, as discussed in this statement.

**.07** This statement is not applicable to internal use assignments from employers to employee members not in public practice, as that term is defined in the code (ET sec. 0.400.42). See also Valuation Interpretation No. 1, "Scope of Applicable Services" (VS sec. 9100), illustrations 24 and 25 (VS sec. 9100 par. .78–.81).

**.08** This statement is not applicable to engagements that are exclusively for the purpose of determining economic damages (for example, lost profits) unless those determinations include an engagement to estimate value. See also Interpretation No. 1, illustrations 1, 2, and 3 (VS sec. 9100 par. .06–.11).

**.09** This statement is not applicable to mechanical computations that do not rise to the level of an engagement to estimate value; that is, when the member does not apply valuation approaches and methods and does not use professional judgment. See Interpretation No. 1, illustration 8 (VS sec. 9100 par. .20–.23).

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<sup>1</sup> This statement includes two glossaries. Appendix B, "International Glossary of Business Valuation Terms" (par. .81), is a verbatim reproduction of the glossary jointly developed by the AICPA, the American Society of Appraisers (ASA), the Canadian Institute of Chartered Business Valuators, the National Association of Certified Valuation Analysts, and the Institute of Business Appraisers. Appendix C, "Glossary of Additional Terms" (par. .82), provides definitions for terms included in this statement but not defined in the jointly developed glossary. The terms defined in appendix B are in boldface type the first time they appear in this statement; the terms defined in appendix C are in italicized boldface type the first time they appear in this statement.

This statement is not applicable when it is not practical or not reasonable to obtain or use relevant information; as a result, the member is unable to apply valuation approaches and methods that are described in this statement.<sup>2</sup>

### ***Jurisdictional Exception***

.10 If any part of this statement differs from published governmental, judicial, or accounting authority, or such authority specifies valuation development procedures or valuation reporting procedures, then the valuation analyst should follow the applicable published authority or stated procedures with respect to that part applicable to the valuation in which the member is engaged. The other parts of this statement continue in full force and effect (Interpretation No. 1 [VS sec. 9100 par. .01–.89]).

## **Overall Engagement Considerations**

### **Professional Competence**

.11 The "General Standards Rule" of the code (ET sec. 1.300.001 and 2.300.001) states that a member shall "undertake only those *professional services* that the *member* or the *member's firm* can reasonably expect to be completed with professional competence." Performing a valuation engagement with professional competence involves special knowledge and skill. A valuation analyst should possess a level of knowledge of valuation principles and theory and a level of skill in the application of such principles that will enable him or her to identify, gather, and analyze data, consider and apply appropriate valuation approaches and methods, and use professional judgment in developing the estimate of value (whether a single amount or a range). An in-depth discussion of valuation theory and principles, and how and when to apply them, is not within the scope of this statement.

.12 In determining whether he or she can reasonably expect to complete the valuation engagement with professional competence, the valuation analyst should consider, at a minimum, the following:

- a. Subject entity and its industry
- b. Subject interest
- c. **Valuation date**
- d. Scope of the valuation engagement
  - i. Purpose of the valuation engagement
  - ii. **Assumptions and limiting conditions** expected to apply to the valuation engagement (see paragraph .18)
  - iii. Applicable **standard of value** (for example, **fair value** or **fair market value**) and the applicable **premise of value** (for example, going concern)
  - iv. Type of valuation report to be issued (see paragraph .48), intended use and users of the report, and restrictions on the use of the report
- e. Governmental regulations or other professional standards that apply to the subject interest or to the valuation engagement

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<sup>2</sup> Unless prohibited by statute or by rule, a member may use the client's estimates for compliance reporting to a third party if the member determines that the estimates are reasonable (based on the facts and circumstances known to the member). See Interpretation No. 1, "Scope of Applicable Services" (VS sec. 9100 par. .01–.89), and Statement for Standards on Tax Services No. 4, *Use of Estimates* (TS sec. 400).

## Nature and Risks of the Valuation Services and Expectations of the Client

.13 In understanding the nature and risks of the *valuation services* to be provided, and the expectations of the client, the valuation analyst should consider the matters in paragraph .12, and in addition, at a minimum, the following:

- a. The proposed terms of the valuation engagement
- b. The identity of the client
- c. The nature of the interest and ownership rights in the business, business interest, security, or intangible asset being valued, including **control** characteristics and the degree of **marketability** of the interest
- d. The procedural requirements of a valuation engagement and the extent, if any, to which procedures will be limited by either the client or circumstances beyond the client's or the valuation analyst's control
- e. The use of and limitations of the report, and the conclusion or calculated value
- f. Any obligation to update the valuation

## Objectivity and Conflict of Interest

.14 The code requires objectivity in the performance of all professional services, including valuation engagements. Objectivity is a state of mind. The principle of objectivity imposes the obligation to be impartial, intellectually honest, disinterested, and free from conflicts of interest. Where a potential conflict of interest may exist, a valuation analyst should make the disclosures and obtain consent as required by the "Conflicts of Interest" interpretation (ET sec. 1.110.010 and 2.110.010) under the "Integrity and Objectivity Rule" (ET sec. 1.100.001 and 2.100.001).

## Independence and Valuation

.15 If valuation services are performed for a client for which the valuation analyst or valuation analyst's firm also performs an attest engagement (defined by the "Independence Rule" of the code), the valuation analyst should meet the requirements included in the interpretations of the "Nonattest Services" subtopic (ET sec. 1.295) under the "Independence Rule" (ET sec. 1.200.001) so as not to impair the member's independence with respect to the client.

## Establishing an Understanding With the Client

.16 The valuation analyst should establish an understanding with the client, preferably in writing, regarding the engagement to be performed. If the understanding is oral, the valuation analyst should document that understanding by appropriate memoranda or notations in the working papers. (If the engagement is being performed for an attest client, the "General Requirements for Performing Nonattest Services" interpretation [ET sec. 1.295.040] of the "Independence Rule" [ET sec. 1.200.001] requires the engagement understanding to be in writing.) Regardless of whether the understanding is written or oral, the valuation analyst should modify the understanding if he or she encounters circumstances during the engagement that make it appropriate to modify that understanding.

.17 The understanding with the client reduces the possibility that either the valuation analyst or the client may misinterpret the needs or expectations of the other party. The understanding should include, at a minimum, the nature,

purpose, and objective of the valuation engagement, the client's responsibilities, the valuation analyst's responsibilities, the applicable assumptions and limiting conditions, the type of report to be issued, and the standard of value to be used.

### ***Assumptions and Limiting Conditions***

.18 Assumptions and limiting conditions are common to valuation engagements. Examples of typical assumptions and limiting conditions for a business valuation are provided in appendix A, "Illustrative List of Assumptions and Limiting Conditions for a Business Valuation" (par. .80). The assumptions and limiting conditions should be disclosed in the valuation report (see paragraphs .52l, .68g, and .71m).

### **Scope Restrictions or Limitations**

.19 A restriction or limitation on the scope of the valuation analyst's work, or the data available for analysis, may be present and known to the valuation analyst at the outset of the valuation engagement or may arise during the course of a valuation engagement. Such a restriction or limitation should be disclosed in the valuation report (see paragraphs .52m, .68e, and .71n).

### **Using the Work of Specialists in the Engagement to Estimate Value**

.20 In performing an engagement to estimate value, the valuation analyst may rely on the work of a third party specialist (for example, a real estate or equipment appraiser). The valuation analyst should note in the assumptions and limiting conditions the level of responsibility, if any, being assumed by the valuation analyst for the work of the third party specialist. At the option of the valuation analyst, the written report of the third party specialist may be included in the valuation analyst's report.

## **Development**

### **Types of Engagement**

.21 There are two types of engagements to estimate value—a ***valuation engagement*** and a ***calculation engagement***. The valuation engagement requires more procedures than does the calculation engagement. The valuation engagement results in a conclusion of value. The calculation engagement results in a calculated value. The type of engagement is established in the understanding with the client (see paragraphs .16 and .17):

- a. *Valuation engagement.* A valuation analyst performs a valuation engagement when (1) the engagement calls for the valuation analyst to estimate the value of a subject interest and (2) the valuation analyst estimates the value (as outlined in paragraphs .23–.45) and is free to apply the valuation approaches and methods he or she deems appropriate in the circumstances. The valuation analyst expresses the results of the valuation as a conclusion of value; the conclusion may be either a single amount or a range.
- b. *Calculation engagement.* A valuation analyst performs a calculation engagement when (1) the valuation analyst and the client agree on the valuation approaches and methods the valuation analyst will use and the extent of procedures the valuation analyst will perform in the

process of calculating the value of a subject interest (these procedures will be more limited than those of a valuation engagement) and (2) the valuation analyst calculates the value in compliance with the agreement. The valuation analyst expresses the results of these procedures as a calculated value. The calculated value is expressed as a range or as a single amount. A calculation engagement does not include all of the procedures required for a valuation engagement (see paragraph .46).

## Hypothetical Conditions

.22 Hypothetical conditions affecting the subject interest may be required in some circumstances. When a valuation analyst uses hypothetical conditions during a valuation or calculation engagement, he or she should indicate the purpose for including the hypothetical conditions and disclose these conditions in the valuation or calculation report (see paragraphs .52*n*, .71*o*, and .74).

## Valuation Engagement

.23 In performing a valuation engagement, the valuation analyst should do the following:

- Analyze the subject interest (paragraphs .25–.30)
- Consider and apply appropriate valuation approaches and methods (paragraphs .31–.42)
- Prepare and maintain appropriate documentation (paragraphs .44–.45)

.24 Even though the list in paragraph .23 and some requirements and guidance in this statement are presented in a manner that suggests a sequential valuation process, valuations involve an ongoing process of gathering, updating, and analyzing information. Accordingly, the sequence of the requirements and guidance in this statement may be implemented differently at the option of the valuation analyst.

### *Analysis of the Subject Interest*

.25 The analysis of the subject interest will assist the valuation analyst in considering, evaluating, and applying the various valuation approaches and methods to the subject interest. The nature and extent of the information needed to perform the analysis will depend on, at a minimum, the following:

- Nature of the subject interest
- Scope of the valuation engagement
- Valuation date
- Intended use of the valuation
- Applicable standard of value
- Applicable **premise of value**
- Assumptions and limiting conditions
- Applicable governmental regulations or other professional standards

.26 In analyzing the subject interest, the valuation analyst should consider financial and nonfinancial information. The type, availability, and significance of such information vary with the subject interest.

### *Nonfinancial Information*

**.27** The valuation analyst should, as available and applicable to the valuation engagement, obtain sufficient nonfinancial information to enable him or her to understand the subject entity, including the following:

- Nature, background, and history
- Facilities
- Organizational structure
- Management team (which may include officers, directors, and key employees)
- Classes of **equity** ownership interests and rights attached thereto
- Products or services, or both
- Economic environment
- Geographical markets
- Industry markets
- Key customers and suppliers
- Competition
- **Business risks**
- Strategy and future plans
- Governmental or regulatory environment

### *Ownership Information*

**.28** The valuation analyst should obtain, where applicable and available, ownership information regarding the subject interest to enable him or her to

- determine the type of ownership interest being valued and ascertain whether that interest exhibits control characteristics.
- analyze the different ownership interests of other owners and assess the potential effect on the value of the subject interest.
- understand the classes of equity ownership interests and rights attached thereto.
- understand the rights included in, or excluded from, each intangible asset.
- understand other matters that may affect the value of the subject interest, such as the following:
  - *For a business, business ownership interest, or security:* Shareholder agreements, partnership agreements, operating agreements, voting trust agreements, buy-sell agreements, loan covenants, restrictions, and other contractual obligations or restrictions affecting the owners and the subject interest.
  - *For an intangible asset:* Legal rights, licensing agreements, sublicense agreements, nondisclosure agreements, development rights, commercialization or exploitation rights, and other contractual obligations.

### *Financial Information*

**.29** The valuation analyst should obtain, where applicable and available, financial information on the subject entity such as the following:

- Historical financial information (including annual and interim financial statements and key financial statement ratios and statistics) for an appropriate number of years
- Prospective financial information (for example, budgets, forecasts, and projections)
- Comparative summaries of financial statements or information covering a relevant time period
- Comparative common size financial statements for the subject entity for an appropriate number of years
- Comparative common size industry financial information for a relevant time period
- Income tax returns for an appropriate number of years
- Information on compensation for owners including benefits and personal expenses
- Information on key man or officers' life insurance
- Management's response to inquiry regarding the following:
  - Advantageous or disadvantageous contracts
  - Contingent or off-balance-sheet assets or liabilities
  - Information on prior sales of company stock

.30 The valuation analyst should read and evaluate the information to determine that it is reasonable for the purposes of the engagement.

### **Valuation Approaches and Methods**

.31 In developing the valuation, the valuation analyst should consider the three most common valuation approaches:

- **Income (income-based) approach**
- **Asset (asset-based) approach** (used for businesses, business ownership interests, and securities) or **cost approach** (used for intangible assets)
- **Market (market-based) approach**

.32 The valuation analyst should use the valuation approaches and methods that are appropriate for the valuation engagement. General guidance on the use of approaches and methods appears in paragraphs .33–.41, but detailed guidance on specific valuation approaches and methods and their applicability is outside the scope of this statement.

.33 *Income Approach.* Two frequently used valuation methods under the income approach include the **capitalization of benefits method** (for example, earnings or cash flows) and the **discounted future benefits method** (for example, earnings or cash flows). When applying these methods, the valuation analyst should consider a variety of factors, including but not limited to, the following:

- a. *Capitalization of benefits (for example, earnings or cash flows) method.* The valuation analyst should consider the following:
  - i. **Normalization** adjustments
  - ii. Nonrecurring revenue and expense items
  - iii. Taxes
  - iv. Capital structure and financing costs

- v. Appropriate capital investments
  - vi. Noncash items
  - vii. Qualitative judgments for risks used to compute discount and **capitalization rates**
  - viii. Expected changes (growth or decline) in future benefits (for example, earnings or cash flows)
- b. *Discounted future benefits method (for example, earnings or cash flows).* In addition to the items in item a, the valuation analyst should consider the following:
- i. Forecast or projection assumptions
  - ii. Forecast or projected earnings or cash flows
  - iii. **Terminal value**
- c. For an intangible asset, the valuation analyst should also consider, when relevant, the following:
- i. Remaining useful life
  - ii. Current and anticipated future use of the intangible asset
  - iii. Rights attributable to the intangible asset
  - iv. Position of intangible asset in its life cycle
  - v. Appropriate discount rate for the intangible asset
  - vi. Appropriate **capital or contributory asset charge**, if any
  - vii. Research and development or marketing expense needed to support the intangible asset in its existing state
  - viii. Allocation of income (for example, **incremental income**, **residual income**, or **profit split income**) to intangible asset
  - ix. Whether any tax amortization benefit would be included in the analysis
  - x. Discounted multi-year excess earnings
  - xi. Market royalties
  - xii. Relief from royalty

### **Asset Approach and Cost Approach**

**.34** A frequently used method under the asset approach is the adjusted net asset method. When using the adjusted net asset method in valuing a business, business ownership interest, or security, the valuation analyst should consider, as appropriate, the following information related to the premise of value:

- Identification of the assets and liabilities
- Value of the assets and liabilities (individually or in the aggregate)
- Liquidation costs (if applicable)

**.35** When using methods under the cost approach to value intangible assets, the valuation analyst should consider the type of cost to be used (for example, reproduction cost or replacement cost), and, where applicable, the appropriate forms of depreciation and obsolescence and the remaining useful life of the intangible asset.

### Market Approach

.36 Three frequently used valuation methods under the market approach for valuing a business, business ownership interest, or security are as follows:

- **Guideline public company method**
- **Guideline company transactions method**
- Guideline sales of interests in the subject entity, such as business ownership interests or securities

Three frequently used market approach valuation methods for intangible assets are as follows:

- Comparable uncontrolled transactions method (which is based on arm's-length sales or licenses of guideline intangible assets)
- Comparable profit margin method (which is based on comparison of the profit margin earned by the subject entity that owns or operates the intangible asset to profit margins earned by guideline companies)
- **Relief from royalty method** (which is based on the royalty rate, often expressed as a percentage of revenue that the subject entity that owns or operates the intangible asset would be obligated to pay to a hypothetical third-party licensor for the use of that intangible asset)

For the methods involving guideline intangible assets (for example, the comparable profit margin method), the valuation analyst should consider the subject intangible asset's remaining useful life relative to the remaining useful life of the guideline intangible assets, if available.

.37 In applying the methods listed in paragraph .36 or other methods to determine valuation pricing multiples or metrics, the valuation analyst should consider the following:

- Qualitative and quantitative comparisons
- Arm's-length transactions and prices
- The dates and, consequently, the relevance of the market data

.38 The valuation analyst should set forth in the report the rationale and support for the valuation methods used (see paragraph .47).

.39 *Rules of Thumb*. Although technically not a valuation method, some valuation analysts use rules of thumb or industry benchmark indicators (hereinafter, collectively referred to as **rules of thumb**) in a valuation engagement. A rule of thumb is typically a reasonableness check against other methods used and should generally not be used as the only method to estimate the value of the subject interest.

### Valuation Adjustments

.40 During the course of a valuation engagement, the valuation analyst should consider whether valuation adjustments (discounts or premiums) should be made to a **pre-adjustment** value. Examples of valuation adjustments for valuation of a business, business ownership interest, or security include a **discount for lack of marketability or liquidity** and a **discount for lack of control**. An example of a valuation adjustment for valuation of an intangible asset is obsolescence.

.41 When valuing a controlling ownership interest under the income approach, the value of any **non-operating assets**, non-operating liabilities, or **excess or deficient operating assets** should be excluded from the computation of the value based on the operating assets and should be added to or deleted

from the value of the operating entity. When valuing a non-controlling ownership interest under the income approach, the value of any non-operating assets, non-operating liabilities, or excess or deficient operating assets may or may not be used to adjust the value of the operating entity depending on the valuation analyst's assessment of the influence exercisable by the non-controlling interest. In the asset-based or cost approach, it may not be necessary to separately consider non-operating assets, non-operating liabilities, or excess or deficient operating assets.

### **Conclusion of Value**

- .42** In arriving at a conclusion of value, the valuation analyst should
- a. correlate and reconcile the results obtained under the different approaches and methods used.
  - b. assess the reliability of the results under the different approaches and methods using the information gathered during the valuation engagement.
  - c. determine, based on items *a* and *b*, whether the conclusion of value should reflect
    - i. the results of one valuation approach and method, or
    - ii. a combination of the results of more than one valuation approach and method.

### **Subsequent Events**

**.43** The valuation date is the specific date at which the valuation analyst estimates the value of the subject interest and concludes on his or her estimation of value. Generally, the valuation analyst should consider only circumstances existing at the valuation date and events occurring up to the valuation date. An event that could affect the value may occur subsequent to the valuation date; such an occurrence is referred to as a **subsequent event**. Subsequent events are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date. The valuation would not be updated to reflect those events or conditions. Moreover, the valuation report would typically not include a discussion of those events or conditions because a valuation is performed as of a point in time—the valuation date—and the events described in this subparagraph, occurring subsequent to that date, are not relevant to the value determined as of that date. In situations in which a valuation is meaningful to the intended user beyond the valuation date, the events may be of such nature and significance as to warrant disclosure (at the option of the valuation analyst) in a separate section of the report in order to keep users informed (see paragraphs .52*p*, .71*r*, and .74). Such disclosure should clearly indicate that information regarding the events is provided for informational purposes only and does not affect the determination of value as of the specified valuation date.

### **Documentation**

**.44** Documentation is the principal record of information obtained and analyzed, procedures performed, valuation approaches and methods considered and used, and the conclusion of value. The quantity, type, and content of documentation are matters of the valuation analyst's professional judgment. Documentation may include the following:

- Information gathered and analyzed to obtain an understanding of matters that may affect the value of the subject interest (paragraphs .25–.30)

- Assumptions and limiting conditions (paragraph .18)
- Any restriction or limitation on the scope of the valuation analyst's work or the data available for analysis (paragraph .19)
- Basis for using any **valuation assumption** during the valuation engagement
- Valuation approaches and methods considered
- Valuation approaches and methods used including the rationale and support for their use
- If applicable, information relating to subsequent events considered by the valuation analyst (paragraph .43)
- For any rule of thumb used in the valuation, source(s) of data used, and how the rule of thumb was applied (paragraph .39)
- Other documentation considered relevant to the engagement by the valuation analyst

.45 The valuation analyst should retain the documentation for a period of time sufficient to meet the needs of applicable legal, regulatory, or other professional requirements for records retention.

## Calculation Engagement

.46 In performing a calculation engagement, the valuation analyst should consider, at a minimum, the following:

- a. Identity of the client
- b. Identity of the subject interest
- c. Whether or not a business interest has ownership control characteristics and its degree of marketability
- d. Purpose and intended use of the calculated value
- e. Intended users of the report and the limitations on its use
- f. Valuation date
- g. Applicable premise of value
- h. Applicable standard of value
- i. Sources of information used in the calculation engagement
- j. Valuation approaches or valuation methods agreed upon with the client
- k. Subsequent events, if applicable (see paragraph .43)

In addition, the valuation analyst should comply with the documentation requirements listed in paragraphs .44 and .45. The quantity, type, and content of documentation are matters of the valuation analyst's professional judgment.

## The Valuation Report

.47 A valuation report is a written or oral communication to the client containing the conclusion of value or the calculated value of the subject interest. Reports issued for purposes of certain controversy proceedings are exempt from this reporting standard (see paragraph .50).

.48 The three types of written reports that a valuation analyst may use to communicate the results of an engagement to estimate value are as follows:

either a detailed report or a summary report for a valuation engagement and a calculation report for a calculation engagement:

- a. *Valuation engagement—detailed report.* This report may be used only to communicate the results of a valuation engagement (conclusion of value); it should not be used to communicate the results of a calculation engagement (calculated value) (paragraph .51).
- b. *Valuation engagement—summary report.* This report may be used only to communicate the results of a valuation engagement (conclusion of value); it should not be used to communicate the results of a calculation engagement (calculated value) (paragraph .71). For a valuation engagement, the determination of whether to prepare a detailed report or a summary report is based on the level of reporting detail agreed to by the valuation analyst and the client.
- c. *Calculation engagement—calculation report.* This type of report should be used only to communicate the results of a calculation engagement (calculated value); it should not be used to communicate the results of a valuation engagement (conclusion of value) (see paragraph .73).

**.49** The valuation analyst should indicate in the valuation report the restrictions on the use of the report (which may include restrictions on the users of the report, the uses of the report by such users, or both) (paragraph .65d).

## Reporting Exemption for Certain Controversy Proceedings

**.50** A valuation performed for a matter before a court, an arbitrator, a mediator or other facilitator, or a matter in a governmental or administrative proceeding, is exempt from the reporting provisions of this statement. The reporting exemption applies whether the matter proceeds to trial or settles. The exemption applies only to the reporting provisions of this statement (see paragraphs .47–.49 and .51–.78). The developmental provisions of the statement (see paragraphs .21–.46) still apply whenever the valuation analyst expresses a conclusion of value or a calculated value (Interpretation No. 1 [VS sec. 9100 par. .01–.89]).

## Detailed Report

**.51** The *detailed report* is structured to provide sufficient information to permit intended users to understand the data, reasoning, and analyses underlying the valuation analyst's conclusion of value. A detailed report should include, as applicable, the following sections titled using wording similar in content to that shown:

- Letter of transmittal
- Table of contents
- Introduction
- Sources of information
- Analysis of the subject entity and related nonfinancial information
- Financial statement or financial information analysis
- Valuation approaches and methods considered
- Valuation approaches and methods used
- Valuation adjustments

- Non-operating assets, non-operating liabilities, and excess or deficient operating assets (if any)
- Representation of the valuation analyst
- Reconciliation of estimates and conclusion of value
- Qualifications of the valuation analyst
- Appendixes and exhibits

The report sections previously listed and the detailed information within the sections described in the following paragraphs .52–.77 may be positioned in the body of the report or elsewhere in the report at the discretion of the valuation analyst.

## Introduction

**.52** This section should provide an overall description of the valuation engagement. The information in the section should be sufficient to enable the intended user of the report to understand the nature and scope of the valuation engagement, as well as the work performed. The introduction section may include, among other things, the following information:

- a.* Identity of the client
- b.* Purpose and intended use of the valuation
- c.* Intended users of the valuation
- d.* Identity of the subject entity
- e.* Description of the subject interest
- f.* Whether the business interest has ownership control characteristics and its degree of marketability
- g.* Valuation date
- h.* Report date
- i.* Type of report issued (namely, a detailed report) (paragraph .51)
- j.* Applicable premise of value
- k.* Applicable standard of value
- l.* Assumptions and limiting conditions (alternatively, these often appear in an appendix) (paragraph .18)
- m.* Any restrictions or limitations in the scope of work or data available for analysis (paragraph .19)
- n.* Any hypothetical conditions used in the valuation engagement, including the basis for their use (paragraph .22)
- o.* If the work of a specialist was used in the valuation engagement, a description of how the specialist's work was relied upon (paragraph .20)
- p.* Disclosure of subsequent events in certain circumstances (paragraph .43)
- q.* Any application of the jurisdictional exception (paragraph .10)
- r.* Any additional information the valuation analyst deems useful to enable the user(s) of the report to understand the work performed

If the items previously listed are not included in the introduction, they should be included elsewhere in the valuation report.

### **Sources of Information**

**.53** This section of the report should identify the relevant sources of information used in performing the valuation engagement. It may include, among other things, the following:

- a. For valuation of a business, business ownership interest, or security, whether and to what extent the subject entity's facilities were visited
- b. For valuation of an intangible asset, whether the legal registration, contractual documentation, or other tangible evidence of the asset was inspected
- c. Names, positions, and titles of persons interviewed and their relationships to the subject interest
- d. Financial information (paragraphs .54 and .56)
- e. Tax information (paragraph .55)
- f. Industry data
- g. Market data
- h. Economic data
- i. Other empirical information
- j. Relevant documents and other sources of information provided by or related to the entity

**.54** If the financial information includes financial statements that were reported on (audit, review, compilation, or attest engagement performed under the Statements on Standards for Attestation Engagements [SSAEs] [AT sec. 20–701]) by the valuation analyst's firm, the valuation report should disclose this fact and the type of report issued. If the valuation analyst or the valuation analyst's firm did not audit, review, compile, or attest under the SSAEs (AT sec. 20–701) to the financial information, the valuation analyst should so state and should also state that the valuation analyst assumes no responsibility for the financial information.

**.55** The financial information may be derived from or may include information derived from tax returns. With regard to such derived information and other tax information (see paragraph .53e), the valuation analyst should identify the tax returns used and any existing relationship between the valuation analyst and the tax preparer. If the valuation analyst or the valuation analyst's firm did not audit, review, compile, or attest under the SSAEs (AT sec. 20–701) to any financial information derived from tax returns that is used during the valuation engagement, the valuation analyst should so state and should also state that the valuation analyst assumes no responsibility for that derived information.

**.56** If the financial information used was derived from financial statements prepared by management that were not the subject of an audit, review, compilation, or attest engagement performed under the SSAEs, the valuation report should do the following:

- Identify the financial statements
- State that, as part of the valuation engagement, the valuation analyst did not audit, review, compile, or attest under the SSAEs (AT sec. 20–710) to the financial information and assumes no responsibility for that information

### ***Analysis of the Subject Entity and Related Nonfinancial Information***

.57 The valuation analyst should include a description of the relevant non-financial information listed and discussed in paragraph .27.

### ***Financial Statement or Financial Information Analysis***

.58 This section should include a description of the relevant information listed in paragraph .29. Such description may include the following:

- a. The rationale underlying any normalization or ***control adjustments*** to financial information
- b. Comparison of current performance with historical performance
- c. Comparison of performance with industry trends and norms, where available

### ***Valuation Approaches and Methods Considered***

.59 This section should state that the valuation analyst has considered the valuation approaches discussed in paragraph .31.

### ***Valuation Approaches and Methods Used***

.60 In this section, the valuation analyst should identify the valuation methods used under each valuation approach and the rationale for their use.

.61 This section should also identify the following for each of the three approaches (if used):

- a. Income approach:
  - Composition of the representative benefit stream
  - Method(s) used, and a summary of the most relevant risk factors considered in selecting the appropriate **discount rate**, the capitalization rate, or both
  - Other factors as discussed in paragraph .33
- b. Asset-based approach or cost approach:
  - *Asset-based approach*. Any adjustments made by the valuation analyst to the relevant balance sheet data
  - *Cost approach*. The type of cost used, how this cost was estimated, and, if applicable, the forms of and costs associated with depreciation and obsolescence used under the approach and how those costs were estimated
- c. Market approach:
  - For the guideline public company method:
    - The selected guideline companies and the process used in their selection
    - The pricing multiples used, how they were used, and the rationale for their selection. If the pricing multiples were adjusted, the rationale for such adjustments
  - For the guideline company transactions method, the sales transactions and pricing multiples used, how they were used, and the rationale for their selection; if the pricing multiples were adjusted, the rationale for such adjustments

- For the guideline sales of interests in the subject entity method, the sales transactions used, how they were used, and the rationale for determining that these sales are representative of arm's length transactions

**.62** When a rule of thumb is used in combination with other methods, the valuation report should disclose the source(s) of data used and how the rule of thumb was applied (see paragraph .39).

### ***Valuation Adjustments***

**.63** This section should (a) identify each valuation adjustment considered and determined to be applicable, for example, discount for lack of marketability, (b) describe the rationale for using the adjustment and the factors considered in selecting the amount or percentage used, and (c) describe the pre-adjustment value to which the adjustment was applied (see paragraph .40).

### ***Non-Operating Assets and Excess Operating Assets***

**.64** When the subject interest is a business, business ownership interest, or security, the valuation report should identify any related non-operating assets, non-operating liabilities, or excess or deficient operating assets and their effect on the valuation (see paragraph .41).

### ***Representation of the Valuation Analyst***

**.65** Each written report should contain the representation of the valuation analyst. The representation is the section of the report wherein the valuation analyst summarizes the factors that guided his or her work during the engagement. Examples of these factors include the following:

- a. The analyses and conclusion of value included in the valuation report are subject to the specified assumptions and limiting conditions (see paragraph .18), and they are the personal analyses and conclusion of value of the valuation analyst.
- b. The economic and industry data included in the valuation report have been obtained from various printed or electronic reference sources that the valuation analyst believes to be reliable (any exceptions should be noted). The valuation analyst has not performed any corroborating procedures to substantiate that data.
- c. The valuation engagement was performed in accordance with the American Institute of Certified Public Accountants Statement on Standards for Valuation Services.
- d. The parties for which the information and use of the valuation report is restricted are identified; the valuation report is not intended to be and should not be used by anyone other than such parties (see paragraph .49).
- e. The analyst's compensation is fee-based or is contingent on the outcome of the valuation.
- f. The valuation analyst used the work of one or more outside specialists to assist during the valuation engagement. (An outside specialist is a specialist other than those employed in the valuation analyst's firm.) If the work of such a specialist was used, the specialist should be identified. The valuation report should include a statement identifying the level of responsibility, if any, the valuation analyst is assuming for the specialist's work.

- g. The valuation analyst has no obligation to update the report or the conclusion of value for information that comes to his or her attention after the date of the report.
- h. The valuation analyst and, if applicable, the person(s) assuming responsibility for the valuation should sign the representation in their own name(s). The names of those providing significant professional assistance should be identified.

### **Representations Regarding Information Provided to the Valuation Analyst**

**.66** It may be appropriate for the valuation analyst to obtain written representations regarding information that the subject entity's management provides to the valuation analyst for purposes of his or her performing the valuation engagement. The decision whether to obtain a representation letter is a matter of judgment for the valuation analyst.

### **Qualifications of the Valuation Analyst**

**.67** The report should contain information regarding the qualifications of the valuation analyst.

### **Conclusion of Value**

**.68** This section should present a reconciliation of the valuation analyst's estimate or various estimates of the value of the subject interest. In addition to a discussion of the rationale underlying the conclusion of value, this section should include the following or similar statements:

- a. A valuation engagement was performed, including the subject interest and the valuation date.
- b. The analysis was performed solely for the purpose described in this report, and the resulting estimate of value should not be used for any other purpose.
- c. The valuation engagement was conducted in accordance with the Statement(s) on Standards for Valuation Services of the American Institute of Certified Public Accountants.
- d. A statement that the estimate of value resulting from a valuation engagement is expressed as a conclusion of value.
- e. The scope of work or data available for analysis is explained, including any restrictions or limitations (see paragraph .19).
- f. A statement describing the conclusion of value, either a single amount or a range.
- g. The conclusion of value is subject to the assumptions and limiting conditions (see paragraph .18) and to the valuation analyst's representation (see paragraph .65).
- h. The report is signed in the name of the valuation analyst or the valuation analyst's firm.
- i. The date of the valuation report is included.
- j. The valuation analyst has no obligation to update the report or the conclusion of value for information that comes to his or her attention after the date of the report.

**.69** The following is an example of report language that could be used, but is not required, when reporting the results of a valuation engagement:

We have performed a *valuation engagement*, as that term is defined in the Statement on Standards for Valuation Services (SSVS) of the American Institute of

Certified Public Accountants, of [DEF Company, GHI business ownership interest of DEF Company, GHI security of DEF Company, or GHI intangible asset of DEF Company] as of [valuation date]. This valuation was performed solely to assist in the matter of [purpose of the valuation]; the resulting estimate of value should not be used for any other purpose or by any other party for any purpose. This valuation engagement was conducted in accordance with the SSVS. The estimate of value that results from a valuation engagement is expressed as a conclusion of value.

[If applicable] We were restricted or limited in the scope of our work or data available for analysis as follows: [describe restrictions or limitations].

Based on our analysis, as described in this valuation report, the estimate of value of [DEF Company, GHI business ownership interest of DEF Company, GHI security of DEF Company, or GHI intangible asset of DEF Company] as of [valuation date] was [value, either a single amount or a range]. This conclusion is subject to the Statement of Assumptions and Limiting Conditions found in [reference to applicable section of valuation report] and to the Valuation Analyst's Representation found in [reference to applicable section of valuation report]. We have no obligation to update this report or our conclusion of value for information that comes to our attention after the date of this report.

[Signature]

[Date]

## Appendixes and Exhibits

.70 Appendixes or exhibits may be used for required information or information that supplements the detailed report. Often, the assumptions and limiting conditions and the valuation analyst's representation are provided in appendixes to the detailed report.

## Summary Report

.71 A summary report is structured to provide an abridged version of the information that would be provided in a detailed report, and therefore, need not contain the same level of detail as a detailed report. However, a summary report should, at a minimum, include the following:

- a. Identity of the client
- b. Purpose and intended use of the valuation
- c. Intended users of the valuation
- d. Identity of the subject entity
- e. Description of the subject interest
- f. The business interest's ownership control characteristics, if any, and its degree of marketability
- g. Valuation date
- h. Valuation report date
- i. Type of report issued (namely, a summary report) (paragraph .48)
- j. Applicable premise of value
- k. Applicable standard of value
- l. Sources of information used in the valuation engagement
- m. Assumptions and limiting conditions of the valuation engagement (paragraph .18)

- n.* The scope of work or data available for analysis including any restrictions or limitations (paragraph .19)
- o.* Any hypothetical conditions used in the valuation engagement, including the basis for their use (paragraph .22)
- p.* If the work of a specialist was used in the valuation (paragraph .20), a description of how the specialist's work was used, and the level of responsibility, if any, the valuation analyst is assuming for the specialist's work
- q.* The valuation approaches and methods used
- r.* Disclosure of subsequent events in certain circumstances (paragraph .43)
- s.* Any application of the jurisdictional exception (paragraph .10)
- t.* Representation of the valuation analyst (paragraph .65)
- u.* The report is signed in the name of the valuation analyst or the valuation analyst's firm
- v.* A section summarizing the reconciliation of the estimates and the conclusion of value as discussed in paragraphs .68 and .69
- w.* A statement that the valuation analyst has no obligation to update the report or the conclusion of value for information that comes to his or her attention after the date of the valuation report

**.72** Appendixes or exhibits may be used for required information (see paragraph .70) or information that supplements the summary report. Often, the assumptions, limiting conditions, and the valuation analyst's representation are provided in appendixes to the summary report.

## Calculation Report

**.73** As indicated in paragraph .48, a calculation report is the only report that should be used to report the results of a calculation engagement. The report should state that it is a calculation report. The calculation report should include the representation of the valuation analyst similar to that in paragraph .65, but adapted for a calculation engagement.

**.74** The calculation report should identify any hypothetical conditions used in the calculation engagement, including the basis for their use (paragraph .22), any application of the jurisdictional exception (paragraph .10), and any assumptions and limiting conditions applicable to the engagement (paragraph .18). If the valuation analyst used the work of a specialist (paragraph .20), the valuation analyst should describe in the calculation report how the specialist's work was used and the level of responsibility, if any, the valuation analyst is assuming for the specialist's work. The calculation report may also include a disclosure of subsequent events in certain circumstances (paragraph .43).

**.75** Appendixes or exhibits may be used for required information (paragraph .72) or information that supplements the calculation report. Often, the assumptions and limiting conditions and the valuation analyst's representation are provided in appendixes to the calculation report.

**.76** The calculation report should include a section summarizing the calculated value. This section should include the following (or similar) statements:

- a.* Certain calculation procedures were performed; include the identity of the subject interest and the calculation date.

- b. Describe the calculation procedures and the scope of work performed or reference the section(s) of the calculation report in which the calculation procedures and scope of work are described.
- c. Describe the purpose of the calculation procedures, including that the calculation procedures were performed solely for that purpose and that the resulting calculated value should not be used for any other purpose or by any other party for any purpose.
- d. The calculation engagement was conducted in accordance with the Statement on Standards for Valuation Services of the American Institute of Certified Public Accountants.
- e. A description of the business interest's characteristics, including whether the subject interest exhibits control characteristics, and a statement about the marketability of the subject interest.
- f. The estimate of value resulting from a calculation engagement is expressed as a calculated value.
- g. A general description of a calculation engagement is given, including that
  - i. a calculation engagement does not include all of the procedures required for a valuation engagement, and
  - ii. had a valuation engagement been performed, the results may have been different.
- h. The calculated value, either a single amount or a range, is described.
- i. The report is signed in the name of the valuation analyst or the valuation analyst's firm.
- j. The date of the valuation report is given.
- k. The valuation analyst has no obligation to update the report or the calculation of value for information that comes to his or her attention after the date of the report.

.77 The following is an example of report language that could be used, but is not required, in reporting a calculation engagement:

We have performed a *calculation engagement*, as that term is defined in the Statement on Standards for Valuation Services (SSVS) of the American Institute of Certified Public Accountants. We performed certain calculation procedures on [DEF Company, GHI business ownership interest of DEF Company, GHI security of DEF Company, or GHI intangible asset of DEF Company] as of [calculation date]. The specific calculation procedures are detailed in paragraphs [reference to paragraph numbers] of our calculation report. The calculation procedures were performed solely to assist in the matter of [purpose of valuation procedures], and the resulting calculation of value should not be used for any other purpose or by any other party for any purpose. This calculation engagement was conducted in accordance with the SSVS. The estimate of value that results from a calculation engagement is expressed as a calculated value.

In a calculation engagement, the valuation analyst and the client agree on the specific valuation approaches and valuation methods the valuation analyst will use and the extent of valuation procedures the valuation analyst will perform to estimate the value of the subject interest. A calculation engagement does not include all of the procedures required in a *valuation engagement*, as that term is defined in the SSVS. Had a valuation engagement been performed, the results might have been different.

Based on our calculations, as described in this report, which are based solely on the procedures agreed upon as previously referred to, the resulting calculated value of [DEF Company, GHI business ownership interest of DEF Company,

*GHI security of DEF Company, or GHI intangible asset of DEF Company] as of [valuation date] was [calculated value, either a single amount or a range]. This calculated value is subject to the Statement of Assumptions and Limiting Conditions found in [reference to applicable section of valuation report] and to the Valuation Analyst's Representation found in [reference to applicable section of valuation report]. We have no obligation to update this report or our calculation of value for information that comes to our attention after the date of this report.*

*[Signature]*

*[Date]*

## Oral Report

**.78** An oral report may be used in a valuation engagement or a calculation engagement. An oral report should include all information the valuation analyst believes necessary to relate the scope, assumptions, limitations, and the results of the engagement so as to limit any misunderstandings between the analyst and the recipient of the oral report. The member should document in the working papers the substance of the oral report communicated to the client.

## Effective Date

**.79** This statement applies to engagements to estimate value accepted on or after January 1, 2008. Earlier application is encouraged.

## Appendix A

### Illustrative List of Assumptions and Limiting Conditions for a Business Valuation

The valuation report or calculation report should include a list of assumptions and limiting conditions under which the engagement was performed. This appendix includes an illustrative list of assumptions and limiting conditions that may apply to a business valuation.

#### Illustrative List of Assumptions and Limiting Conditions

1. The conclusion of value (or the calculated value) arrived at herein is valid only for the stated purpose as of the date of the valuation.
2. Financial statements and other related information provided by [ABC Company] or its representatives, in the course of this engagement, have been accepted without any verification as fully and correctly reflecting the enterprise's business conditions and operating results for the respective periods, except as specifically noted herein. [Valuation Firm] has not audited, reviewed, or compiled the financial information provided to us and, accordingly, we express no audit opinion or any other form of assurance on this information.
3. Public information and industry and statistical information have been obtained from sources we believe to be reliable. However, we make no representation as to the accuracy or completeness of such information and have performed no procedures to corroborate the information.
4. We do not provide assurance on the achievability of the results forecasted by [ABC Company] because events and circumstances frequently do not occur as expected; differences between actual and expected results may be material; and achievement of the forecasted results is dependent on actions, plans, and assumptions of management.
5. The conclusion of value (or the calculated value) arrived at herein is based on the assumption that the current level of management expertise and effectiveness would continue to be maintained, and that the character and integrity of the enterprise through any sale, reorganization, exchange, or diminution of the owners' participation would not be materially or significantly changed.
6. This report and the conclusion of value (or the calculated value) arrived at herein are for the exclusive use of our client for the sole and specific purposes as noted herein. They may not be used for any other purpose or by any other party for any purpose. Furthermore the report and conclusion of value (or the calculated value) are not intended by the author and should not be construed by the reader to be investment advice in any manner whatsoever. The stated valuation represents the considered conclusion of value (or the calculated value) of [Valuation Firm], based on information furnished to them by [ABC Company] and other sources.
7. Neither all nor any part of the contents of this report (especially the conclusion of value [or the calculated value], the identity of any

valuation specialist(s), or the firm with which such valuation specialists are connected or any reference to any of their professional designations) should be disseminated to the public through advertising media, public relations, news media, sales media, mail, direct transmittal, or any other means of communication without the prior written consent and approval of [Valuation Firm].

8. Future services regarding the subject matter of this report, including, but not limited to testimony or attendance in court, shall not be required of [Valuation Firm] unless previous arrangements have been made in writing.
9. [Valuation Firm] is not an environmental consultant or auditor, and it takes no responsibility for any actual or potential environmental liabilities. Any person entitled to rely on this report, wishing to know whether such liabilities exist, or the scope and their effect on the value of the property, is encouraged to obtain a professional environmental assessment. [Valuation Firm] does not conduct or provide environmental assessments and has not performed one for the subject property.
10. [Valuation Firm] has not determined independently whether [ABC Company] is subject to any present or future liability relating to environmental matters (including, but not limited to CERCLA/Superfund liability) nor the scope of any such liabilities. [Valuation Firm]'s valuation takes no such liabilities into account, except as they have been reported to [Valuation Firm] by [ABC Company] or by an environmental consultant working for [ABC Company], and then only to the extent that the liability was reported to us in an actual or estimated dollar amount. Such matters, if any, are noted in the report. To the extent such information has been reported to us, [Valuation Firm] has relied on it without verification and offers no warranty or representation as to its accuracy or completeness.
11. [Valuation Firm] has not made a specific compliance survey or analysis of the subject property to determine whether it is subject to, or in compliance with, the American Disabilities Act of 1990, and this valuation does not consider the effect, if any, of noncompliance.
12. [Sample wording for use if the jurisdictional exception is invoked.] The conclusion of value (or the calculated value) in this report deviates from the Statement on Standards for Valuation Services as a result of published governmental, judicial, or accounting authority.
13. No change of any item in this report shall be made by anyone other than [Valuation Firm], and we shall have no responsibility for any such unauthorized change.
14. Unless otherwise stated, no effort has been made to determine the possible effect, if any, on the subject business due to future Federal, state, or local legislation, including any environmental or ecological matters or interpretations thereof.
15. If prospective financial information approved by management has been used in our work, we have not examined or compiled the prospective financial information and therefore, do not express an audit opinion or any other form of assurance on the prospective financial information or the related assumptions. Events and circumstances frequently do not occur as expected and there will

usually be differences between prospective financial information and actual results, and those differences may be material.

16. We have conducted interviews with the current management of [ABC Company] concerning the past, present, and prospective operating results of the company.
17. Except as noted, we have relied on the representations of the owners, management, and other third parties concerning the value and useful condition of all equipment, real estate, investments used in the business, and any other assets or liabilities, except as specifically stated to the contrary in this report. We have not attempted to confirm whether or not all assets of the business are free and clear of liens and encumbrances or that the entity has good title to all assets.

## Appendix B

### International Glossary of Business Valuation Terms\*

To enhance and sustain the quality of business valuations for the benefit of the profession and its clientele, the subsequently identified societies and organizations have adopted the definitions for the terms included in this glossary.

The performance of business valuation services requires a high degree of skill and imposes upon the valuation professional a duty to communicate the valuation process and conclusion in a manner that is clear and not misleading. This duty is advanced through the use of terms whose meanings are clearly established and consistently applied throughout the profession.

If, in the opinion of the business valuation professional, one or more of these terms needs to be used in a manner which materially departs from the enclosed definitions, it is recommended that the term be defined as used within that valuation engagement.

This glossary has been developed to provide guidance to business valuation practitioners by further memorializing the body of knowledge that constitutes the competent and careful determination of value and, more particularly, the communication of how that value was determined.

Departure from this glossary is not intended to provide a basis for civil liability and should not be presumed to create evidence that any duty has been breached.

**American Institute of Certified Public Accountants**

**American Society of Appraisers**

**Canadian Institute of Chartered Business Valuators**

**National Association of Certified Valuation Analysts**

**The Institute of Business Appraisers**

**Adjusted Book Value Method**—a method within the asset approach whereby all assets and liabilities (including off-balance sheet, intangible, and contingent) are adjusted to their fair market values. {NOTE: In Canada on a going concern basis}

**Adjusted Net Asset Method** —see **Adjusted Book Value Method**.

**Appraisal**—see **Valuation**.

**Appraisal Approach**—see **Valuation Approach**.

**Appraisal Date**—see **Valuation Date**.

**Appraisal Method**—see **Valuation Method**.

**Appraisal Procedure**—see **Valuation Procedure**.

**Arbitrage Pricing Theory**—a multivariate model for estimating the cost of equity capital, which incorporates several systematic risk factors.

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\* Reproduced verbatim from the International Glossary of Business Valuation Terms (the Glossary), which appears at [www.aicpa.org/InterestAreas/ForensicAndValuation/Membership/DownloadableDocuments/Intl%20Glossary%20of%20BV%20Terms.pdf](http://www.aicpa.org/InterestAreas/ForensicAndValuation/Membership/DownloadableDocuments/Intl%20Glossary%20of%20BV%20Terms.pdf). Note that the phrase, "we discourage the use of this term," that appears herein is also reproduced verbatim.

- Asset (Asset-Based) Approach**—a general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets net of liabilities.
- Beta**—a measure of systematic risk of a stock; the tendency of a stock's price to correlate with changes in a specific index.
- Blockage Discount**—an amount or percentage deducted from the current market price of a publicly traded stock to reflect the decrease in the per share value of a block of stock that is of a size that could not be sold in a reasonable period of time given normal trading volume.
- Book Value**—see **Net Book Value**.
- Business**—see **Business Enterprise**.
- Business Enterprise**—a commercial, industrial, service, or investment entity (or a combination thereof) pursuing an economic activity.
- Business Risk**—the degree of uncertainty of realizing expected future returns of the business resulting from factors other than financial leverage. See **Financial Risk**.
- Business Valuation**—the act or process of determining the value of a business enterprise or ownership interest therein.
- Capital Asset Pricing Model (CAPM)**—a model in which the cost of capital for any stock or portfolio of stocks equals a risk-free rate plus a risk premium that is proportionate to the systematic risk of the stock or portfolio.
- Capitalization**—a conversion of a single period of economic benefits into value.
- Capitalization Factor**—any multiple or divisor used to convert anticipated economic benefits of a single period into value.
- Capitalization of Earnings Method**—a method within the income approach whereby economic benefits for a representative single period are converted to value through division by a capitalization rate.
- Capitalization Rate**—any divisor (usually expressed as a percentage) used to convert anticipated economic benefits of a single period into value.
- Capital Structure**—the composition of the invested capital of a business enterprise; the mix of debt and equity financing.
- Cash Flow**—cash that is generated over a period of time by an asset, group of assets, or business enterprise. It may be used in a general sense to encompass various levels of specifically defined cash flows. When the term is used, it should be supplemented by a qualifier (for example, "discretionary" or "operating") and a specific definition in the given valuation context.
- Common Size Statements**—financial statements in which each line is expressed as a percentage of the total. On the balance sheet, each line item is shown as a percentage of total assets, and on the income statement, each item is expressed as a percentage of sales.
- Control**—the power to direct the management and policies of a business enterprise.
- Control Premium**—an amount or a percentage by which the pro rata value of a controlling interest exceeds the pro rata value of a non-controlling interest in a business enterprise to reflect the power of control.

**Cost Approach**—a general way of determining a value indication of an individual asset by quantifying the amount of money required to replace the future service capability of that asset.

**Cost of Capital**—the expected rate of return that the market requires in order to attract funds to a particular investment.

**Debt-Free**—*we discourage the use of this term.* See **Invested Capital**.

**Discount for Lack of Control**—an amount or percentage deducted from the pro rata share of value of 100% of an equity interest in a business to reflect the absence of some or all of the powers of control.

**Discount for Lack of Marketability**—an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability.

**Discount for Lack of Voting Rights**—an amount or percentage deducted from the per share value of a minority interest voting share to reflect the absence of voting rights.

**Discount Rate**—a rate of return used to convert a future monetary sum into present value.

**Discounted Cash Flow Method**—a method within the income approach whereby the present value of future expected net cash flows is calculated using a discount rate.

**Discounted Future Earnings Method**—a method within the income approach whereby the present value of future expected economic benefits is calculated using a discount rate.

**Economic Benefits**—inflows such as revenues, net income, net cash flows, etc.

**Economic Life**—the period of time over which property may generate economic benefits.

**Effective Date**—see **Valuation Date**.

**Enterprise**—see **Business Enterprise**.

**Equity**—the owner's interest in property after deduction of all liabilities.

**Equity Net Cash Flows**—those cash flows available to pay out to equity holders (in the form of dividends) after funding operations of the business enterprise, making necessary capital investments, and increasing or decreasing debt financing.

**Equity Risk Premium**—a rate of return added to a risk-free rate to reflect the additional risk of equity instruments over risk free instruments (a component of the cost of equity capital or equity discount rate).

**Excess Earnings**—that amount of anticipated economic benefits that exceeds an appropriate rate of return on the value of a selected asset base (often net tangible assets) used to generate those anticipated economic benefits.

**Excess Earnings Method**—a specific way of determining a value indication of a business, business ownership interest, or security determined as the sum of a) the value of the assets derived by capitalizing excess earnings and b) the value of the selected asset base. Also frequently used to value intangible assets. See **Excess Earnings**.

**Fair Market Value**—the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and

able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts. {NOTE: In Canada, the term "price" should be replaced with the term "highest price."}

**Fairness Opinion**—an opinion as to whether or not the consideration in a transaction is fair from a financial point of view.

**Financial Risk**—the degree of uncertainty of realizing expected future returns of the business resulting from financial leverage. See **Business Risk**.

**Forced Liquidation Value**—liquidation value, at which the asset or assets are sold as quickly as possible, such as at an auction.

**Free Cash Flow**—*we discourage the use of this term*. See **Net Cash Flow**.

**Going Concern**—an ongoing operating business enterprise.

**Going Concern Value**—the value of a business enterprise that is expected to continue to operate into the future. The intangible elements of Going Concern Value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place.

**Goodwill**—that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified.

**Goodwill Value**—the value attributable to goodwill.

**Guideline Public Company Method**—a method within the market approach whereby market multiples are derived from market prices of stocks of companies that are engaged in the same or similar lines of business and that are actively traded on a free and open market.

**Income (Income-Based) Approach**—a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount.

**Intangible Assets**—nonphysical assets such as franchises, trademarks, patents, copyrights, goodwill, equities, mineral rights, securities, and contracts (as distinguished from physical assets) that grant rights and privileges and have value for the owner.

**Internal Rate of Return**—a discount rate at which the present value of the future cash flows of the investment equals the cost of the investment.

**Intrinsic Value**—the value that an investor considers, on the basis of an evaluation or available facts, to be the "true" or "real" value that will become the market value when other investors reach the same conclusion. When the term applies to options, it is the difference between the exercise price and strike price of an option and the market value of the underlying security.

**Invested Capital**—the sum of equity and debt in a business enterprise. Debt is typically (a) all interest-bearing debt or (b) long-term, interest-bearing debt. When the term is used, it should be supplemented by a specific definition in the given valuation context.

**Invested Capital Net Cash Flows**—those cash flows available to pay out to equity holders (in the form of dividends) and debt investors (in the form of

principal and interest) after funding operations of the business enterprise and making necessary capital investments.

**Investment Risk**—the degree of uncertainty as to the realization of expected returns.

**Investment Value**—the value to a particular investor based on individual investment requirements and expectations. {NOTE: in Canada, the term used is "*Value to the Owner*."}

**Key Person Discount**—an amount or percentage deducted from the value of an ownership interest to reflect the reduction in value resulting from the actual or potential loss of a key person in a business enterprise.

**Levered Beta**—the beta reflecting a capital structure that includes debt.

**Limited Appraisal**—the act or process of determining the value of a business, business ownership interest, security, or intangible asset with limitations in analyses, procedures, or scope.

**Liquidity**—the ability to quickly convert property to cash or pay a liability.

**Liquidation Value**—the net amount that would be realized if the business is terminated and the assets are sold piecemeal. Liquidation can be either "orderly" or "forced."

**Majority Control**—the degree of control provided by a majority position.

**Majority Interest**—an ownership interest greater than 50% of the voting interest in a business enterprise.

**Market (Market-Based) Approach**—a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold.

**Market Capitalization of Equity**—the share price of a publicly traded stock multiplied by the number of shares outstanding.

**Market Capitalization of Invested Capital**—the market capitalization of equity plus the market value of the debt component of invested capital.

**Market Multiple**—the market value of a company's stock or invested capital divided by a company measure (such as economic benefits, number of customers).

**Marketability**—the ability to quickly convert property to cash at minimal cost.

**Marketability Discount**—see **Discount for Lack of Marketability**.

**Merger and Acquisition Method**—a method within the market approach whereby pricing multiples are derived from transactions of significant interests in companies engaged in the same or similar lines of business.

**Mid-Year Discounting**—a convention used in the Discounted Future Earnings Method that reflects economic benefits being generated at midyear, approximating the effect of economic benefits being generated evenly throughout the year.

**Minority Discount**—a discount for lack of control applicable to a minority interest.

**Minority Interest**—an ownership interest less than 50% of the voting interest in a business enterprise.

**Multiple**—the inverse of the capitalization rate.

**Net Book Value**—with respect to a business enterprise, the difference between total assets (net of accumulated depreciation, depletion, and amortization) and total liabilities as they appear on the balance sheet (synonymous with Shareholder's Equity). With respect to a specific asset, the capitalized cost less accumulated amortization or depreciation as it appears on the books of account of the business enterprise.

**Net Cash Flows**—when the term is used, it should be supplemented by a qualifier. See **Equity Net Cash Flows** and **Invested Capital Net Cash Flows**.

**Net Present Value**—the value, as of a specified date, of future cash inflows less all cash outflows (including the cost of investment) calculated using an appropriate discount rate.

**Net Tangible Asset Value**—the value of the business enterprise's tangible assets (excluding excess assets and nonoperating assets) minus the value of its liabilities.

**Nonoperating Assets**—assets not necessary to ongoing operations of the business enterprise. {NOTE: in Canada, the term used is "Redundant Assets."}

**Normalized Earnings**—economic benefits adjusted for nonrecurring, noneconomic, or other unusual items to eliminate anomalies and/or facilitate comparisons.

**Normalized Financial Statements**—financial statements adjusted for nonoperating assets and liabilities and/or for nonrecurring, noneconomic, or other unusual items to eliminate anomalies and/or facilitate comparisons.

**Orderly Liquidation Value**—liquidation value at which the asset or assets are sold over a reasonable period of time to maximize proceeds received.

**Premise of Value**—an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation; for example, going concern, liquidation.

**Present Value**—the value, as of a specified date, of future economic benefits and/or proceeds from sale, calculated using an appropriate discount rate.

**Portfolio Discount**—an amount or percentage deducted from the value of a business enterprise to reflect the fact that it owns dissimilar operations or assets that do not fit well together.

**Price/Earnings Multiple**—the price of a share of stock divided by its earnings per share.

**Rate of Return**—an amount of income (loss) and/or change in value realized or anticipated on an investment, expressed as a percentage of that investment.

**Redundant Assets**—see **Nonoperating Assets**.

**Report Date**—the date conclusions are transmitted to the client.

**Replacement Cost New**—the current cost of a similar new property having the nearest equivalent utility to the property being valued.

**Reproduction Cost New**—the current cost of an identical new property.

**Required Rate of Return**—the minimum rate of return acceptable by investors before they will commit money to an investment at a given level of risk.

**Residual Value**—the value as of the end of the discrete projection period in a discounted future earnings model.

**Return on Equity**—the amount, expressed as a percentage, earned on a company's common equity for a given period.

**Return on Investment**—See **Return on Invested Capital** and **Return on Equity**.

**Return on Invested Capital**—the amount, expressed as a percentage, earned on a company's total capital for a given period.

**Risk-Free Rate**—the rate of return available in the market on an investment free of default risk.

**Risk Premium**—a rate of return added to a risk-free rate to reflect risk.

**Rule of Thumb**—a mathematical formula developed from the relationship between price and certain variables based on experience, observation, hearsay, or a combination of these; usually industry specific.

**Special Interest Purchasers**—acquirers who believe they can enjoy post-acquisition economies of scale, synergies, or strategic advantages by combining the acquired business interest with their own.

**Standard of Value**—the identification of the type of value being utilized in a specific engagement; for example, fair market value, fair value, investment value.

**Sustaining Capital Reinvestment**—the periodic capital outlay required to maintain operations at existing levels, net of the tax shield available from such outlays.

**Systematic Risk**—the risk that is common to all risky securities and cannot be eliminated through diversification. The measure of systematic risk in stocks is the beta coefficient.

**Tangible Assets**—physical assets (such as cash, accounts receivable, inventory, property, plant and equipment, etc.).

**Terminal Value**—See **Residual Value**.

**Transaction Method**—See **Merger and Acquisition Method**.

**Unlevered Beta**—the beta reflecting a capital structure without debt.

**Unsystematic Risk**—the risk specific to an individual security that can be avoided through diversification.

**Valuation**—the act or process of determining the value of a business, business ownership interest, security, or intangible asset.

**Valuation Approach**—a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more valuation methods.

**Valuation Date**—the specific point in time as of which the valuator's opinion of value applies (also referred to as "Effective Date" or "Appraisal Date").

**Valuation Method**—within approaches, a specific way to determine value.

**Valuation Procedure**—the act, manner, and technique of performing the steps of an appraisal method.

**Valuation Ratio**—a fraction in which a value or price serves as the numerator and financial, operating, or physical data serve as the denominator.

**Value to the Owner**—see **Investment Value**.

**Voting Control**—*de jure* control of a business enterprise.

**Weighted Average Cost of Capital (WACC)**—the cost of capital (discount rate) determined by the weighted average, at market value, of the cost of all financing sources in the business enterprise's capital structure.

## Appendix C

### Glossary of Additional Terms

**assumptions and limiting conditions.** Parameters and boundaries under which a valuation is performed, as agreed upon by the valuation analyst and the client or as acknowledged or understood by the valuation analyst and the client as being due to existing circumstances. An example is the acceptance, without further verification, by the valuation analyst from the client of the client's financial statements and related information.

**business ownership interest.** A designated share in the ownership of a business (business enterprise).

**calculated value.** An estimate as to the value of a business, business ownership interest, security, or intangible asset, arrived at by applying valuation procedures agreed upon with the client and using professional judgment as to the value or range of values based on those procedures.

**calculation engagement.** An engagement to estimate value wherein the valuation analyst and the client agree on the specific valuation approaches and valuation methods that the valuation analyst will use and the extent of valuation procedures the valuation analyst will perform to estimate the value of a subject interest. A calculation engagement generally does not include all of the valuation procedures required for a valuation engagement. If a valuation engagement had been performed, the results might have been different. The valuation analyst expresses the results of the calculation engagement as a calculated value, which may be either a single amount or a range.

**capital or contributory asset charge.** A fair return on an entity's *contributory assets*, which are tangible and intangible assets used in the production of income or cash flow associated with an intangible asset being valued. In this context, *income or cash flow* refers to an applicable measure of income or cash flow, such as net income, or operating cash flow before taxes and capital expenditures. A capital charge may be expressed as a percentage return on an economic rent associated with, or a profit split related to, the contributory assets.

**capitalization of benefits method.** A method within the income approach whereby expected future benefits (for example, earnings or cash flow) for a representative single period are converted to value through division by a capitalization rate.

**comparable profits method.** A method of determining the value of intangible assets by comparing the profits of the subject entity with those of similar uncontrolled companies that have the same or similar complement of intangible assets as the subject company.

**comparable uncontrolled transaction method.** A method of determining the value of intangible assets by comparing the subject transaction to similar transactions in the market place made between independent (uncontrolled) parties.

**conclusion of value.** An estimate of the value of a business, business ownership interest, security, or intangible asset, arrived at by applying the valuation procedures appropriate for a valuation engagement and using

professional judgment as to the value or range of values based on those procedures.

**control adjustment.** A valuation adjustment to financial statements to reflect the effect of a controlling interest in a business. An example would be an adjustment to owners' compensation that is in excess of market compensation.

**engagement to estimate value.** An engagement, or any part of an engagement (for example, a tax, litigation, or acquisition-related engagement), that involves determining the value of a business, business ownership interest, security, or intangible asset. Also known as *valuation service*.

**excess operating assets.** Operating assets in excess of those needed for the normal operation of a business.

**fair value.** In valuation applications, there are two commonly used definitions for fair value:

- (1) For financial reporting purposes only, 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. *Source:* Financial Accounting Standards Board *Accounting Standards Codification* glossary.
- (2) For state legal matters only, some states have laws that use the term *fair value* in shareholder and partner matters. For state legal matters only, therefore, the term may be defined by statute or case law in the particular jurisdiction.

**guideline company transactions method.** A method within the market approach whereby market multiples are derived from the sales of entire companies engaged in the same or similar lines of business.

**hypothetical condition.** That which is or may be contrary to what exists, but is supposed for the purpose of analysis.

**incremental income.** Additional income or cash flow attributable to an entity's ownership or operation of an intangible asset being valued, as determined by a comparison of the entity's income or cash flow with the intangible asset to the entity's income or cash flow without the intangible asset. In this context, *income or cash flow* refers to an applicable measure of income or cash flow, such as license royalty income or operating cash flow before taxes and capital expenditures.

**normalization.** See *Normalized Earnings* in appendix B, "International Glossary of Business Valuation Terms." (see paragraph .81).

**pre-adjustment value.** The value arrived at prior to the application, if appropriate, of valuation discounts or premiums.

**profit split income.** With respect to the valuation of an intangible asset of an entity, a percentage allocation of the entity's income or cash flow whereby (1) a split (or percentage) is allocated to the subject intangible and (2) the remainder is allocated to all of the entity's tangible and other intangible assets. In this context, *income or cash flow* refers to an applicable measure of income or cash flow, such as net income or operating cash flow before taxes and capital expenditures.

**relief from royalty method.** A valuation method used to value certain intangible assets (for example, trademarks and trade names) based on the premise that the only value that a purchaser of the assets receives is the

exemption from paying a royalty for its use. Application of this method usually involves estimating the fair market value of an intangible asset by quantifying the present value of the stream of market-derived royalty payments that the owner of the intangible asset is exempted from or "relieved" from paying.

**residual income.** For an entity that owns or operates an intangible asset being valued, the portion of the entity's income or cash flow remaining after subtracting a capital charge on all of the entity's tangible and other intangible assets. *Income or cash flows* can refer to any appropriate measure of income or cash flow, such as net income or operating cash flow before taxes and capital expenditures.

**security.** A certificate evidencing ownership or the rights to ownership in a business enterprise that (1) is represented by an instrument or by a book record or contractual agreement, (2) is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment, and (3) either one of a class or series or, by its terms, is divisible into a class or series of shares, participations, interests, rights, or interest-bearing obligations.

**subject interest.** A business, business ownership interest, security, or intangible asset that is the subject of a valuation engagement.

**subsequent event.** An event that occurs subsequent to the valuation date.

**valuation analyst.** For purposes of this statement, an AICPA member who performs an engagement to estimate value that culminates in the expression of a conclusion of value or a calculated value.

**valuation assumptions.** Statements or inputs utilized in the performance of an engagement to estimate value that serve as a basis for the application of particular valuation methods.

**valuation engagement.** An engagement to estimate value in which a valuation analyst determines an estimate of the value of a subject interest by performing appropriate valuation procedures, as outlined in the AICPA Statement on Standards for Valuation Services, and is free to apply the valuation approaches and methods he or she deems appropriate in the circumstances. The valuation analyst expresses the results of the valuation engagement as a conclusion of value, which may be either a single amount or a range.

**valuation service.** See **engagement to estimate value.**

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, January 2015, to reflect the revised Code of Professional Conduct.]

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## VS Section 9100

# ***Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset: Valuation Services Interpretations of Section 100***

### 1. Scope of Applicable Services

#### Background

.01 The Statement on Standards for Valuation Services (SSVS) No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* [VS section 100] establishes standards of performance and reporting for all AICPA members performing those valuation services that are within the scope of the Statement. When originally proposed on March 30, 2005, the Exposure Draft contained a list of questions and answers (Appendix A of the March 30, 2005 Exposure Draft) that were intended to assist members in determining if an engagement, particularly with regard to litigation or tax engagements, fell within the scope of the Statement. Through the Exposure Draft process, it was determined that the questions and answers were an integral part of the Statement and should be made authoritative. This Interpretation is part of the AICPA's continuing efforts at self-regulation of its members in valuation practice, and its desire to provide guidance to members when providing valuation services. The Interpretation does not change or elevate any level of conduct prescribed by any standard. Its goal is to clarify existing standards.

#### General Interpretation

.02 The SSVSs apply to an engagement to estimate value if, as all or as part of another engagement, a member determines the value of a business, business ownership interest, security, or intangible asset (SSVS No. 1, paragraphs 1 and 2 [VS section 100.01–.02]). In the process of estimating value, professional judgment is used to apply valuation approaches and valuation methods as described in the SSVS No. 1, paragraph 4 [VS section 100.04].

.03 In determining whether a particular service falls within the scope of the Statement, a member should consider those services that are specifically excluded:

- Audit, review, and compilation engagements (SSVS No. 1, paragraph 5 [VS section 100.05])
- Use of values provided by the client or a third party (SSVS No. 1, paragraph 6 [VS section 100.06])
- Internal use assignments from employers to employee members not in the *practice of public accounting* (SSVS No. 1, paragraph 7 [VS section 100.07])
- Engagements that are exclusively for the purpose of determining economic damages (for example, lost profits) and that do not include an

engagement to estimate value (SSVS No. 1, paragraph 8 [VS section 100.08])

- Mechanical computations that do not rise to the level of an engagement to estimate value (SSVS No. 1, paragraph 9(a) [VS section 100.09a])
- Engagements where it is not practical or reasonable to obtain or use relevant information and, therefore, the member is unable to apply valuation approaches and methods described in this Statement. (SSVS No. 1, paragraph 9(b) [VS section 100.09b])
- Engagements meeting the jurisdictional exception (SSVS No. 1, paragraph 10 [VS section 100.10])

**.04** A member should be diligent in determining if an engagement falls within the scope of the Statement. Unless specifically excluded by the SSVS, if the engagement requires a member to apply valuation approaches and methods, and use professional judgment in applying those approaches and methods, the SSVS would apply. In determining the scope and requirements of the engagement, a member should consider the clients needs, or the requirements of a third party for which the valuation is intended, including governmental, judicial, and accounting authorities. In addition, a member should consider other professional standards that might apply.

### Specific Illustrations

**.05** The following illustrations address general fact patterns. Accordingly, the application of the guidance discussed in the "General Interpretation" section to variations in general facts, or to particular facts and circumstances, may lead to different conclusions. In each illustration, there is no authority other than that indicated.

### Illustrations Relating to Litigation Engagements and Certain Controversy Proceedings

**.06** *Illustration 1.* Do lost profits damage computations fall within the scope of the Statement?

**.07** *Conclusion.* No, unless the computations are undertaken as part of an engagement to estimate value (SSVS No. 1, paragraphs 1, 2, and 8 [VS section 100.01, .02, and .08]).

**.08** *Illustration 2.* Is an economic damages computation that incorporates a terminal value within the scope of the Statement?

**.09** *Conclusion.* The use of a terminal value exclusively for the determination of lost profits is not within the scope of this statement unless that determination will be used as part of an engagement to estimate value (*Illustration 1*).

**.10** *Illustration 3.* If a start-up business is destroyed, is the economic damages computation within the scope of the Statement?

**.11** *Conclusion.* There are two common measures of damages: lost profits and loss of value. If a valuation analyst performs an engagement to estimate value to determine the loss of value of a business or intangible asset, the Statement applies. Otherwise, the Statement does not apply (*Illustration 1*). In order to determine whether the Statement applies, a member acting as an expert witness should evaluate whether the particular damages calculation constitutes an engagement to estimate value with respect to the business, business interest, security, or intangible asset or whether it constitutes a lost-profits computation.

**.12 Illustration 4.** Does the Statement include any exceptions relating to litigation or controversy proceedings?

**.13 Conclusion.** Yes, the Statement includes a reporting exemption for certain controversy proceedings (SSVS No. 1, paragraph 50 [VS section 100.50]); however, there is no litigation or controversy proceeding exemption from the developmental provisions of the Statement (SSVS No. 1, paragraphs 21–46 [VS section 100.21–.46]) in circumstances in which an engagement to estimate value is performed (*Illustration 1*).

**.14 Illustration 5.** Is the Statements reporting exemption for litigation or controversy proceedings (see SSVS No. 1, paragraph 50 [VS section 100.50]) the same as the "litigation exemption" in the AICPA attestation standards?

**.15 Conclusion.** No, the so-called "litigation exemption" is provided for in the AICPA attestation standards and is further discussed in the attestation interpretations. The attestation standards do not apply to engagements in which a practitioner is engaged to testify as an expert witness in accounting, auditing, taxation, or other matters, given certain stipulated facts. This is clarified in the attestation interpretation, which states, in part, that the attestation standards do not apply to litigation services engagements when (among other requirements) the practitioner "has not been engaged to issue and does not issue an examination, a review, or an agreed-upon procedures report on the subject matter, or an assertion about the subject matter that is the responsibility of another party." (Interpretation No. 3, "Applicability of Attestation Standards to Litigation Services," of Chapter 1, "Attest Engagements," of Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification*, as revised [AT section 9101.34–.42]. However, unlike the AICPA attestation standards, which do not apply in any capacity to litigation or controversy proceeding situations, as discussed above, the Statements exemption for litigation or certain controversy proceedings is an exemption from the reporting provisions of the Statement (SSVS No. 1, paragraphs 47–78 [VS section 100.47–.78]).

## Illustrations Relating to Tax Engagements

**.16 Illustration 6.** When does the Statement apply to members who determine values related to tax reporting and planning engagements?

**.17 Conclusion.** The Statement applies when the member is engaged to estimate the value of a business, business ownership interest, security, or intangible asset (SSVS No. 1, paragraph 1 [VS section 100.01]). The application of valuation approaches and methods and the use of professional judgment (SSVS No. 1, paragraph 4 [VS section 100.04]) are required, unless an exception applies (SSVS No. 1, paragraphs 5–10 [VS section 100.05–.10]).

**.18 Illustration 7.** If the sole purpose of an engagement is reporting a value in a tax return and the Statement applies to this engagement, are any separate reports (specifically, valuation reports) required to be issued? To whom are those reports required to be provided? Is a report required to be attached to the tax return? Are any specific disclosures required?

**.19 Conclusion.** The Statement requires the preparation of a written or oral valuation report (SSVS No. 1, paragraphs 47–78 [VS section 100.47–.78]) that is communicated to the client (SSVS No. 1, paragraph 47 [VS section 100.47]) but does not require that any report be attached to the tax return or mandate any other tax-specific disclosures. In limited circumstances, a taxing authority may require its own report, which would obviate the need for a separate valuation report (SSVS No. 1, paragraph 10 [VS section 100.10] and *Illustration 18*).

There is also a reporting exemption for certain controversy proceedings (SSVS No. 1, paragraph 50 [VS section 100.50] and *Illustration 4*).

**.20 *Illustration 8.*** Are mechanical computations of value, for example, computations using actuarial tables, excluded from the Statement?

**.21 *Conclusion.*** Mechanical computations of value are excluded from the Statement if they do not rise to the level of an engagement to estimate value, that is, if the member does not apply valuation approaches and methods, and does not use professional judgment, as described in the Statement (SSVS No. 1, paragraph 9(a) [VS section 100.09a]).

**.22** Examples of services that do **not** rise to the level of an engagement to estimate value include: (a) computations of a remainder interest under a grantor retained annuity trust (GRAT) using actuarial tables; (b) determining the value of relatively small blocks (relative to the total amount of corporate stock outstanding) of publicly traded stock whose per share price is readily ascertainable; (c) preparing a tax return using the valuation of a business that was provided by a third-party appraiser, or by the client (SSVS No. 1, paragraph, [VS section 100.06]); and (d) calculating cash "hold back" requirements for tax contingencies (SSVS No. 1, paragraphs 4 and 9(a) [VS section 100.01, .04, and .09a]).

**.23** Examples of services that rise to the level of an engagement to estimate value include: (a) valuing a block of publicly traded stock, if the analysis includes consideration of a discount for blockage, lock-up, or other contractual or market restrictions such that valuation approaches and methods are applied, and professional judgment is used to determine the fair value, fair market value, or other applicable standard of value; (b) valuing stock that is not publicly traded; and (c) computing the fair market value of assets in a charitable remainder trust (CRT), if the engagement requires the application of valuation approaches and methods, and the use of professional judgment to estimate the fair market value.

**.24 *Illustration 9.*** Does the "jurisdictional exception" (SSVS No. 1, paragraph 10 [VS section 100.10]) provide that an engagement to estimate value is not subject to the Statement if a member determines and reports values using procedures mandated or allowed by the Internal Revenue Code (IRC), Internal Revenue Service (IRS) regulations, court cases, or other published guidance and other sources of federal, state, and local law solely for purposes of tax return preparation and other tax services using these methods?

**.25 *Conclusion.*** No, the "jurisdictional exception" would not exempt the engagement from this Statement, even if the engagements sole purpose was to value a subject interest (SSVS No. 1, paragraph 1 [VS section 100.01]) for tax reporting purposes. Only the portion of the Statement that differs from the published governmental or judicial authority is superseded for purposes of the engagement. The remainder of the Statement applies to the engagement.

**.26 *Illustration 10.*** Is an interest in a publicly traded partnership whose shares are frequently traded considered a "security" under the Statement? Is an interest in a family limited partnership (FLP), or in another nontraded partnership, considered a "security" under the Statement?

**.27 *Conclusion.*** Whether interest constitutes a "security" is a legal determination. However, where the value of a security is readily ascertainable, a valuation analyst does not need to apply valuation approaches and methods and use professional judgment. Accordingly, the valuation of such an interest would not be subject to the Statement (SSVS No. 1, paragraphs 1 and 9(a) [VS section 100.01 and .09a]). An interest in a nonpublicly traded partnership, such

as an FLP, whether considered a security or not, is a business ownership interest. The valuation of such nonpublicly traded interest requires the application of valuation approaches and methods and the use of professional judgment, and, accordingly, would be subject to the Statement (SSVS No. 1, paragraphs 1, 4, [VS section 100.01 and .04], and *Illustration 6*), unless the exception under SSVS No. 1, paragraph 9(b) [VS section 100.09b] applies (*Illustration 13e*). If the engagement requires the valuation analyst to consider and apply adjustments, for example, valuation discounts or premiums, then the engagement would be subject to the Statement.

**.28 *Illustration 11.*** A client engages a member to provide advice for planning purposes (such as estate planning, personal financial planning, or merger and acquisitions planning). The client holds an ownership interest in a family business being operated as a limited liability company, an interest in a private real estate limited partnership, publicly traded stock, a personal residence, and a retirement account (not an IRA). Is this a valuation engagement subject to the Statement?

**.29 *Conclusion.*** It depends. Providing technical advice, without reference to values for the various assets, is not subject to the Statement. However, if a member calculates a value to illustrate various planning options, he or she may fall under the Statement with regard to various assets. If one or more of the assets for which value is to be determined for purposes of the plan illustrations is a business, business ownership interest, security, or intangible asset, and the client or a third party does not provide the values for these assets, or the member does not use assumed or hypothetical values as part of the overall engagement, the member performing the valuation(s) is subject to the Statement with regard to these assets (SSVS No. 1, paragraph 1, [VS section 100.01] and *Illustration 6*). In this example, if the member applies valuation approaches and methods and uses professional judgment to determine the value of the ownership interest in the family business or the interest in the private real estate limited partnership in order to provide planning advice, the Statement would apply. In contrast, if the client or a third party provides the values for these assets, or the member uses assumed or hypothetical values, the Statement would not apply because the member would not be applying valuation approaches and methods and using professional judgment. In addition, the exception under SSVS No. 1, paragraph 9(b), [VS section 100.09b], where it is not practical or reasonable to obtain or use relevant information, could apply (see *Illustration 13e*). The computation of the "estimated estate tax" or other taxes once the values have been determined, assumed, or provided is not subject to the Statement, as the computation is a tax computation but would be subject to the Statements on Standards for Tax Services [TS sections 100–900] (*Illustration 10* at paragraph .27 of this Interpretation).

**.30 *Illustration 12.*** There are many instances where a tax engagement involves the need for a member to estimate value. The estimation of value may not be the primary purpose of the engagement, but rather a necessary task to perform or item to consider, when making a tax determination concerning the reporting of a transaction on a tax return. Consider the following practice situations:

**.31 *Illustration 12a.*** A member has been engaged to determine the deductibility of interest on a nonrecourse loan. Under applicable regulations, interest on a nonrecourse loan cannot be deducted if it is clear that the company will be unable to service the debt. For purposes of tax reporting, a conclusion must be reached concerning the ability of the company to service the debt. Is this considered a valuation engagement subject to the Statement?

**.32 Conclusion.** This is not a valuation engagement covered by the Statement because it is not the valuation of a subject interest (SSVS No. 1, paragraph 1 [VS section 100.01]). This example is a debt-service analysis.

**.33 Illustration 12b.** There are compliance filings that require an estimate of the value of a company. For example, the "market value" of "intangible personal property," as defined by a states taxing authority may need to be reported annually on an intangible personal property tax return. A client has a subject interest that is considered intangible personal property for purposes of the return. The member has been engaged to prepare the tax return. Is this a valuation engagement subject to the Statement?

**.34 Conclusion.** It depends. If the state requires an estimation of the value of a subject interest, and the estimation of value requires the application of valuation approaches and methods and the use of professional judgment (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04]), the Statement applies. If, however, the client or a third-party appraiser provides the value of the subject interest to the member, the Statement does not apply (SSVS No. 1, paragraphs 1 and 6 [VS section 100.01 and .06]). In addition, the exception under SSVS No. 1, paragraph 9(b) [VS section 100.09b], where it is not practical or reasonable to obtain or use relevant information, could apply (*Illustration 13e*). Alternatively, if the state follows more informal rules where the application of valuation approaches or valuation methods are not necessary, the Statement does not apply (SSVS No. 1, paragraph 4 [VS section 100.04]).

**.35 Illustration 12c.** There are times when a member must allocate value among various assets. For example, IRC sections 1060 and 338 require the allocation to assets, based on relative values, of consideration paid. In partnership taxation, there may be allocations under IRC sections 754, 743, and 734 and special tax basis adjustments for partnerships (sales or exchanges and transfers at or upon death) may require an allocation of value among various partnership assets. Are these types of allocations engagements to estimate value subject to the Statement?

**.36 Conclusion.** It depends. If one or more of the assets to which value is to be allocated is a subject interest (that is, a business, business ownership interest, security, or intangible asset), and the client or a third party did not provide the member with a value for those assets, then the member performing the allocation would be subject to the Statement, and the member is required to apply valuation approaches and methods, and use professional judgment to value those assets (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04], and *Illustration 6*), unless an exception applies (SSVS No. 1, paragraphs 5–10 [VS section 100.05–.10]). For example, in an IRC section 1060 allocation, after the allocation of purchase price to cash, receivables, inventory, and depreciable tangible assets, there is a residual amount of value allocable to goodwill or going concern. The mechanical assignment of the residual amount to goodwill or going concern is not subject to the Statement. However, if the member allocates this residual amount to specific intangible assets (such as to various customer-based and supplier-based intangibles), such allocation is based on the assets relative values. Because the member applies valuation approaches and methods and uses professional judgment to value those specific intangible assets, the Statement applies.

**.37 Illustration 12d.** If the member does not apply any discount and simply computes the fair market value of an interest in a family limited partnership (FLP) for tax purposes, is this a valuation engagement subject to the Statement?

**.38 Conclusion.** Yes, the Statement applies if the member determines the value of the FLP or an interest in an FLP. The application of valuation

approaches and methods, and the use of professional judgment are required, unless an exception applies (SSVS No. 1, paragraphs 5–10 [VS section 100.05–.10]). The fact that the member does not apply a discount does not exempt the engagement from the Statement (SSVS No. 1, paragraphs 1–4 and 9(a) [VS section 100.01–.04 and .09a]).

**.39 Illustration 12e.** Would the Statement apply to the computation of the fair market value of assets in, or the computation of the required distribution of, a charitable remainder trust (CRT)?

**.40 Conclusion.** It depends on the underlying assets held by the CRT. The Statement would apply only if the member determines the value of a business, business ownership interest, security, or intangible asset (SSVS No. 1, paragraph 1 [VS section 100.01]). To the extent that the CRT holds assets that, to be valued, require the application of valuation approaches and methods, and the use of professional judgment, such as an interest in a limited liability corporation (LLC), the Statement would apply. However, if the CRT only holds publicly traded stock with a readily ascertainable value, the Statement would not apply because valuation approaches and methods and professional judgment would not be needed in the computation (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04], and *Illustration 6*).

**.41 Illustration 12f.** In circumstances in which the value of assets contributed by partners to a partnership differ from their cost basis, each difference must be tracked for tax purposes under IRC section 704(c) so that amounts of gain or loss can be properly assigned to the contributing partners. Are these types of asset value assignments valuation engagements subject to the Statement?

**.42 Conclusion.** It depends. If one or more of the assets for which value is relevant under IRC section 704(c) is a subject interest that is, a business, business ownership interest, security, or intangible asset, and the client or a third party does not provide the valuation, and the member applies valuation approaches and methods and uses professional judgment to value these assets for IRC section 704(c) tax purposes, then the Statement applies (SSVS No. 1, paragraphs 1 and 6 [VS section 100.01 and .06], and *Illustration 6*).

**.43 Illustration 12g.** A member has been engaged to perform a cost segregation study. The study involves an analysis of the costs of building a structure and the allocation of such costs to the real and personal property components of the structure so that depreciation of those components may be properly computed. Is this a valuation engagement subject to the Statement?

**.44 Conclusion.** No, none of the assets constitutes a subject interest (SSVS No. 1, paragraph 1 [VS section 100.01]).

**.45 Illustration 12h.** A member has been engaged to provide advice to a company regarding the tax planning for income from discharge of indebtedness under IRC section 108. The company has advised the member that the company will be able to negotiate a settlement in complete satisfaction of an obligation at 30 cents on the dollar. Is this a valuation engagement subject to the Statement?

**.46 Conclusion.** It depends. Under IRC section 108(a), gross income of the company excludes income from discharge of indebtedness only under certain circumstances. One of those circumstances is the insolvency of the company. Under IRC section 108(d) (3), insolvency results from an excess of liabilities over the fair market value of assets. If (a) the company must rely on the insolvency provisions of IRC section 108; (b) one or more of the assets for which value is relevant under IRC section 108 is a subject interest (that is, a business, business ownership interest, security, or intangible asset); (c) the company or a third

party does not provide the valuation; and (d) the member applies valuation approaches and methods, and uses professional judgment to value the subject interest(s) for purposes of the IRC section 108(d)(3) insolvency determination, the Statement applies.

**.47 Illustration 13.** An executor has engaged a member to prepare an estate tax return, which requires determining values for the following estate assets: (a) shares in a publicly traded company, "TI Corporation," whose shares are infrequently traded; (b) a large block of stock in "LB Corporation," a publicly traded company; (c) a brokerage account consisting of shares in various publicly traded companies; (d) "CHB Corporation," a closely held business owned by the decedent and the decedent's family; and (e) a 5 percent interest in "RP," a privately held rental real estate partnership. Does the Statement apply to any of the following assets owned by the estate? (See *Illustration 10* at paragraph .27 of this Interpretation regarding the valuation of a security.)

**.48 Illustration 13a.** Does the Statement apply to shares in a publicly traded company, "TI Corporation," whose shares are traded infrequently?

**.49 Conclusion.** It depends; although the price of a share of publicly traded stock is ascertainable from published sources, there are no definitive criteria that would indicate when the Statement applies to shares that are infrequently traded. A key consideration is the average daily trading volume of TI Corporation stock on or around the valuation date. The concept of fair market value incorporates the notions that (1) cash could have been received for the stock at the valuation date, and (2) the share price of an infrequently traded stock could decrease if a relatively large block of the stock were to be put on the market on that date. If the subject shares held by the estate do not represent a significant percentage of the daily trading volume of TI stock on or around the valuation date, and the price of a share of the stock is readily ascertainable on the valuation date, then the resulting value (the quoted share price times the number of shares owned) represents a cash price that could have been received at the valuation date for the block, and the Statement does not apply because the calculation of value is mechanical (SSVS No. 1, paragraph 9(a) [VS section 100.09a]). If, however, the subject shares held by the estate represent a large percentage of the average daily trading volume of the stock, the quoted market price for a share may not be adequate for purposes of determining the fair market value of the block of shares on the valuation date. In that case, the Statement applies because valuation approaches and methods need to be applied, and professional judgment needs to be used in determining the value of the block (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04]) (See *Illustration 10* at paragraph .27 of this Interpretation regarding the valuation of a security.)

**.50 Illustration 13b.** Does the Statement apply to a large block of stock in "LB Corporation," a publicly traded company?

**.51 Conclusion.** The answer depends on the amount of shares to be valued in relation to the average daily trading volume in LB Corporation on or around the valuation date. There are no definitive criteria that would indicate when the Statement applies to the valuation of a large block of publicly traded stock. The concept of fair market value incorporates the notion that cash could have been received from a sale of the block on the valuation date. A large block could decrease the share price if sold on the valuation date. The Statement would typically not apply to the valuation of a large block (for example, 200,000 shares) of a large and actively-traded public company. Even though the value of the estate's stock may be large in absolute terms, the daily trading volume in such stock on the valuation date may be sufficiently high that a sale of the block on the valuation date would not affect the market price of a company's

shares. In such a case, the quoted market price of a share times the number of shares held by the estate may be considered to reflect the fair market value of the subject block of stock, and because it would not be the case that valuation approaches and methods would need to be applied and professional judgment used, the Statement would not apply. If, however, the large block of publicly traded shares represents a significant percentage of the daily trading volume, the Statement would apply because valuation approaches and methods would need to be applied and professional judgment used to determine the value (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04]).

**.52 *Illustration 13c.*** Does the Statement apply to a brokerage account consisting of shares in various publicly traded companies?

**.53 *Conclusion.*** The Statement would not apply to the determination of the value of a brokerage account consisting of publicly traded securities, except as discussed in paragraphs .49 and .51 of this Interpretation. Absent certain scenarios involving infrequently traded securities or large blocks of stock, the application of valuation approaches and methods and the use of professional judgment are not necessary in that determination (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04]).

**.54 *Illustration 13d.*** Does the Statement apply to "CHB Corporation," a closely held business owned by the decedent and the decedent's family?

**.55 *Conclusion.*** The Statement would apply to the determination of value of CHB Corporation because valuation approaches and methods need to be applied, and professional judgment needs to be used to determine the fair market value of the ownership interest in CHB (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04]).

**.56 *Illustration 13e.*** Does the Statement apply to a 5 percent interest in a privately held rental real estate partnership (RP)?

**.57 *Conclusion.*** The Statement would apply to the determination of value of the 5 percent interest in rental real estate partnership (RP) because valuation approaches and methods need to be applied and professional judgment needs to be used to determine the fair market value of the ownership of a fractional interest in a privately held partnership (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04]). However, where it is not practical or not reasonable to obtain or use relevant information and, therefore, the member is unable to apply valuation approaches and methods, the Statement would not apply. For example, the member has requested from RP's general partner financial information the member needs in order to apply valuation approaches and methods. The general partner is not responsive to the member's requests, and the due date for filing the estate tax return is near. Given the small ownership interest, and given that RP is likely a relatively small percent of the total estate, unless prohibited by statute or by rule, the member may then use the taxpayer's estimates if the member determines that the estimates are reasonable (based on the facts and circumstances known to the member) (SSVS No. 1, paragraph 9(b) [VS section 100.09b]).

**.58 *Illustration 14.*** Would the answers to *Illustration 13* change if the values were provided by the client or a client-engaged third party?

**.59 *Conclusion.*** The Statement would not apply if the values were provided by the client or by a client-engaged third party because the member is not applying valuation approaches and methods and using professional judgment to determine value (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04]). However, the member would be subject to Statement on Standards for Tax Services No. 3, *Certain Procedural Aspects of Preparing Returns* [TS section 300],

in providing appropriate due diligence with respect to the values provided to the member. It is also recommended that the understanding between member and client in these circumstances include documentation of the fact that the member is not determining but rather is being provided with the value of the subject interest.

**.60 *Illustration 15.*** Would the answers to *Illustration 13* change if the values were provided by an outside third-party specialist hired by the member?

**.61 *Conclusion.*** If the member engages an outside third-party specialist to assist with the member's work, and it is the member expressing a conclusion or calculated value, the member will be applying valuation approaches and methods and using professional judgment; thus, the Statement would apply (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04]; SSVS No. 1, paragraph 20, "Using the Work of Specialists in the Valuation Engagement," [VS section 100.20]). If, however, the third-party specialist is determining the value in his or her own name and providing that value to the client, and the member will not be applying valuation approaches and methods or using professional judgment (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04], and *Illustration 6*), the Statement would not apply, but the member would be subject to Statement on Standards for Tax Services No. 3, *Certain Procedural Aspects of Preparing Returns* [TS section 300] in providing appropriate due diligence with respect to the values provided.

**.62 *Illustration 16.*** The client and the member agree that the member will value a partnership interest and then apply an "average" discount that the member is to determine (based on the results of various studies and case law). Does the Statement apply? If so, is this a valuation engagement or a calculation engagement?

**.63 *Conclusion.*** Yes, the Statement applies because the member determined the value of the partnership interest by applying valuation approaches and valuation methods and using professional judgment. This would be considered a calculation engagement because the member and the client have agreed on the specific valuation approaches or valuation methods the valuation analyst will use and the extent of valuation procedures the valuation analyst will perform (SSVS No. 1, paragraph 21(b) [VS section 100.21b] and *Illustration 6*).

**.64 *Illustration 17.*** Would the Statement apply if a member has an informal conversation or communicates in writing with a client regarding the alternative tax consequences of gifting versus selling a business using a presumption of a specific value of the business?

**.65 *Conclusion.*** No, the Statement would not apply. The member is providing tax advice using an assumed or hypothetical value of a business and is not determining value, applying valuation approaches and methods, and using professional judgment to value a business (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04], and *Illustration 6*).

**.66 *Illustration 18.*** Would the Statement apply to a transfer pricing study (IRC section 482) that involves the use of specific methodologies, data, terminology, and documentation requirements that are provided in the IRS regulations and procedures, and whose methodologies and documentation requirements differ from those contained in the Statement?

**.67 *Conclusion.*** No. To the extent that the transfer pricing study applies, for example, to the valuation of inventory or services, the Statement would not apply (see SSVS No. 1, paragraph 1 [VS section 100.01] and *Illustration 6*). To the extent that the transfer pricing study applies to the valuation of intangible assets, the Statement would normally apply. However, because the

IRS regulations require that the taxpayer reasonably calculate an arm's-length price according to the best method that is determined using third-party comparable data under explicit IRS rules and documentation procedures, and to the extent these IRS rules and procedures differ from the Statement, the jurisdictional exception (SSVS No. 1, paragraph 10 [VS section 100.10]) would exempt the valuation of the intangible assets from the developmental provisions of the Statement (SSVS No. 1, paragraphs 25–48 [VS section 100.25–.48]). In addition, to the extent that the IRS regulations (such as IRS regulation section 1.6662-6(d) (2) (iii)) and procedures provide specific documentation requirements for avoiding potential penalties, and if a transfer pricing report is provided to a client according to such IRS documentation requirements, the jurisdictional exception would apply to the reporting provisions of the Statement (SSVS No. 1, paragraphs 50–78 [VS section 100.50–.78]) and thus a valuation report would not be necessary.

**.68 Illustration 19.** In a situation where the Statement applies to members who determine value as part of tax engagements, would the member also be required to be in compliance with the Statements on Standards for Tax Services (SSTSs) [TS sections 100–900]?

**.69 Conclusion.** Yes, the Statement would apply only to the valuation determination and reporting aspects of the engagement but the SSTSs would apply to all aspects of the engagement. For example, even though the Statement would govern the determination of value of an applicable asset reported on a tax return, the member would also have to be in compliance with SSTS No. 1, *Tax Return Positions*, [TS section 100], for that valuation.

**.70 Illustration 21.** Do settlements or negotiations of value in offers-in-compromise or tax disputes fall under the Statement?

**.71 Conclusion.** No, settlements or negotiations of value in offers-in-compromise or tax disputes are part of a tax process. However, if a member prepares a valuation in preparation for a settlement or negotiation of value, and the valuation involves the application of valuation approaches and methods and the use of professional judgment, the valuation would fall under the developmental aspects of the Statement. The settlement or negotiation process itself is not a valuation and would not fall under the Statement. In addition, the Statement's reporting exemption for certain controversy proceedings would apply as the valuation was performed specifically for the administrative matter (SSVS No. 1, paragraph 50 [VS section 100.50]).

## Illustrations Relating to Other Engagements

**.72 Illustration 20.** Does determining the value of accounts receivable fall under the Statement?

**.73 Conclusion.** No, accounts receivable constitute **tangible assets** under the Statement (SSVS No. 1, Appendix B [VS section 100.81], and do not constitute a subject interest (SSVS No. 1, paragraph 1 [VS section 100.01]).

**.74 Illustration 22.** In the course of performing a valuation under the Statement, if a valuation analyst prepares prospective financial information (for example, as part of a discounted cash flow or discounted earnings analysis within the income approach), does this require the valuation analyst to examine or compile such information in accordance with the Statements on Standards for Attestation Engagements (SSAEs) [AT sections 20–701]?

**.75 Conclusion.** No, Chapter 1, "Attest Engagements," of SSAE No. 10, *Attestation Standards: Revision and Recodification*, as amended [AT section 101.01] states that the attestation standards apply when a practitioner is "engaged to issue or does issue an examination, a review, or an agreed-upon procedures report on subject matter, or an assertion about the subject matter..., that is the responsibility of another party." If the valuation analyst has not been engaged to examine, compile, assemble, review, or apply agreed-upon procedures to prospective financial information, and does not issue an examination, compilation, assembly, or agreed-upon report on prospective financial information, the SSAEs [AT sections 20–701] do not apply (SSARS 14 [AR section 120]).

**.76 Illustration 23.** Under a valuation engagement, a valuation analyst is free to select any and all valuation approaches and methods the valuation analyst deems appropriate in the circumstances. Under a calculation engagement, the valuation analyst and the client agree to the specific approaches or methods the valuation analyst will use or the extent of calculation procedures the valuation analyst will perform. (SSVS No. 1, paragraph 21 [VS section 100.21]) Under SSVS No. 1, paragraph 18 [VS section 100.18], a restriction or limitation on the scope of the valuation analyst's work, or the data available for analysis may be present and known to the valuation analyst at the outset of the engagement, or may arise during the course of an engagement (and such restriction or limitation should be disclosed in the report). Is it possible to have a restriction or limitation that is of such a degree that a valuation analyst engaged to perform a valuation engagement should propose altering the engagement to be a calculation engagement?

**.77 Conclusion.** Although the two engagements represent two different types of service performed by valuation analysts, the possibility exists. If, in the course of a valuation engagement, restrictions, or limitations on the scope of the valuation analyst's work or the data available for analysis are so significant that the valuation analyst believes that he or she cannot, even with disclosure in the valuation report of the restrictions or limitations, adequately perform a valuation engagement leading to a conclusion of value, the valuation analyst should determine whether he or she has the ability to adequately complete the engagement as a calculation engagement or should consider resigning from the engagement.

**.78 Illustration 24.** If a member employed in industry, government, or education "moonlights" doing engagements to estimate value, do the Standards apply?

**.79 Conclusion.** Yes, the Standard applies. By moonlighting, the member is holding him or herself out as a certified public accountant and as being in public practice. The Standard would apply just as it would to any other member in public practice unless one of the exceptions applies.

**.80 Illustration 25.** Does the Statement apply to an assignment from an employer to an employee member not in public practice to prepare a valuation for internal financial reporting purposes?

**.81 Conclusion.** No, SSVS No. 1, paragraph 7 [VS section 100.07] exempts internal use assignments from an employer to an employee member not in the practice of public accounting. However, if the valuation is to be used for financial reporting purposes, the employer and the employee may wish to consider whether the work will be accepted by the employer's outside auditors if the statement is not followed.

## Illustrations for PFP-Specific Engagements

*These illustrations assume the member has not been engaged to perform a business valuation.*

**.82 Illustration 26.** When does the Statement apply to members who determine values related to personal financial planning engagements?

**.83 Conclusion.** The Statement applies to personal financial planning engagements when the member determines the value of a business, business ownership interest, security, or intangible asset (SSVS No. 1, paragraph 1 [VS section 100.01]) and in the process of determining the value applies valuation approaches and methods and uses professional judgment (SSVS No. 1, paragraph 4 [VS section 100.04]) unless an exception applies (SSVS No. 1, paragraphs 5–10 [VS section 100.05–.10]).

**.84 Illustration 27.** If a member is engaged to provide personal financial planning services to a client and, in the course of the engagement, estimates the proceeds from a hypothetical future sale of the client's business interest, does the Statement apply?

**.85 Conclusion.** No. The Statement does not apply because estimate of future sales proceeds does not in itself constitute a valuation engagement (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04]).

**.86 Illustration 28.** A member is engaged to provide personal financial planning services to a client and, in the course of the engagement, estimates the proceeds from a hypothetical future sale of the client's business interest. As part of that engagement, the member shares general industry knowledge to assist the client in estimating the current value of the business interest. Does the Statement apply?

**.87 Conclusion:**

(a) If, in the process of determining the current value from which the member estimates future sales proceeds, the member applies valuation approaches and methods and uses professional judgment, the Statement applies to the determination of the current value (SSVS No. 1, paragraph 4 [VS section 100.04]). However, the Statement does not apply when the member shares general industry knowledge with the client instead of applying professional judgment.

(b) If the client or another party provides the current value, and the member does not apply valuation approaches and methods, the Statement does not apply (SSVS No. 1, paragraphs 4 and 6 [VS section 100.04 and .06]).

(c) If the member uses a hypothetical or assumed value as the starting point for the calculation of future sales proceeds and does not apply valuation approaches and methods, the Statement does not apply (SSVS No. 1, paragraphs 1 and 4 [VS section 100.01 and .04]). The Statement does not apply to a general discussion with the client of valuation concepts or industry price multiples based on the member's industry knowledge, which assists the client in determining a hypothetical or assumed value (SSVS No. 1, paragraphs 4 and 6 [VS section 100.04 and .06]).

**.88 Illustration 29.** The client has asked the member to prepare a personal financial plan that includes an estimate of future proceeds from a sale of the business interest at retirement. The member estimates the future proceeds based on an estimate of the business' current value by applying a rule of thumb for the business' industry, but the member does not consider the risk factors of the subject interest or exercise other professional judgment in applying the multiple. Does the Statement apply?

**.89 Conclusion.** No, the Statement does not apply because the member did not use professional judgment (SSVS No. 1, paragraph 4 [VS section 100.04]). If the member considers specific risk factors of the business interest in applying the price multiple, the Statement applies.

*This Statement titled Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset was unanimously adopted by the assenting votes of the AICPA Consulting Services Executive Committee.*

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## CS Section

# CONSULTING SERVICES

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### STATEMENT ON STANDARDS FOR CONSULTING SERVICES

Statements on Standards for Consulting Services are issued by the AICPA Management Consulting Services Executive Committee, the senior technical committee of the Institute designated to issue pronouncements in connection with consulting services. Council has designated the AICPA Management Consulting Services Executive Committee as a body to establish professional standards under the "Compliance with Standards Rule" (ET sec. 1.310.001) of the Institute's Code of Professional Conduct (code). Members should be prepared to justify departures from this statement.

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## CS Section 100

# Consulting Services: Definitions and Standards

**Source: Statement on Standards for Consulting Services No. 1**

**Effective for engagements accepted on or after January 1, 1992, unless otherwise indicated.**

## Introduction

**.01** Consulting services that CPAs provided to their clients have evolved from advice on accounting-related matters to a wide range of services involving diverse technical disciplines, industry knowledge, and consulting skills. Most practitioners, including those who provide audit and tax services, also provide business and management consulting services to their clients.

**.02** Consulting services differ fundamentally from the CPA's function of attesting to the assertions of other parties. In an attest service, the practitioner expresses a conclusion about the reliability of a written assertion that is the responsibility of another party, the asserter. In a consulting service, the practitioner develops the findings, conclusions, and recommendations presented. The nature and scope of work is determined solely by the agreement between the practitioner and the client. Generally, the work is performed only for the use and benefit of the client.

**.03** Historically, CPA consulting services have been commonly referred to as management consulting services, management advisory services, business advisory services, or management services. A series of Statements on Standards for Management Advisory Services (SSMASs) previously issued by the AICPA contained guidance on certain types of consulting services provided by members. This Statement on Standards for Consulting Services (SSCS) supersedes the SSMASs and provides standards of practice for a broader range of professional services, as described in paragraph .05.

**.04** This SSCS and any subsequent SSCSs apply to any AICPA member holding out as a CPA while providing consulting services as defined herein.

## Definitions

**.05** Terms established for the purpose of SSCSs are as follows:

**Consulting services practitioner.** Any AICPA member holding out as a CPA while engaged in the performance of a Consulting Service for a client, or any other individual who is carrying out a Consulting Service for a client on behalf of any Institute member or member's firm holding out as a CPA.

**Consulting process.** The analytical approach and process applied in a Consulting Service. It typically involves some combination of activities relating to determination of client objective, fact-finding, definition of the problems or opportunities, evaluation of alternatives, formulation of proposed action, communication of results, implementation, and follow-up.

**Consulting services.** Professional services that employ the practitioner's technical skills, education, observations, experiences, and knowledge of the consulting process.<sup>1</sup> Consulting services may include one or more of the following:

- a. *Consultations*, in which the practitioner's function is to provide counsel in a short time frame, based mostly, if not entirely, on existing personal knowledge about the client, the circumstances, the technical matters involved, client representations, and the mutual intent of the parties. Examples of consultations are reviewing and commenting on a client-prepared business plan and suggesting computer software for further client investigation.
- b. *Advisory services*, in which the practitioner's function is to develop findings, conclusions, and recommendations for client consideration and decision making. Examples of advisory services are an operational review and improvement study, analysis of an accounting system, assistance with strategic planning, and definition of requirements for an information system.
- c. *Implementation services*, in which the practitioner's function is to put an action plan into effect. Client personnel and resources may be pooled with the practitioner's to accomplish the implementation objectives. The practitioner is responsible to the client for the conduct and management of engagement activities. Examples of implementation services are providing computer system installation and support, executing steps to improve productivity, and assisting with the merger of organizations.
- d. *Transaction services*, in which the practitioner's function is to provide services related to a specific client transaction, generally with a third party. Examples of transaction services are insolvency services, valuation services, preparation of information for obtaining financing, analysis of a potential merger or acquisition, and litigation services.
- e. *Staff and other support services*, in which the practitioner's function is to provide appropriate staff and possibly other support to perform tasks specified by the client. The staff provided will be directed by the client as circumstances require. Examples of staff and other support services are data processing facilities management, computer programming, bankruptcy trusteeship, and controllership activities.
- f. *Product services*, in which the practitioner's function is to provide the client with a product and associated professional services in support of the installation, use, or maintenance of the product.

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<sup>1</sup> The definition of consulting services excludes the following:

- a. Services subject to other AICPA professional standards such as Statements on Auditing Standards (SASs), Statements on Standards for Attestation Engagements (SSAEs), or Statements on Standards for Accounting and Review Services (SSARSs). (These excluded services may be performed in conjunction with consulting services, but only the consulting services are subject to the Statement on Standards for Consulting Services [SSCS].)
- b. Engagements specifically to perform tax return preparation, tax planning or advice, tax representation, personal financial planning or bookkeeping services, or situations involving the preparation of written reports or the provision of oral advice on the application of accounting principles to specified transactions or events, either completed or proposed, and the reporting thereof.
- c. Recommendations and comments prepared during the same engagement as a direct result of observations made while performing the excluded services.

Examples of product services are the sale and delivery of packaged training programs, the sale and implementation of computer software, and the sale and installation of systems development methodologies.

## Standards for Consulting Services

**.06** The general standards of the profession are contained in the "General Standards Rule" of the code (ET sec. 1.300.001 and 2.300.001) and apply to all services performed by members. They are as follows:

- *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.

**.07** The following additional general standards for all consulting services are promulgated to address the distinctive nature of consulting services in which the understanding with the client may establish valid limitations on the practitioner's performance of services. These standards are established under the "Compliance with Standards Rule" of the code (ET sec. 1.310.001 and 2.310.001):

- *Client interest.* Serve the client interest by seeking to accomplish the objectives established by the understanding with the client while maintaining integrity and objectivity.<sup>2</sup>
- *Understanding with client.* Establish with the client a written or oral understanding about the responsibilities of the parties and the nature, scope, and limitations of services to be performed, and modify the understanding if circumstances require a significant change during the engagement.
- *Communication with client.* Inform the client of (a) conflicts of interest that may occur pursuant to the "Integrity and Objectivity Rule" of the code (ET sec. 1.100.001 and 2.100.001),<sup>3</sup> (b) significant

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<sup>2</sup> In "Integrity" (ET sec. 0.300.040), *integrity* is described as follows: "Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. Integrity can accommodate the inadvertent error and the honest difference of opinion; it cannot accommodate deceit or subordination of principle."

In "Objectivity and Independence" (ET sec. 0.300.050), *objectivity* and *independence* are differentiated as follows: "Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. *Independence* precludes relationships that may appear to *impair a member's* objectivity in rendering attestation services."

<sup>3</sup> The "Conflict of Interest Rule" (ET sec. 1.110.010) states, in part, the following:

A conflict of interest may occur if a *member* or the *member's firm* has a relationship with another person, entity, product, or service that, in the member's professional judgment, the client or other appropriate parties may view as impairing the *member's* objectivity...

A *member* may perform the *professional service* if he or she determines that the service can be performed with objectivity because the *threats* are not significant or can be reduced to an *acceptable level* through the application of *safeguards*...

reservations concerning the scope or benefits of the engagement, and (c) significant engagement findings or events.

**.08** Professional judgment must be used in applying Statements on Standards for Consulting Services in a specific instance because the oral or written understanding with the client may establish constraints within which services are to be provided. For example, the understanding with the client may limit the practitioner's effort with regard to gathering relevant data. The practitioner is not required to decline or withdraw from a consulting engagement when the agreed-upon scope of services includes such limitations.

## Consulting Services for Attest Clients

**.09** The performance of consulting services for an attest client does not impair independence.<sup>4</sup> However, members and their firms performing attest services for a client should comply with applicable independence standards, rules and regulations issued by AICPA, the state boards of accountancy, state CPA societies, and other regulatory agencies.

## Effective Date

**.10** This section is effective for engagements accepted on or after January 1, 1992. Early application of the provisions of this section is permissible.

[Revised, January 2015, to reflect the revised Code of Professional Conduct.]

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<sup>4</sup> AICPA independence standards relate only to the performance of attestation services; objectivity standards apply to all services. See footnote 2.

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# QC Section

## QUALITY CONTROL

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### STATEMENTS ON QUALITY CONTROL STANDARDS

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## QC Section 10

# A Firm's System of Quality Control

(Supersedes SQCS No. 7.)

Source: SQCS No. 8; SAS No. 122; SAS No. 128.

**Effective date: Applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2012.**

## Introduction

### Scope of This Section

**.01** This section addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. This section is to be read in conjunction with the AICPA Code of Professional Conduct and other relevant ethical requirements.

**.02** This section, although applicable to audit and attestation engagements performed by CPA firms in accordance with *Government Auditing Standards*, does not apply to government audit organizations. Instead, those government audit organizations are subject to the quality control and assurance requirements of *Government Auditing Standards*, which are similar to those of this section.

**.03** Other professional standards set out additional requirements and guidance on the responsibilities of firm personnel regarding quality control procedures for specific types of engagements. AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, for example, addresses quality control procedures for engagements conducted in accordance with generally accepted auditing standards. [Revised, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 122.]

**.04** A system of quality control consists of policies designed to achieve the objective set out in paragraph .12 and the procedures necessary to implement and monitor compliance with those policies.

### Authority of the SQCSs

**.05** This section applies to all CPA firms with respect to engagements in their accounting and auditing practice. The nature and extent of the policies and procedures developed by an individual firm to comply with this section will depend on various factors, such as the size and operating characteristics of the firm and whether it is part of a network.

**.06** Statements on Quality Control Standards (SQCSs) contain the objective of the firm in following the SQCSs and requirements designed to enable the firm to meet that stated objective. In addition, SQCSs contain related guidance in the form of application and other explanatory material, as discussed further in paragraph .09, and introductory material that provides context relevant to a proper understanding of the SQCSs and definitions.

.07 The objective provides the context in which the requirements of SQCSs are set and is intended to assist the firm in the following:

- Understanding what needs to be accomplished
- Deciding whether more needs to be done to achieve the objective

.08 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 such a requirement is relevant. SQCSs use the word *must* 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 such a requirement is relevant; however, in rare circumstances, the firm may depart from a presumptively mandatory requirement, provided that the firm documents the justification for the departure and how the alternative policies established, or 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.

.09 When necessary, the application and other explanatory material provides further explanation of the requirements and guidance for carrying them out. In particular, it may

- explain more precisely what a requirement means or is intended to cover.
- include examples of policies and procedures that may be appropriate in the circumstances.

The words *may*, *might*, and *could*, among others, are used to describe these actions and procedures. Although such guidance does not, in itself, impose a requirement, it is relevant to the proper application of the requirements. The application and other explanatory material may also provide background information on matters addressed in SQCSs. When appropriate, additional considerations specific to governmental entities or smaller firms are included within the application and other explanatory material. These additional considerations assist in the application of the requirements in SQCSs. They do not, however, limit or reduce the responsibility of the firm to apply and comply with the requirements in SQCSs.

.10 SQCSs include, under the heading "Definitions," a description of the meanings attributed to certain terms for purposes of the SQCSs. These are provided to assist in the consistent application and interpretation of SQCSs and are not intended to override definitions that may be established for other purposes, whether in law, regulation, or otherwise. The AU-C glossary contains a complete listing of terms defined in this section. It also includes descriptions of other terms found in this section to assist in common and consistent

interpretation. [Revised, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 122.]

## Effective Date

.11 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, 2012.

## Objective

.12 The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that

- a. the firm and its personnel comply with professional standards and applicable legal and regulatory requirements and
- b. reports issued by the firm are appropriate in the circumstances.

## Definitions

.13 For purposes of SQCSs, the following terms have the meanings attributed as follows:

**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 promulgated by the AICPA Auditing Standards Board (ASB) or the AICPA Accounting and Review Services Committee (ARSC) under the "General Standards Rule" (ET sec. 1.300.001) or the "Compliance With Standards Rule" (ET sec. 1.310.001) of the AICPA Code of Professional Conduct. Although standards for other engagements may be promulgated by other AICPA technical committees, engagements performed in accordance with those standards are not encompassed in the definition of an *accounting and auditing practice*.

**Engagement documentation.** The record of the work performed, results obtained, and conclusions that the practitioner reached (also known as *working papers* or *workpapers*).

**Engagement partner.** The partner or other person in the firm who is responsible for the engagement and its performance and for the report that is issued on behalf of the firm and who, when required, has the appropriate authority from a professional, legal, or regulatory body.

**Engagement quality control review.** A process designed to provide an objective evaluation, before the report is released, of the significant judgments the engagement team made and the conclusions it reached in formulating the report. The engagement quality control review process is only for those engagements, if any, for which the firm has determined that an engagement quality control review is required, in accordance with its policies and procedures.

**Engagement quality control reviewer.** A partner, other person in the firm, suitably qualified external person, or team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments that the engagement team made and the conclusions it reached in formulating the report.

**Engagement team.** All partners and staff performing the engagement and any individuals engaged by the firm or a network firm who

perform procedures on the engagement. This excludes external specialists engaged by the firm or a network firm.<sup>1</sup>

The term *engagement team* also excludes individuals within the client's internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of section 610, *Using the Work of Internal Auditors*.

**Firm.** A form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the AICPA and that is engaged in public practice.

**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 includes a review of completed engagements.

**Monitoring.** A process comprising an ongoing consideration and evaluation of the firm's system of quality control, including inspection or a periodic review of engagement documentation, reports, and clients' financial statements for a selection of completed engagements, designed to provide the firm with reasonable assurance that its system of quality control is designed appropriately and operating effectively.

**Network.** An association of entities, as defined in ET section 0.400, *Definitions*.

**Network firm.** A firm or other entity that belongs to a network, as defined in ET section 0.400.

**Partner.** Any 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.

**Personnel.** Partners and staff.

**Professional standards.** Standards promulgated by the ASB or ARSC under the "General Standards Rule" or the "Compliance With Standards Rule" of the AICPA Code of Professional Conduct, or other standards-setting bodies that set auditing and attest standards applicable to the engagement being performed and relevant ethical requirements.

**Reasonable assurance.** In the context of this section, 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 applicable state boards of accountancy and applicable regulatory agencies that are more restrictive.

**Staff.** Professionals, other than partners, including any specialists that the firm employs.

**Suitably qualified external person.** An individual outside the firm with the competence and capabilities to act as an engagement partner (for example, a partner of another firm).

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<sup>1</sup> Paragraph .06 of AU-C section 620, *Using the Work of an Auditor's Specialist*, defines the term *auditor's specialist*. [Footnote revised, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 122.]

[Revised, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 122. As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128. Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

## Requirements

### Applying and Complying With Relevant Requirements

**.14** Personnel within the firm responsible for establishing and maintaining the firm's system of quality control should have an understanding of the entire text of this section, including its application and other explanatory material, to understand its objective and apply its requirements properly.

**.15** The firm should comply with each requirement of this section unless, in the circumstances of the firm, the requirement is not relevant to the services provided by a firm's accounting and auditing practice. (Ref: par. .A1)

**.16** The requirements are designed to enable the firm to achieve the objective stated in this section. The proper application of the requirements is, therefore, expected to provide a sufficient basis for the achievement of the objective. However, because circumstances vary widely and all such circumstances cannot be anticipated, the firm should consider whether there are particular matters or circumstances that require the firm to establish policies and procedures in addition to those required by this section to meet the stated objective.

### Elements of a System of Quality Control

**.17** The firm must establish and maintain a system of quality control. The 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

Policies and procedures established by the firm related to each element are designed to achieve reasonable assurance with respect to the purpose of that element. Deficiencies in policies and procedures for an element may result in not achieving reasonable assurance with respect to the purpose of that element; however, the system of quality control as a whole may still be effective in achieving the objective described in paragraph .12.

**.18** The firm should document its policies and procedures and communicate them to the firm's personnel. (Ref: par. .A2–.A3)

### Leadership Responsibilities for Quality Within the Firm

**.19** The firm should establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures should require the firm's

leadership (managing partner or board of managing partners, CEO, or equivalent) to assume ultimate responsibility for the firm's system of quality control. (Ref: par. .A4–.A5)

**.20** The firm should establish policies and procedures designed to provide it with reasonable assurance that any person or persons assigned operational responsibility for the firm's system of quality control by the firm's leadership has sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility. (Ref: par. .A6)

## Relevant Ethical Requirements

**.21** 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. (Ref: par. .A7–.A9)

### *Independence*

**.22** The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm; its personnel; and, when applicable, others subject to independence requirements (including network firm personnel) maintain independence when required by relevant ethical requirements. Such policies and procedures should enable the firm to

- a. communicate its independence requirements to its personnel and, when applicable, others subject to them and
- 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 considered appropriate, to withdraw from the engagement when withdrawal is possible under applicable law or regulation.

**.23** Such policies and procedures should require

- a. engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall effect, if any, on independence requirements;
- b. personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken; and
- c. the accumulation and communication of relevant information to appropriate personnel so that
  - i. the firm and its personnel can readily determine whether they satisfy independence requirements,
  - ii. the firm can maintain and update information relating to independence, and
  - iii. the firm can take appropriate action regarding identified threats to independence that are not at an acceptable level.

**.24** 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 to
  - i. the engagement partner who, with the firm, needs to address the breach and
  - ii. other relevant personnel in the firm and, when appropriate, the network and those subject to the independence requirements who need to take appropriate action; and
- c. prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in subparagraph (b)(ii) of the actions taken to resolve the matter so that the firm can determine whether it should take further action.

**.25** 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 the "Independence Rule" (ET sec. 1.200.001) and related interpretations of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. (Ref: par. .A10) [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

**.26** The firm should establish policies and procedures for all audit or attestation engagements for which regulatory or other authorities require the rotation of personnel after a specified period, in compliance with such 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 when the firm

- a. is competent to perform the engagement and has the capabilities, including time and resources, to do so; (Ref: par. .A11)
- b. can comply with legal and relevant ethical requirements; and
- c. has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity. (Ref: par. .A12–.A13)

**.28** Such policies and procedures should

- a. require the firm to 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. (Ref: par. .A14)
- b. require the firm to determine whether it is appropriate to accept the engagement if a potential conflict of interest is identified in accepting an engagement from a new or an existing client.
- c. if issues have been identified and the firm decides to accept or continue the client relationship or a specific engagement, require the firm to
  - i. consider whether ethical requirements that exist under the "Conflicts of Interest" interpretation (ET sec.

1.110.010) under the "Integrity and Objectivity Rule" (ET sec. 1.100.001) apply, and

- ii. document how the issues were resolved.

[Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

**.29** To minimize the risk of misunderstandings regarding the nature, scope, and limitations of the services to be performed, the firm should establish policies and procedures that provide for obtaining an understanding with the client regarding those services. (Ref: par. .A15)

**.30** The firm should establish policies and procedures on continuing an engagement and the client relationship that address the circumstances when the firm obtains information that would have caused it to decline the engagement had that information been available earlier. Such policies and procedures should include consideration of the following:

- a. The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to regulatory authorities
- b. The possibility of withdrawing from the engagement or from both the engagement and the client relationship (Ref: par. .A16)

## Human Resources

**.31** The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the competence, capabilities, and commitment to ethical principles necessary to

- a. perform engagements in accordance with professional standards and applicable legal and regulatory requirements and
- b. enable the firm to issue reports that are appropriate in the circumstances. (Ref: par. .A17–.A24)

**.32** The firm's policies and procedures should provide that personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities that they will be called on to assume.

## Assignment of Engagement Teams

**.33** 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 competence, capabilities, and authority to perform the role; and (Ref: par. .A25–.A30)
- c. the responsibilities of the engagement partner are clearly defined and communicated to that individual.

**.34** The firm should establish policies and procedures to assign appropriate personnel with the necessary competence and capabilities to

- a. perform engagements in accordance with professional standards and applicable legal and regulatory requirements and
- b. enable the firm to issue reports that are appropriate in the circumstances. (Ref: par. .A31)

## Engagement Performance

**.35** The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements and that the firm issues reports that are appropriate in the circumstances. Such policies and procedures should include the following:

- a. Matters relevant to promoting consistency in the quality of engagement performance (Ref: par. .A32–.A33)
- b. Supervision responsibilities (Ref: par. .A34)
- c. Review responsibilities (Ref: par. .A35)

**.36** The firm's review responsibility policies and procedures should be determined on the basis that suitably experienced engagement team members, which may include the engagement partner, review work performed by other engagement team members.

### Consultation

**.37** The firm should establish policies and procedures designed to provide it with reasonable assurance that

- a. appropriate consultation takes place on difficult or contentious issues;
- b. sufficient resources are available to enable appropriate consultation to take place;
- c. the nature and scope of such consultations are documented and are agreed upon by both the individual seeking consultation and the individual consulted; and
- d. the conclusions resulting from consultations are documented, understood by both the individual seeking consultation and the individual consulted, and implemented. (Ref: par. .A36–.A40)

### Engagement Quality Control Review

**.38** The firm should establish criteria against which all engagements covered by this section should be evaluated to determine whether an engagement quality control review should be performed. (Ref: par. .A41)

**.39** The firm's policies and procedures should require that if an engagement meets the criteria established, an engagement quality control review should be performed for that engagement.

**.40** The firm should establish policies and procedures setting out the nature, timing, and extent of an engagement quality control review. Such policies and procedures should require that the engagement quality control review be completed before the report is released. (Ref: par. .A42–.A44)

**.41** The firm should establish policies and procedures to require the engagement quality control review to include

- a. discussion of significant findings and issues with the engagement partner;
- b. reading the financial statements or other subject matter information and the proposed report;
- c. review of selected engagement documentation relating to significant judgments that the engagement team made and the related conclusions it reached; and

- d. evaluation of the conclusions reached in formulating the report and consideration of whether the proposed report is appropriate. (Ref: par. .A45–.A47)

*Criteria for the Eligibility of Engagement Quality Control Reviewers*

**.42** The firm should establish policies and procedures to address the appointment of engagement quality control reviewers and to establish their eligibility through

- a. the technical qualifications required to perform the role, including the necessary experience and authority, and (Ref: par. .A48)
- b. the degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer's objectivity. (Ref: par. .A49)

**.43** 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 although 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. Accordingly, such policies and procedures should provide that the engagement quality control reviewer

- a. when practicable, is not selected by the engagement partner.
- b. does not otherwise participate in the performance of the engagement during the period of review.
- c. does not make decisions for the engagement team.
- d. is not subject to other considerations that would threaten the reviewer's objectivity.

**.44** 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 is likely to have been impaired. (Ref: par. .A50)

*Documentation of the Engagement Quality Control Review*

**.45** The firm should establish policies and procedures on documentation of the engagement quality control review, which require 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 that the engagement team made and the conclusions it reached were not appropriate.

***Differences of Opinion***

**.46** The firm should establish policies and procedures for addressing and resolving differences of opinion within the engagement team; with those consulted; and, when applicable, between the engagement partner and the engagement quality control reviewer. (Ref: par. .A51–.A52)

**.47** Such policies and procedures should enable a member of the engagement team to document that member's disagreement with the conclusions reached after appropriate consultation.

- .48 Such policies and procedures should require the following:
- a. Conclusions reached be documented and implemented
  - b. The report not be released until the matter is resolved

### **Engagement Documentation**

#### *Completion of the Assembly of Final Engagement Files*

.49 The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been released. (Ref: par. .A53–.A54)

#### *Confidentiality, Safe Custody, Integrity, Accessibility, and Retrievability of Engagement Documentation*

.50 The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation. (Ref: par. .A55–.A58)

#### *Retention of Engagement Documentation*

.51 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. (Ref: par. .A59–.A62)

## **Monitoring**

### **Monitoring the Firm's Quality Control Policies and Procedures**

.52 The firm should establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. This process should

- a. include an ongoing consideration and evaluation of the firm's system of quality control, including inspection or a periodic review of engagement documentation, reports, and clients' financial statements for a selection of completed engagements;
- b. require responsibility for the monitoring process to be assigned to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility; and
- c. assign the performance of monitoring the firm's system of quality control to qualified individuals. (Ref: par. .A63–.A73)

### **Evaluating, Communicating, and Remedying Identified Deficiencies**

.53 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.

.54 The firm should evaluate the effect of deficiencies noted as a result of the monitoring process and determine whether they are either

- a. instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and applicable legal and regulatory requirements and that the reports issued by the firm are appropriate in the circumstances or

- b. systemic, repetitive, or other significant deficiencies that require prompt corrective action.

**.55** 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. (Ref: par. .A74)

**.56** Recommendations for appropriate remedial actions for deficiencies noted should include 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

**.57** The firm should establish policies and procedures to address cases 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. Such policies and procedures should require the firm to

- a. determine what further action is appropriate to comply with relevant professional standards and legal and regulatory requirements and
- b. consider whether to obtain legal advice.

**.58** The firm should communicate, at least annually, the results of the monitoring of its system of quality control to engagement partners and other appropriate individuals within the firm, including the firm's leadership. This communication should be sufficient to enable the firm and these individuals to take prompt and appropriate action, when necessary, in accordance with their defined roles and responsibilities to 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. When relevant, a description of systemic, repetitive, or other significant deficiencies and of the actions taken to resolve or amend those deficiencies

**.59** Some firms operate as part of a network and, for consistency, may implement some of their monitoring procedures on a network basis. When firms within a network operate under common monitoring policies and procedures designed to comply with this section, and these firms place reliance on such a monitoring system, the firm's policies and procedures should require that

- a. at least annually, the network communicate the overall scope, extent, and results of the monitoring process to appropriate individuals within the network firms and
- b. the network communicate promptly any identified deficiencies in the quality control system to appropriate individuals within the relevant network firm or firms so that the necessary action can be taken in order that engagement partners in the network firms can rely on the results of the monitoring process implemented within the network, unless the firms or the network advise otherwise.

### **Complaints and Allegations**

**.60** 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 applicable legal and regulatory requirements and
- b. allegations of noncompliance with the firm's system of quality control.

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. (Ref: par. .A75)

**.61** If, during the investigations into complaints and allegations, deficiencies in the design or operation of the firm's quality control policies and procedures, or instances of noncompliance with the firm's system of quality control by an individual or individuals are identified, the firm should take appropriate actions, as set out in paragraph .56. (Ref: par. .A76–.A77)

### **Documentation of the System of Quality Control**

**.62** 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. (Ref: par. .A78–.A80)

**.63** 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 of the firm to evaluate the firm's compliance with its system of quality control or for a longer period if required by law or regulation.<sup>2</sup>

**.64** The firm should establish policies and procedures requiring documentation of complaints and allegations described in paragraph .60 and the responses to them.

## **Application and Other Explanatory Material**

### **Applying and Complying With Relevant Requirements**

#### ***Considerations Specific to Smaller Firms (Ref: par. .15)***

**.A1** This section does not call for compliance with requirements that are not relevant (for example, in the circumstances of a sole practitioner with no staff). Requirements in this section, such as those for policies and procedures for the assignment of appropriate personnel to the engagement team (see paragraph .34), for review responsibilities (see paragraph .36), and for the annual communication of the results of monitoring to engagement partners within the firm (see paragraph .58) are not relevant in the absence of staff.

### **Elements of a System of Quality Control (Ref: par. .18)**

**.A2** In general, communication of quality control policies and procedures to firm personnel includes a description of the quality control policies and procedures and the objectives they are designed to achieve and the message that each

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<sup>2</sup> PR section 100, *Standards for Performing and Reporting on Peer Reviews*, is applicable to firms enrolled in the AICPA Peer Review Program.

individual has a personal responsibility for quality and is expected to comply with these policies and procedures. By encouraging firm personnel to communicate their views or concerns on quality control matters, the firm recognizes the importance of obtaining feedback on the firm's system of quality control. Although communication is enhanced if it is in writing, the communication of quality control policies and procedures is not required to be in writing.

### ***Considerations Specific to Smaller Firms***

**.A3** Documentation and communication of policies and procedures for smaller firms may be less formal and extensive than for larger firms.

## **Leadership Responsibilities for Quality Within the Firm**

### ***Promoting an Internal Culture of Quality (Ref: par. .19)***

**.A4** The firm's leadership, and the examples it sets, significantly influences 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 applicable legal and regulatory 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, but are not limited to, training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They may be incorporated in partner and staff appraisal procedures and the firm's internal documentation and training materials, such that they will support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.

**.A5** 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. Promoting such an internal culture includes the following:

- a. Establishment of policies and procedures that address performance evaluation, compensation, and advancement (including incentive systems) with regard to its personnel in order to demonstrate the firm's overarching commitment to quality
- b. Assignment of management responsibilities so that commercial considerations do not override the quality of the work performed
- c. Provision of sufficient and appropriate resources for the development, documentation, and support of its quality control policies and procedures

### ***Assigning Operational Responsibility for the Firm's System of Quality Control (Ref: par. .20)***

**.A6** Sufficient and appropriate experience and ability enables the person or persons responsible for the firm's system of quality control to identify and understand quality control issues and to develop appropriate policies and procedures. Necessary authority enables the person or persons to implement those policies and procedures.

## Relevant Ethical Requirements

### ***Compliance With Relevant Ethical Requirements (Ref: par. .21)***

.A7 The AICPA Code of Professional Conduct establishes the fundamental principles of professional ethics, which include the following:

- Responsibilities
- The public interest
- Integrity
- Objectivity and independence
- Due care
- Scope and nature of services

.A8 Independence requirements are set forth in the "Independence Rule" and related interpretations of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Guidance on threats to independence and safeguards to mitigate such threats involving matters that are not explicitly addressed in the Code of Professional Conduct are set forth in the "Conceptual Framework for Independence" (ET sec. 1.210.010). [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

.A9 The fundamental principles are reinforced, in particular, by the following:

- The leadership of the firm
- Education and training
- Monitoring
- A process for dealing with noncompliance

*Written Confirmation (Ref: par. .25)*

.A10 Written confirmation may be in paper or electronic form. By obtaining confirmation and taking appropriate action on information indicating noncompliance, the firm demonstrates the importance that it attaches to independence and keeps the issue current for, and visible to, its personnel.

## Acceptance and Continuance of Client Relationships and Specific Engagements

### ***Competence, Capabilities, and Resources (Ref: par. .27a)***

.A11 Consideration of whether the firm has the competence, capabilities, and resources to undertake a new engagement from a new or an existing client involves reviewing the specific requirements of the engagement and the existing partner and staff profiles at all relevant levels, including 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 competence and capabilities;
- specialists are available, if needed;

- individuals meeting the criteria and eligibility requirements to perform an engagement quality control review are available, when applicable; and
- the firm is able to complete the engagement within the reporting deadline.

### ***Integrity of a Client (Ref: par. .27c)***

.A12 Matters to consider regarding the integrity of a client include, for example, the following:

- The identity and business reputation of the client's principal owners, key management, and those charged with governance
- 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 governance toward such matters as internal control or aggressive interpretation of accounting standards
- Indications of an inappropriate limitation in the scope of the work
- Indications that the client might be involved in money laundering or other criminal activities
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm

The extent of knowledge that a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

.A13 Sources of information on such matters obtained by the firm may include the following:

- Communications with existing or previous providers of professional accountancy services to the client, in accordance with relevant ethical requirements, and discussions with other third parties
- Inquiry of other firm personnel or third parties, such as bankers, legal counsel, and industry peers
- Background searches of relevant databases

### ***Continuance of a Client Relationship (Ref: par. .28a)***

.A14 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. For example, a client may have started to expand its business operations into an area where the firm does not possess, and cannot obtain, the necessary expertise.

### ***Obtaining an Understanding With the Client (Ref: par. .29)***

.A15 Professional standards applicable to the engagement may contain requirements for obtaining a written understanding with the client.

### ***Withdrawal (Ref: par. .30)***

.A16 Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship may address issues that include the following:

- Discussing with the appropriate level of the client's management and those charged with governance the appropriate action that the firm might take based on the relevant facts and circumstances
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with governance withdrawal from the engagement or from both the engagement and the client relationship and the reasons for the withdrawal
- Considering whether there is a professional, legal, or regulatory 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
- Documenting significant matters, consultations, conclusions, and the basis for the conclusions

### Human Resources (Ref: par. .31)

.A17 Personnel issues relevant to the firm's policies and procedures related to human resources include, for example, the following:

- Recruitment and hiring, if applicable
- Performance evaluation, compensation, and advancement
- Determining competencies and capabilities, including time to perform assignments
- Professional development
- The estimation of personnel needs

Effective recruitment processes and procedures help the firm select individuals of integrity who have the capacity to develop the competence and capabilities 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.

.A18 *Competencies and capabilities* are the knowledge, skills, and abilities that qualify personnel to perform an engagement covered by this section. Competencies and capabilities 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.

.A19 Competence can be developed through a variety of methods; these methods include, for example, the following:

- Professional education
- Continuing professional development, including training
- Work experience
- Mentoring by more experienced staff, such as other members of the engagement team
- Independence education for personnel who are required to be independent

**.A20** 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 (CPE) and other professional development activities that enable them to fulfill responsibilities assigned and to satisfy applicable CPE 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 competence and capabilities.

**.A21** The firm may use a suitably qualified external person, for example, when internal technical and training resources are unavailable.

**.A22** 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 that a firm may take in developing and maintaining competence and commitment to ethical principles include the following:

- Making personnel aware of the firm's expectations regarding performance and ethical principles
- Providing personnel with an evaluation of, and counseling on, performance, progress, and career development
- 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.

### ***Considerations Specific to Smaller Firms***

**.A23** 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.

### ***The Relationship of the Competency Requirement of the Uniform Accountancy Act to the Human Resource Element of Quality Control***

**.A24** CPAs are required to follow the accountancy laws of the individual licensing jurisdictions in the United States that govern public practice. These jurisdictions may have adopted, in whole or in part, the Uniform Accountancy Act (UAA), which is a model legislative statute, including related administrative rules, designed by the AICPA and the National Association of State Boards of Accountancy to provide a uniform approach to the regulation of the accounting profession. The UAA provides that "[a]ny 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 accounting and auditing services on the firm's behalf to meet the competency requirement referred to in the UAA. [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

## Assignment of Engagement Teams

*Engagement Partners (Ref: par. .33)*

**.A25** 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 public practice, such as in relevant industry, governmental, and academic positions. When necessary, the experience of the engagement partner may be supplemented by 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.

[Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

**.A26** 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 example

- the competencies expected of an engagement partner 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 the effectiveness of an entity's internal control over financial reporting that is integrated with an audit of financial statements would be expected to have technical proficiency in understanding and evaluating the effectiveness of controls, whereas an engagement partner of 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.

**.A27** In practice, the competencies necessary for the engagement partner are broad and varied in both their nature and number. 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 IT 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***

**.A28** The competencies previously listed 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.

**.A29** In establishing policies and procedures related to the nature of competencies needed by the engagement partner of 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.

**.A30** 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.

*Engagement Teams (Ref: par. .34)*

**.A31** The firm's assignment of engagement teams and the determination of the level of supervision required include, for example, consideration of 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 legal and regulatory requirements;
- technical knowledge and expertise, including knowledge of relevant IT;
- knowledge of relevant industries in which the clients operate;
- ability to apply professional judgment; and
- 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.

## Engagement Performance

### *Consistency in the Quality of Engagement Performance (Ref: par. .35a)*

**.A32** The firm promotes consistency in the quality of engagement performance through its policies and procedures. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed may include the following:

- 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
- Processes to keep all policies and procedures current

**.A33** Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

### *Supervision (Ref: par. .35b)*

**.A34** Engagement supervision includes the following:

- Tracking the progress of the engagement
- Considering the competence and capabilities 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 findings and issues arising during the engagement, considering their significance, and modifying the planned approach appropriately
- Identifying matters for consultation or consideration by more experienced engagement team members during the engagement

**Review (Ref: par. .35c)**

**.A35** A review consists of consideration of whether

- the work has been performed in accordance with professional standards and applicable legal and regulatory 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 the 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.

**Consultation (Ref: par. .37)**

**.A36** Consultation includes discussion at the appropriate professional level with individuals within or outside the firm who have relevant specialized expertise.

**.A37** Consultation uses appropriate research resources, as well as the collective experience and technical expertise of the firm. Consultation helps promote quality and improves the application of professional judgment. Appropriate recognition of consultation in the firm's policies and procedures helps promote a culture in which consultation is recognized as a strength and personnel are encouraged to consult on difficult or contentious issues.

**.A38** Effective consultation on significant technical, ethical, and other matters within the firm or, when applicable, outside the firm can be achieved when those consulted

- are given all the relevant facts that will enable them to provide informed advice and
- have appropriate knowledge, authority, and experience

and when conclusions resulting from consultations are appropriately documented and implemented.

**.A39** Documentation that is sufficiently complete and detailed of consultations with other professionals that involve difficult or contentious matters 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.

**Considerations Specific to Smaller Firms**

**.A40** A firm needing to consult externally may take advantage of advisory services provided by the following:

- Other firms
- Professional and regulatory bodies
- Commercial organizations that provide relevant quality control services

Before contracting for such services, consideration of the competence and capabilities of the external provider helps the firm determine whether the external provider is suitably qualified for that purpose.

**Engagement Quality Control Review**

*Criteria for an Engagement Quality Control Review (Ref: par. .38)*

**.A41** The structure and nature of the firm's practice are important considerations in establishing criteria for determining which engagements are to be subject to an engagement quality control review. Such criteria may include, for example, the following:

- 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
- Whether laws or regulations require an engagement quality control review

*Nature, Timing, and Extent of the Engagement Quality Control Review (Ref: par. .40-.41)*

**.A42** 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
- Whether documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached

**.A43** If the engagement quality control review is completed after the report is dated and identifies instances where additional procedures are needed or additional evidence is required, the date of the report is changed to the date when the additional procedures have been satisfactorily completed or the additional evidence has been obtained, in accordance with the professional standards applicable to the engagement.

**.A44** Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant issues to be promptly resolved to the engagement quality control reviewer's satisfaction before the report is released.

**.A45** 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. The performance of

an engagement quality control review does not reduce the responsibilities of the engagement partner.

**.A46** Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review for audits, as well as reviews of financial statements and other assurance and related services engagements, include the following:

- 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, when applicable, other parties, such as regulatory bodies

**.A47** 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.

*Criteria for the Eligibility of Engagement Quality Control Reviewers*

Sufficient and Appropriate Technical Expertise, Experience, and Authority (Ref: par. .42a)

**.A48** What constitutes sufficient and appropriate technical expertise, experience, and authority depends on the circumstances of the engagement.

Consultation With the Engagement Quality Control Reviewer (Ref: par. .42b)

**.A49** 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 avoids identification of differences of opinion at a late stage of the engagement and does not necessarily impair the engagement quality control reviewer's eligibility to perform the role. 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. When this is not possible, another individual within the firm or a suitably qualified external person may be appointed to take on the role of either the engagement quality control reviewer or the person to be consulted on the engagement.

*Objectivity of the Engagement Quality Control Reviewer (Ref: par. .43–.44)*

Considerations Specific to Smaller Firms

**.A50** Suitably qualified external persons may be contracted when sole practitioners or small firms identify engagements requiring engagement quality control reviews and no person in the firm meets the eligibility requirements for an engagement quality control reviewer. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. When the firm contracts suitably qualified external persons or other firms, the requirements in paragraphs .43–.44 and the guidance in paragraph .A49 apply.

**Differences of Opinion (Ref: par. .46)**

**.A51** 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.

**.A52** Procedures to resolve such differences may include consulting with another practitioner or firm or a professional or regulatory body.

**Engagement Documentation**

*Completion of the Assembly of Final Engagement Files (Ref: par. .49)*

**.A53** Professional standards, law, or regulation may prescribe the time limits by which the assembly of final engagement files for specific types of engagements is to be completed. When no such time limits are prescribed, paragraph .49 requires the firm to establish time limits that reflect the need to complete the assembly of final engagement files on a timely basis.

**.A54** When two or more different reports are issued regarding the same subject matter information of an entity, the firm's policies and procedures relating to time limits for the assembly of final engagement files address each report as if it were for a separate engagement. This may, for example, be the case when the firm issues an auditor's report on financial information prepared in accordance with generally accepted accounting principles and, at a subsequent date, an auditor's report on the same financial information prepared in accordance with a special purpose framework for regulatory purposes.

*Confidentiality, Safe Custody, Integrity, Accessibility, and Retrievability of Engagement Documentation (Ref: par. .50)*

**.A55** 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 a legal or professional duty exists to do so. Specific laws or regulations may impose additional obligations on the firm's personnel to maintain client confidentiality, particularly when data of a personal nature are concerned.

**.A56** Whether engagement documentation is in paper, electronic, or other media, the integrity, accessibility, or retrievability of the underlying data may be compromised if the documentation could be altered, added to, or deleted without the firm's knowledge or if it could be permanently lost or damaged. Accordingly, controls that the firm designs and implements to avoid unauthorized alteration or loss of engagement documentation may include those that

- enable the determination of 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.

**.A57** Controls that the firm designs and implements to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation may include the following:

- 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
- Procedures for restricting access to, and enabling proper distribution and confidential storage of, hard copy engagement documentation

**.A58** For practical reasons, original paper documentation may be electronically scanned or otherwise copied to another media for inclusion in engagement files. In such cases, the firm's procedures designed to maintain the integrity, accessibility, and retrievability of the documentation may include requiring the engagement teams to

- generate scanned copies that reflect 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 scanned copies as necessary.
- enable the scanned copies to be retrieved and printed as necessary.

There may be legal, regulatory, or other reasons for a firm to retain original paper documentation.

*Retention of Engagement Documentation (Ref: par. .51)*

**.A59** The needs of the firm for retention of engagement documentation and the period of such retention will vary with 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, law, or regulation prescribe specific retention periods for certain types of engagements or whether generally accepted retention periods exist in the absence of specific legal or regulatory requirements.

**.A60** In the specific case of audit engagements, the retention period would be no shorter than five years from the report release date.<sup>3</sup>

**.A61** Procedures that the firm may adopt for retention of engagement documentation include those that enable the requirements of paragraph .51 to be met during the retention period, such as, for example, procedures to

- 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.

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<sup>3</sup> Paragraph .17 of AU-C section 230, *Audit Documentation*. [Footnote revised, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 122.]

- provide, when 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.

#### *Ownership of Engagement Documentation*

**.A62** Unless otherwise specified by law or regulation, engagement documentation is the property of the firm. The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided that such disclosure does not undermine the validity of the work performed or, in the case of assurance engagements, the independence of the firm or its personnel.

## **Monitoring**

### ***Monitoring the Firm's Quality Control Policies and Procedures (Ref: par. .52)***

**.A63** The purpose of monitoring compliance with quality control policies and procedures is to assess, for the system of quality control as a whole, whether the firm is achieving the objective described in paragraph .12 through an evaluation of the following:

- Adherence to professional standards and applicable legal and regulatory requirements
- Whether the system of quality control 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

The evaluation may identify circumstances that necessitate changes to, or improve compliance with, the firm's policies and procedures to provide the firm with reasonable assurance that its system of quality control is effective.

**.A64** Ongoing consideration and evaluation of the system of quality control may include matters such as the following:

- Review of selected administrative and personnel records pertaining to the quality control elements
- Review of engagement documentation, reports, and clients' financial statements
- Discussions with the firm's personnel
- Determination of corrective actions to be taken and improvements to be made in the system, including providing feedback into the firm's policies and procedures relating to education and training
- Communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with the system
- Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures

**.A65** Monitoring procedures also may include an assessment of the following:

- The appropriateness of the firm's guidance materials and any practice aids
- New developments in professional standards and legal and regulatory requirements and how they are reflected in the firm's policies and procedures, when appropriate
- Written confirmation of 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
- Firm personnel's understanding of the firm's quality control policies and procedures and implementation thereof

**.A66** Some of the monitoring procedures discussed previously may be accomplished through the performance of the following:

- Engagement quality control review
- Review of engagement documentation, reports, and clients' financial statements for selected engagements after the report release date
- Inspection procedures

Reviews of the work or report when performed by engagement team members prior to the date of the report are not monitoring procedures.

**.A67** 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.

**.A68** 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, such as the following:

- The size of the firm
- The number and geographical location of offices
- The results of previous monitoring procedures
- The degree of authority of both personnel and office (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

**.A69** 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.

**.A70** 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.

### ***The Relationship of Peer Review to Monitoring***

**.A71** A peer review does not substitute for all monitoring procedures. However, because 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 documentation, reports, and clients' financial statements for some or all engagements for the period covered by the peer review.

#### ***Considerations Specific to Smaller Firms***

**.A72** 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 review of engagement working papers, reports, and clients' financial statements by the engagement partner or other qualified personnel after the report release date. 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 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.

**.A73** 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 suitably qualified external person or another firm to perform engagement inspections and other monitoring procedures.

#### ***Communicating Deficiencies (Ref: par. .55)***

**.A74** The reporting of identified deficiencies to individuals other than the relevant engagement partners 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 partners.

#### ***Complaints and Allegations***

##### ***Source of Complaints and Allegations (Ref: par. .60)***

**.A75** 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.

*Investigation Policies and Procedures (Ref: par. .61)*

**.A76** Policies and procedures established for the investigation of complaints and allegations may include, for example, that the partner supervising the investigation

- has sufficient and appropriate experience,
- has authority within the firm, and
- is otherwise not involved in the engagement.

The partner supervising the investigation may involve legal counsel as necessary.

*Considerations Specific to Smaller Firms*

**.A77** In the case of firms with few partners, it may not be practicable for the partner supervising the investigation not to be involved in the engagement. These small firms and sole practitioners may use the services of a suitably qualified external person or another firm to carry out the investigation into complaints and allegations.

**Documentation of the System of Quality Control (Ref: par. .62)**

**.A78** 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:

- 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.

**.A79** Appropriate documentation relating to monitoring includes, for example, 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 applicable legal and regulatory requirements
  - Whether the system of quality control has been appropriately designed and effectively implemented
  - Whether the firm's quality control policies and procedures have been appropriately applied so that the reports that are issued by the firm are appropriate in the circumstances
- Identification of the deficiencies noted, an evaluation of their effect, and the basis for determining whether and what further action is necessary

***Considerations Specific to Smaller Firms***

**.A80** Smaller firms may use more informal methods in the documentation of their systems of quality control, such as manual notes, checklists, and forms.

.A81

## **Exhibit—Comparison of Section 10, *A Firm's System of Quality Control*, and International Standard on Quality Control 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements***

This analysis was prepared by the AICPA Audit and Attest Standards staff to highlight substantive differences between section 10, *A Firm's System of Quality Control*, and International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, and the rationale therefore. This analysis is not authoritative and is prepared for informational purposes only. It has not been acted on or reviewed by the Auditing Standards Board (ASB).

### **Differences in Language**

The ASB has made various changes to the language throughout section 10, as compared with ISQC 1. Such changes have been made to use terms applicable in the United States and to make section 10 easier to read and apply. The ASB believes that such changes will not create differences between the application of ISQC 1 and the application of section 10.

### **Requirements in Section 10 Not in ISQC 1**

Section 10 requires firms to establish policies and procedures providing

- in paragraph .30, for obtaining an understanding with the client regarding the nature, scope, and limitations of the services to be performed.
- in paragraph .33, that personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.
- in paragraph .44, that although 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.
- in paragraph .48, that when differences of opinion exist, a member of the engagement team be able to document that member's disagreement with the conclusions reached, after appropriate consultation.

ISQC 1 does not have equivalent requirements.

## Requirements in ISQC 1 Not in Section 10

Paragraph 25 of ISQC 1 requires the firm to establish policies and procedures setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time. The ASB believes that the familiarity threat should not be singled out among other threats to independence.

Paragraph 48(a) of ISQC 1 requires including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner as a monitoring procedure. The ASB believes that this requirement is overly prescriptive and that a risk-based approach to inspections is more appropriate.

## Requirements in ISQC 1 Revised in Section 10

Paragraph .41 of section 10 requires that when an engagement quality control review is performed, the engagement quality control review be completed before the report is released. Paragraph 36 of ISQC 1 requires that the quality control review be completed before the report is dated. The ASB believes that an engagement quality control review is an independent review of the engagement team's significant judgments, including the date selected by the engagement team to date the report. As noted in the application material to section 10, when the engagement quality control review results in additional procedures having to be performed, the date of the report would be changed.

Paragraph 48(c) of ISQC 1 requires that those performing the engagement or the engagement quality control review are not involved in inspecting the engagements. Paragraph .53c of section 10, consistent with the requirement in paragraph 100 of Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control*, requires that performance of monitoring of the firm's system of quality control be assigned to qualified individuals. Paragraph .A72 of section 10 notes that 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. The ASB concluded that it was not necessary to change existing practice because in the United States, the peer review process provides a safeguard and provides evidence that the monitoring procedures are effective.

Paragraph A49 of ISQC 1 references the requirement in paragraph 40 of ISQC 1 to establish policies and procedures to maintain the objectivity of the engagement quality control reviewer and states, "Accordingly, such policies and procedures provide. . . ." The ASB believes that notwithstanding its placement as application material, the language is indicative of a requirement and, accordingly, has included a requirement for the provision of these specific policies and procedures in paragraph .44 of section 10. The ASB believes this will not create a difference in the application of ISQC 1 and the application of section 10.

[Revised, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 122.]

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## PR Section

# STANDARDS FOR PERFORMING AND REPORTING ON PEER REVIEWS

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## PR Section 100

# ***Standards for Performing and Reporting on Peer Reviews***

Effective for Peer Reviews Commencing on or After January 1, 2009.

### **NOTICE TO READERS**

In order to be admitted to or retain their membership in the AICPA, members of the AICPA who are engaged in the practice of public accounting in the United States or its territories are required to be practicing as partners or employees of firms enrolled in an approved practice-monitoring program or, if practicing in firms not eligible to enroll, are themselves enrolled in such a program if the services performed by such a firm or individual are within the scope of the AICPA's practice-monitoring standards and the firm or individual issues reports purporting to be in accordance with AICPA professional standards.

Firms have peer reviews because of the public interest in the quality of the accounting, auditing, and attestation services provided by public accounting firms. In addition, firms indicate that peer review contributes to the quality and effectiveness of their practices. Furthermore, most state boards of accountancy require its licensees to undergo peer review, which they may also call compliance assurance, to practice in their state. Other regulators require peer review in order to perform engagements and to issue reports under their standards.

A firm (or individual) enrolled in the AICPA Peer Review Program is deemed to be enrolled in an approved practice-monitoring program. See BL sections 230, *2.3 Requirements for Retention of Membership*, 220, *2.2 Requirements for Admission to Membership*, and 760, *7.6 Publication of Disciplinary Action*; "Form of Organization and Name Rule" and its interpretations (ET sec. 1.800.001); and the implementing council resolutions under those sections.

These standards are applicable to firms (and individuals) enrolled in the program and to individuals and firms who perform and report on such peer reviews, to entities approved to administer the peer reviews, and to associations of CPA firms authorized by the AICPA Peer Review Board (board) to assist its members in forming review teams. These standards are not intended for peer reviews of organizations that are not public accounting firms.

Users of these standards should be knowledgeable about the standards and their interpretations and effective dates, as well as guidance issued by the board that might affect the application of these standards. Those subject to the standards should be prepared to justify departures from these standards, and it is expected that departures will be rare.

These standards are effective for peer reviews commencing on or after January 1, 2009. Early implementation of these standards is not permitted.

## Overview

### Summary of the Nature, Objectives, Scope, Limitations of, and Procedures Performed in System and Engagement Reviews (as Referred to in a Peer Review Report)

.01 The purpose of this document is to provide standards for administering, planning, performing, reporting on and the acceptance of peer reviews of CPA firms (and individuals) enrolled in the AICPA Peer Review Program (see interpretations). Those processes collectively are also called *practice monitoring* because it is the monitoring of a CPA firm's accounting and auditing practice.

.02 The goal of practice monitoring, and the program itself, is to promote quality in the accounting and auditing services provided by the CPA firms (and individuals) subject to these standards. This goal serves the public interest and enhances the significance of AICPA membership.

.03 Firms (and individuals) (see interpretations) enrolled in the program are required to have a peer review, once every three years, of their accounting and auditing practice related to non-SEC issuers covering a one-year period. The peer review is conducted by an independent evaluator known as a peer reviewer. The AICPA oversees the program, and the review is administered by an entity approved by the AICPA to perform that role.

.04 There are two types of peer reviews: System Reviews and Engagement Reviews. System Reviews focus on a firm's system of quality control, and Engagement Reviews focus on work performed on selected engagements. A further description of these peer reviews as well as a summary of the nature, objectives, scope, limitations of, and procedures performed in them is included in appendix A.

## Introduction and Scope

.05 Firms (and individuals) (see interpretations) enrolled in the program have the responsibility to:

- a. Design and comply with a system of quality control for its accounting and auditing practice that provides the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Statement on Quality Control Standards (SQCS) No. 8, *A Firm's System of Quality Control (Redrafted)* (QC sec. 10), requires every CPA firm, regardless of its size, to have a system of quality control for its accounting and auditing practice.
- b. Perform accounting and auditing engagements in accordance with applicable professional standards using competent personnel<sup>1</sup> (partners<sup>2</sup> and staff<sup>3</sup>).
- c. Have independent peer reviews of their accounting and auditing practices (see interpretations). All firms that an AICPA member

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<sup>1</sup> Personnel are defined per Statement on Quality Control Standards (SQCS) as partners and staff.

<sup>2</sup> Partners are defined per SQCS as any individual with authority to bind the firm with respect to the performance of a professional services engagement.

<sup>3</sup> Staff are defined per SQCS as professionals, other than partners, including any specialists that the firm employs.

- is associated with should undergo a peer review if the services performed and reports issued by the firm require a peer review.
- d. Engage a peer reviewer to perform the peer review in accordance with these standards, in a timely manner.
  - e. Take such measures, if any, as may be necessary to satisfy its obligations concerning client confidentiality any time state statutes or ethics rules promulgated by state boards of accountancy do not clearly provide an exemption from confidentiality requirements when peer reviews are undertaken.
  - f. Provide written representations to describe matters significant to the peer review (see appendix B, "Considerations and Illustrations of Firm Representations").
  - g. Understand the AICPA Peer Review Board's guidance on resignations from the program (see interpretations).
  - h. Cooperate with the peer reviewer, administering entity, and the AICPA Peer Review Board (board) in all matters related to the peer review, that could impact the firm's enrollment in the program, including arranging, scheduling, and completing the review and taking remedial, corrective actions and implementing other plans as needed (see interpretations).

**.06** An *accounting and auditing practice* for the purposes of these standards is defined as all engagements performed under Statements on Auditing Standards (SASs); Statements on Standards for Accounting and Review Services (SSARs);<sup>4</sup> Statements on Standards for Attestation Engagements (SSAEs); *Government Auditing Standards* (the Yellow Book) issued by the U.S. Government Accountability Office; and engagements performed under PCAOB standards (see interpretations). Engagements covered in the scope of the program are those included in the firm's accounting and auditing practice that are not subject to PCAOB permanent inspection (see interpretations).

**.07** The objectives of the program are achieved through the performance of peer reviews involving procedures tailored to the size of the firm and the nature of its practice. Firms that perform engagements under the SASs or *Government Auditing Standards*, examinations under the SSAEs, or engagements under PCAOB standards, as their highest level of service have peer reviews called *System Reviews*. A System Review includes determining whether the firm's system of quality control for its accounting and auditing practice is designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards, including SQCS No. 8, in all material respects. Firms that only perform services under SSARs or services under the SSAEs not included in System Reviews are eligible to have peer reviews called *Engagement Reviews*, however firms that only perform preparation engagements (with or without disclaimer reports) under SSARs are not required to enroll in the program (see interpretations). These standards are not intended for and exclude the review of the firm's accounting and auditing practice applicable to engagements subject to PCAOB permanent inspection (see interpretations). Firms that do not provide any of the services listed in paragraph .06 are not peer reviewed (see interpretations).

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<sup>4</sup> Statements on Standards for Accounting and Review Services that provide an exemption from those standards in certain situations are likewise excluded from this definition of an accounting and auditing practice for peer review purposes (see interpretations).

**.08** The majority of the procedures in a System Review should be performed at the reviewed firm's office (see interpretations). Engagement Reviews are normally performed at a location other than the reviewed firm's office.

**.09** The program is based on the principle that a systematic monitoring and educational process is the most effective way to attain high quality performance throughout the profession. Thus, it depends on mutual trust and cooperation. On System Reviews, the reviewed firm is expected to take appropriate actions in response to findings, deficiencies, and significant deficiencies identified with their system of quality control or their compliance with the system, or both. On Engagement Reviews, the reviewed firm is expected to take appropriate actions in response to findings, deficiencies, and significant deficiencies identified in engagements. These actions will be positive and remedial. Disciplinary actions (including those that can result in the termination of a firm's enrollment in the program and the subsequent loss of membership in the AICPA and some state CPA societies by its partners<sup>5</sup> and employees) will be taken only for a failure to cooperate, failure to correct inadequacies, or when a firm is found to be so seriously deficient in its performance that education and remedial, corrective actions are not adequate.

**.10** Compliance with the positive enforcement program of a state board of accountancy does not constitute compliance with the AICPA's peer review requirements.

## General Considerations

### Administrative Requirements

**.11** All peer reviews intended to meet the requirements of the program should be carried out in conformity with these standards under the supervision of a state CPA society, group of state CPA societies, the AICPA Peer Review Board's National Peer Review Committee (National PRC) (see interpretations), or other entity (hereinafter, administering entity) approved by the board to administer peer reviews.

**.12** Peer reviews, including the reviewed firm and peer reviewers, are subject to oversight by the administering entity. In addition, peer reviews and administering entities are subject to oversight by the board and other bodies agreed upon by the board or the administering entity. The objectives of oversight are to ensure compliance with the standards and consistency in implementation. Reviewed firms, peer reviewers, and administering entities are expected to cooperate during the oversight process.

### Timing of Peer Reviews

**.13** A firm's due date for its initial peer review is ordinarily 18 months from the date it enrolled in the program or should have enrolled, whichever date is earlier (see interpretations).

**.14** A firm does not undergo a peer review if it does not perform engagements requiring it to undergo a peer review (see paragraph .07). However, when a firm performs its first engagement requiring a peer review or its first engagement requiring it to have a System Review, the firm's next due date ordinarily

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<sup>5</sup> A *partner* is a proprietor, shareholder, equity or non-equity partner, or any individual who assumes the risks and benefits of firm ownership or who is otherwise held out by the firm to be the equivalent of any of the aforementioned. Depending on how a CPA firm is legally organized, its partner(s) could have other names, such as *shareholder*, *member*, or *proprietor*.

will be 18 months from the year-end of that engagement (18 months from the report date if it is a financial forecast, projection or agreed upon procedures engagement) (see interpretations).

**.15** A firm's subsequent peer review ordinarily has a due date of three years and six months from the year-end of the previous peer review.

**.16** The due date for a peer review is the date by which the peer review report, and if applicable, letter of response, and the peer reviewer's materials are to be submitted to the administering entity.

**.17** Peer reviews must cover a current period of one year to be mutually agreed upon by the reviewed firm and the reviewing firm. Ordinarily, the peer review should be conducted within three to five months following the end of the year to be reviewed.

**.18** A firm is expected to maintain the same year-end on subsequent peer reviews (which is three years from the previous year-end) and the same review due date (which is three years from the previous review due date) (see interpretations).

**.19** If a firm resigns from the program and subsequently reenrolls in the program, the firm's due date is the later of the due date originally assigned or 90 days after reenrolling.

## Confidentiality

**.20** A peer review should be conducted in compliance with the confidentiality requirements set forth in the "Confidential Client Information Rule" (ET sec. 1.700.001) and its interpretations. Except as discussed in paragraph .146, information concerning the reviewed firm or any of its clients or personnel that is obtained as a consequence of the review is confidential. Such information should not be disclosed, except as required by law, by review team members or by administering entities to anyone not involved in performing the review, or administering or carrying out the program, or used in any way not related to meeting the objectives of the program.

## Independence, Integrity, and Objectivity

**.21** Independence in fact and in appearance should be maintained with respect to the reviewed firm by a reviewing firm, by review team members, and by any other individuals who participate in or are associated with the review (see interpretations). In addition, the review team should perform all peer review responsibilities with integrity and maintain objectivity in discharging those responsibilities.

**.22** *Independence* encompasses an impartiality that recognizes an obligation for fairness not only to the reviewed firm but also to those who may use the peer review report. The reviewing firm, the review team, and any other individuals who participate on the peer review should be free from any obligation to, or interest in, the reviewed firm or its personnel. The concepts in the "Integrity" principle (ET sec. 0.300.040) and the "Objectivity and Independence" principle (ET sec. 0.300.050) should be considered in making independence judgments. *Integrity* requires the review team to be honest and candid within the constraints of the reviewed firm's confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. *Objectivity* is a state of mind and a quality that lends value to a review team's services. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.

## Due Professional Care

**.23** Due professional care, as addressed by the "Due Care" principle (ET sec. 0.300.060), should be exercised in performing and reporting on the review. This imposes an obligation on all those involved in carrying out the review to fulfill assigned responsibilities in a professional manner (see interpretations).

## Peer Review Documentation and Retention Policy

**.24** Peer review documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. The documentation provides evidence of the work performed and is the basis for the review of the quality of the work. It should demonstrate that the peer reviewer complied with these standards and should support the basis for the peer reviewer's conclusions. Also, the documentation should be appropriately organized to provide a clear link from the working papers to the peer review report (see interpretations).

**.25** Peer review documentation should not be retained for an extended period of time after the peer review's completion, with the exception of certain documents that are maintained until the subsequent peer review's acceptance and completion (see interpretations).

## Organizing the System or Engagement Review Team

**.26** A System Review team comprises one or more individuals, depending upon the size and nature of the reviewed firm's practice and other factors. An Engagement Review team ordinarily comprises one individual. A review team may be formed by a firm engaged by the firm under review (a firm-on-firm review) or an association of CPA firms authorized by the board to assist its members in forming review teams (an association formed review team) (see interpretations). For Engagement Reviews, review teams may also be formed by the administering entity if it chooses to appoint such teams (hereinafter, a committee-appointed review team, also known as a CART review).

**.27** A reviewing firm (including for these purposes the team captain, for an association formed review team) must determine its capability to perform a peer review. This determination includes assigning peer reviewers with appropriate levels of expertise and experience to perform the review. Before accepting a peer review engagement, the reviewing firm should obtain and consider information about the firm to be reviewed, including certain operating statistics concerning size, nature of practice, industry specializations, and levels of service.

**.28** In determining its capability to perform the review, the reviewing firm should consider the size of the firm to be reviewed in relation to its own size. A reviewing firm must recognize that the performance of a peer review may demand substantial commitments of time, especially from its supervisory accounting and auditing personnel. Therefore, a reviewing firm should consider carefully the number and availability of its supervisory personnel in determining whether it can perform a peer review of another firm.

**.29** One member of the System Review team is designated the team captain. The individual performing an Engagement Review is designated the review captain. The team captain or review captain is responsible for supervising and conducting the review, communicating the review team's findings to the reviewed firm and to the administering entity, preparing the report on the review, and ensuring that peer review documentation is complete and submitted to the administering entity on a timely basis. If applicable, the team captain,

or review captain in unusual circumstances, should supervise and review the work performed by other reviewers on the review team to the extent deemed necessary under the circumstances.

.30 A System Review team, a review captain on an Engagement Review and, in unusual circumstances any additional reviewers on an Engagement Review, ordinarily should be approved by the administering entity prior to the planning and commencement of the peer review (see interpretations).

## Qualifying for Service as a Peer Reviewer

### System and Engagement Reviewers

.31 Performing and reporting on a peer review requires the exercise of professional judgment by peers (see paragraphs .147–.153 for a discussion of a reviewer's responsibilities when performing a peer review). Accordingly, an individual serving as a reviewer on a System or Engagement Review should at a minimum:

- a. Be a member of the AICPA in good standing (that is, AICPA membership in active, non-suspended status) licensed to practice as a CPA.
- b. Be currently active in public practice at a supervisory level in the accounting or auditing function of a firm enrolled in the program (see interpretations), as a partner of the firm, or as a manager or person with equivalent supervisory responsibilities.<sup>6, 7</sup> To be considered currently active in the accounting or auditing function, a reviewer should be presently involved in the accounting or auditing practice of a firm supervising one or more of the firm's accounting or auditing engagements or carrying out a quality control function on the firm's accounting or auditing engagements (see interpretations).
- c. Be associated with a firm (or all firms if associated with more than one firm) that has received a report with a peer review rating of *pass*<sup>8</sup> for its most recent System or Engagement Review that was accepted timely, ordinarily within the last three years and six months.<sup>9</sup>

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<sup>6</sup> The board recognizes that practitioners often perform a number of functions, including tax and consulting work, and cannot restrict themselves to accounting and auditing work. These standards are not intended to require that reviewers be individuals who spend all their time on accounting and auditing engagements. However, CPAs who wish to serve as reviewers should carefully consider whether their day-to-day involvement in accounting and auditing work is sufficiently comprehensive to enable them to perform a peer review with professional expertise. For instance, in a System Review, a reviewer of auditing engagements should be currently reviewing or performing auditing engagements. In an Engagement Review, a reviewer of engagements performed under the Statements on Standards for Attestation Engagements should also be currently reviewing or performing the same type of engagements.

<sup>7</sup> A manager or person with equivalent supervisory responsibilities is a professional employee of the firm who has either a continuing responsibility for the overall planning and supervision of engagements for specified clients or authority to determine that an engagement is complete subject to final partner approval if required.

<sup>8</sup> If a firm's most recent peer review rating was a *pass with deficiencies* or *fail*, the firm's members are not eligible to perform peer reviews.

<sup>9</sup> If a firm's most recent review was a report review, then the firm's members are not eligible to perform peer reviews.

- d. Possess current knowledge of professional standards applicable to the kind of practice to be reviewed, including quality control and peer review standards. This includes recent experience in and knowledge about current rules and regulations appropriate to the level of service applicable to the industries of the engagements that the individual will be reviewing (see interpretations).
- e. Have at least five years of recent experience in the practice of public accounting in the accounting or auditing function.<sup>10</sup>
- f. Have provided the administering entity with information that accurately reflects the qualifications of the reviewer including recent industry experience, which is updated on a timely basis (see interpretations).
- g. If the reviewer is from a firm that is a provider of quality control materials (QCM) or is affiliated with a provider of quality control materials and is required to have a QCM review under these standards, be associated with a provider firm or affiliated entity that has received a QCM report with a review rating of *pass* for its most recent QCM review that was submitted timely, ordinarily within six months of the provider's year-end.

### Team Captain or Review Captain

**.32** In addition to adhering to the general requirements in paragraph .31 to be a peer reviewer, a System Review team captain must be a partner.<sup>11</sup> For an Engagement Review, the review captain is not required to be a partner. The team captain, or the review captain in limited circumstances, is required to ensure that all team members possess the necessary capabilities and competencies to perform assigned responsibilities and that team members are adequately supervised. The team captain or review captain has the ultimate responsibility for the review, including the work performed by team members (see interpretations).

**.33** Also, team captains and review captains should have completed peer review training that meets the requirements established by the board (see interpretations). For additional team captain qualification requirements, see the interpretations.

### Other Peer Reviewer or Reviewing Firm Qualification Considerations

**.34** Communications from regulatory, monitoring, or enforcement bodies relating to allegations or investigations of a peer reviewer or reviewing firm's accounting and auditing practice, and notifications of limitations or restrictions on a peer reviewer or reviewing firm to practice, may impact the peer reviewer or reviewing firm's ability to perform the peer review. The peer reviewer or reviewing firm has a responsibility to inform the administering entity of such communications or notifications (see interpretations).

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<sup>10</sup> For this purpose, *recent* means having experience within the last five years in the industries and related levels of service for which engagements are reviewed. However, a reviewer should be cautious of those high-risk engagements or industries in which new standards have been issued. For example, in those cases in which new industry standards or practices have occurred in the most recent year, it may be necessary to have *current* practice experience in that industry in order to have *recent* experience.

<sup>11</sup> If the peer reviewer's firm's (see paragraph .31c) most recent peer review was an Engagement Review, then the peer reviewer is not eligible to be a System Review team captain.

**.35** If required by the nature of the reviewed firm's practice, individuals with expertise in specialized areas may assist the review team in a consulting capacity (see interpretations). For example, computer specialists, statistical sampling specialists, actuaries, or experts in continuing professional education (CPE) may participate in certain segments of the review.

## Performing System Reviews

### Objectives

**.36** A System Review is intended to provide the reviewer with a reasonable basis for expressing an opinion on whether, during the year under review:

- a. The reviewed firm's system of quality control for its accounting and auditing practice has been designed in accordance with quality control standards established by the AICPA (see SQCS No. 8).
- b. The reviewed firm's quality control policies and procedures were being complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.

**.37** A System Review is designed to test a reasonable cross section of the firm's engagements with a focus on high-risk engagements, in addition to significant risk areas where the possibility exists of engagements not being performed or reported on in conformity with applicable professional standards in all material respects. A System Review is not designed to test every engagement or compliance with every professional standard and every detailed component of the firm's system of quality control.

### Basic Requirements

**.38** A System Review should include, but not be limited to, the following procedures:

- a. Planning the review, as follows:
  - i. Obtain the results of the prior peer review (see paragraph .39).
  - ii. Inquire of the firm about the areas to be addressed in the written representations (see paragraph .40).
  - iii. Obtain a sufficient understanding of the nature and extent of the firm's accounting and auditing practice to plan the review (see paragraphs .41–.45).
  - iv. Obtain a sufficient understanding of the design of the firm's system of quality control, including an understanding of the monitoring procedures performed since the prior review, to plan the review (see paragraphs .41–.45).
  - v. Assess peer review risk (see paragraphs .46–.52).
  - vi. Use the knowledge obtained from the foregoing to select the offices and the engagements to be reviewed and to determine the nature and extent of the tests to be applied in the functional areas (see paragraphs .53–.63).
- b. Performing the review, as follows:
  - i. Review the firm's design and compliance with its system of quality control. The review should cover all organizational

- or functional levels within the firm (see paragraphs .53–.54).
- ii. Review significant risk areas on selected engagements, including the relevant accounting, audit, and attestation documentation and reporting (see paragraphs .64–.65).
  - iii. Conclude on the review of engagements (see paragraphs .66–.67).
  - iv. Reassess the adequacy of the scope of the review based on the results obtained to determine whether additional procedures are necessary (see paragraph .68).
  - v. Determine the relative importance of matters (see paragraphs .69–.72).
  - vi. Prepare the Matter for Further Consideration (MFC) forms, Disposition of MFC (DMFC) forms, and any related Finding for Further Consideration (FFC) forms (see paragraphs .73–.74).
  - vii. Aggregate and systemically evaluate the matters (see paragraphs .75–.86).
  - viii. Form conclusions on the type of report to issue (see paragraphs .87–.90).
  - ix. Obtain the written representations from the reviewed firm (see paragraph .05f and appendix B).
  - x. Conduct an exit conference with senior members of the reviewed firm to discuss the review team's comments; matters, findings, deficiencies, and significant deficiencies identified; recommendations; MFCs and related FFCs; and the type of report to be issued and the deficiencies or significant deficiencies to be included in such report and to resolve any disagreements (see paragraphs .91–.92).
  - xi. Prepare a written report on the results of the review (see paragraphs .94–.96).
  - xii. Review and provide comments to the reviewed firm on its response to the report, if applicable (see paragraphs .97–.101).

## Planning Considerations

**.39** To assist the review team in the planning of the review, the team captain should obtain the prior peer review report, the letter of response, if applicable, and the letter of acceptance, all from the reviewed firm. The team captain should also obtain the prior FFC forms, if applicable (from the administering entity if the team captain's firm did not perform the prior peer review). The team captain should consider whether the issues discussed in those documents require additional emphasis in the current review and, in the course of the review, should evaluate the actions of the firm in response to the prior report.

**.40** The reviewer should inquire of the firm regarding the areas to be addressed in the written representation (see paragraph .05f and appendix B) and consider whether the areas discussed require additional emphasis in the course of the review (see interpretations).

## Understanding the Firm's Accounting and Auditing Practice and System of Quality Control

.41 The review team should obtain a sufficient understanding of the nature and extent of the reviewed firm's accounting and auditing practice to plan the review. This understanding should include knowledge about the reviewed firm's organization and philosophy, as well as the composition of its accounting and auditing practice.

.42 The review team should also obtain a sufficient understanding of the reviewed firm's system of quality control with respect to each of the quality control elements in SQCS No. 8 to plan the review (see interpretations). SQCS No. 8 requires every CPA firm, regardless of its size, to have a system of quality control for its accounting and auditing practice. It states that the quality control policies and procedures applicable to a professional service provided by the firm should encompass the following elements: leadership responsibilities for quality within the firm (the "tone at the top"); relevant ethical requirements (such as independence, integrity and objectivity); acceptance and continuance of client relationships and specific engagements; human resources; engagement performance; and monitoring. It also states that the nature, extent, and formality of a firm's quality control policies and procedures should be appropriately comprehensive and suitably designed in relation to the firm's size, the number of its offices, the degree of operating autonomy allowed its personnel and its offices, the knowledge and experience of its personnel, the nature and complexity of the firm's practice, and appropriate cost-benefit considerations.

.43 The understanding obtained by the review team should include knowledge about the design of the reviewed firm's quality control policies and procedures in accordance with quality control standards established by the AICPA and how the policies and procedures identify and mitigate risk of material non-compliance with applicable professional standards.

.44 The understanding of the firm's accounting and auditing practice and system of quality control is ordinarily obtained through such procedures as inquiries of appropriate management and other personnel, reviewing the firm's internal policies and procedures, and reviewing the firm's responses to questionnaires developed by the board.

.45 The review team should obtain a sufficient understanding of the reviewed firm's monitoring policies and procedures since its last peer review and their potential effectiveness. In doing so, the review team may determine that the firm's current year's internal monitoring procedures could enable the review team to reduce, in a cost-beneficial manner, the number of offices and engagements selected for review or the extent of the other testing (see interpretations).

## Understanding and Assessing Peer Review Risk Factors

.46 Just as the performance of an audit involves audit risk, the performance of a System Review involves peer review risk. Peer review risk is the risk that the review team:

- a. Fails to identify significant weaknesses in the reviewed firm's system of quality control for its accounting and auditing practice, its lack of compliance with that system, or a combination thereof.
- b. Issues an inappropriate opinion on the reviewed firm's system of quality control for its accounting and auditing practice, its compliance with that system, or a combination thereof.

- c. Reaches an inappropriate decision about the matters to be included in, or excluded from, the report.

.47 Peer review risk consists of the following two parts:

- a. The risk (consisting of *inherent risk* and *control risk*) that an engagement will not be performed or reported on in conformity with applicable professional standards in all materials respects, that the reviewed firm's system of quality control will not prevent such failure, or both.<sup>12, 13</sup>
- b. The risk (*detection risk*) that the review team will fail to detect and report on the design or compliance deficiencies or significant deficiencies in the reviewed firm's system of quality control.

.48 Inherent risk and control risk relate to the reviewed firm's accounting and auditing practice and its system of quality control. These risks may be affected by circumstances arising within the firm (for example, individual partners have engagements in numerous specialized industries or the firm has a few engagements constituting a significant portion of the firm's accounting and auditing practice) or outside the firm (for example, new professional standards being applied for the first time or adverse economic developments in an industry).

### **Assessing Peer Review Risk**

.49 In planning the review, the review team should use the understanding it has obtained of the reviewed firm's accounting and auditing practice and its system of quality control to assess the inherent and control risks. The assessment of risks is qualitative and not quantitative. The lower the inherent and control risk, the higher the detection risk that can be tolerated and vice versa. Based on its assessment of inherent and control risk, the review team determines the acceptable level of detection risk.

.50 When assessing risk, the review team should evaluate the reviewed firm's quality control policies and procedures over its accounting and auditing practice in relation to the requirements contained in SQCS No. 8. This evaluation provides a basis for the review team to determine whether the reviewed firm has adopted appropriately comprehensive and suitably designed policies and procedures that are relevant to the size and nature of its practice.

### **Relationship of Risk to Scope**

.51 The review team should consider the combined assessed levels of inherent and control risk when selecting offices and engagements to be reviewed. The higher the combined assessed levels of inherent and control risk, the higher the peer review risk. To reduce the peer review risk to an acceptable low level, the detection risk needs to be low, and thus the greater the scope (that is, the greater the number of offices that should be visited or the greater the number of engagements that should be reviewed, or both). Conversely, the lower the combined assessed levels of inherent and control risk, the smaller the scope that

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<sup>12</sup> *Inherent risk* is the likelihood that an accounting or auditing engagement will fail to conform to professional standards, assuming the firm does not have a system of quality control.

<sup>13</sup> *Control risk* is the risk that a firm's system of quality control will not prevent the performance of an engagement that does not conform to professional standards. It consists of two parts: the firm's control environment and its quality control policies and procedures. The control environment represents the collective effort of various factors on establishing, enhancing, or mitigating the effectiveness of specific quality control policies and procedures. The control environment reflects the overall attitude, awareness, and actions of firm management concerning the importance of quality work and its emphasis in the firm.

needs to be considered for review. The combined assessed levels of inherent and control risk may vary among offices and engagements so that the scope may be greater for some types of offices and engagements than for others.

**.52** However, even when the combined assessed levels are low, the peer review team must review some engagements to obtain reasonable assurance that the reviewed firm is complying with its quality control policies and procedures and applicable professional standards. For the review team to obtain such assurance, a reasonable cross section of the reviewed firm's accounting and auditing engagements must be reviewed or inspected, with greater emphasis on those portions of the practice with higher combined assessed levels of inherent and control risk (see interpretations).

## Planning and Performing Compliance Tests

**.53** After performing the aforementioned planning procedures, the team captain should then develop a general plan for the nature and extent of conducting compliance tests of engagements (to directly test the "engagement performance" element in SQCS No. 8) and the other elements described in SQCS No. 8 (collectively referred to as the *functional areas*). The compliance tests should be tailored to the practice of the reviewed firm and, taken as a whole, should be sufficiently comprehensive to provide a reasonable basis for concluding whether the reviewed firm's system of quality control was complied with to provide the firm with reasonable (not absolute) assurance of performing and reporting in conformity with applicable professional standards in the conduct of its accounting and auditing practice in all material respects.

**.54** Such tests should be performed at the practice office(s) visited and should relate to individual engagements and the functional areas. The tests should include the following:

- a. Review significant risk areas (see paragraph .65) on selected engagements, including accounting and auditing documentation, and reports, to evaluate whether the engagements were performed and reported on in conformity with applicable professional standards and in compliance with relevant firm quality control policies and procedures.
- b. Interview firm personnel at various levels and, if applicable, other persons responsible for a function or activity to assess their understanding of, and compliance with, the firm's quality control policies and procedures.
- c. Review evidential material to determine whether the firm has complied with its policies and procedures for monitoring its system of quality control.
- d. Review other evidential material as appropriate. Examples include selected administrative or personnel files, correspondence files documenting consultations on technical or ethical questions, files evidencing compliance with human resource requirements, and the firm's technical reference sources (see interpretations).

### Scope Limitations

**.55** There is a presumption that all engagements and all aspects of functional areas otherwise subject to the peer review will be included in the scope of the review. However, in the rare situations when exclusions or other limitations on the scope of the review are being contemplated, a team captain should carefully consider the implications of such exclusion. This includes communicating

to the firm and the administering entity the effect on the review and on the ability of the team captain to issue a peer review report (see interpretations).

### ***Selection of Offices***

**.56** Visits to practice offices should be sufficient to provide the review team with a reasonable basis for its conclusions regarding whether the reviewed firm's quality control policies and procedures are adequately communicated throughout the firm and whether its system of quality control was complied with during the year under review based on a reasonable cross section of the reviewed firm's accounting and auditing practice, with greater emphasis on those offices with higher assessed levels of peer review risk. Examples of the factors to consider when assessing peer review risk at the office level include the following (see interpretations):

- a. The number, size, and geographic distribution of offices
- b. The degree of centralization of accounting and auditing practice control and supervision
- c. The review team's evaluation, if applicable, of the firm's monitoring procedures
- d. Recently merged or recently opened offices
- e. The significance of industry concentrations and of specialty practice areas, such as governmental compliance audits or regulated industries, to the firm and to individual offices
- f. Extent of non-audit services to audit clients
- g. Significant clients' fees to practice office(s) and partner(s)

**.57** For a multi-office firm, the review should include, in addition to any offices selected using the risk-based criteria, a visit to the firm's executive office if one is designated as such.

### ***Selection of Engagements***

**.58** Engagements subject to selection for review ordinarily should be those with periods ending during the year under review, except financial forecasts or projections and agreed upon procedures (see interpretations). Financial forecasts or projections and agreed upon procedures with report dates during the year under review would be subject to selection. If the current year's engagement has not been completed and issued, and if a comparable engagement within the peer review year is not available, the prior year's engagement may be reviewed. If the subsequent year's engagement has been completed and issued, the review team should consider, based on its assessment of peer review risk, whether the more recently completed and issued engagement should be reviewed instead (see interpretations). Review team members should not have contact with or access to any client of the reviewed firm in connection with the peer review.

**.59** Engagements selected for review should provide a reasonable cross section of the reviewed firm's accounting and auditing practice, with greater emphasis on those engagements in the practice with higher assessed levels of peer review risk. Examples of the factors to consider when assessing peer review risk at the engagement level include size; industry area; level of service; personnel (including turnover, use of merged-in personnel, or personnel not routinely assigned to accounting and auditing engagements); communications from regulatory, monitoring, or enforcement bodies; extent of non-audit services to audit clients; significant clients' fees to practice office(s) and partner(s); and initial engagements (see interpretations).

**.60** The review of engagements should usually be directed toward the accounting and auditing work performed by the practice office visited, including the work performed on those engagements by other practice offices of the reviewed firm or other public accounting firms. For those situations in which the practice office being visited performed accounting and auditing work for another practice office, the review team may limit its review to portions of the engagements performed by the practice office being visited but should evaluate the appropriateness of the instructions issued by the other practice office and the adequacy of the procedures followed in performing and reporting in conformity with applicable professional standards. When combined with other procedures performed, the number and type of accounting and auditing engagements selected by the review team for review should be sufficient to provide the review team with a reasonable basis for its conclusions regarding the reviewed firm's system of quality control.

**.61** The initial selection of engagements to be reviewed should ordinarily be provided to the reviewed firm no earlier than three weeks prior to the commencement of the peer review procedures at the related practice office or location. This should provide ample time to enable the firm (or office) to assemble the required client information and engagement documentation before the review team commences the review. However, at least one engagement from the initial selection to be reviewed should be provided to the firm once the review commences and not provided to the firm in advance. Ordinarily, based on the nature of the firm's practice and assuming that the engagement would not be automatically anticipated for selection by the reviewed firm, the engagement should be an audit. Otherwise, the engagement should be the firm's next highest level of service where the same criteria can be met. This should not increase the scope of the review (see interpretations).

**.62** The process of engagement selection, except as noted in paragraph .63, like office selection, is not subject to definitive criteria. Nevertheless, if the team captain finds that meeting all of the preceding criteria results in the selection of an inappropriate scope of the firm's accounting and auditing practice, the team captain should consult with the administering entity about the selection of engagements for review (see interpretations).

**.63** Specific types or number of engagements must be selected in a System Review (see interpretations).

### ***Extent of the Review of Engagements***

**.64** The review of engagements should include the review of financial statements, accountants' reports, accounting and audit documentation, and correspondence, as well as discussions with professional personnel of the reviewed firm.

**.65** Audit engagements have areas in which risk may be inherently significant, such as, but not limited to, fraud considerations, use of estimates, emerging issues, and assertions that are difficult to audit. The review team's procedures should include determining whether the reviewed firm has appropriately:

- a. Identified the significant risk areas on each audit engagement selected for the peer review,
- b. Performed the necessary audit procedures related to the identified significant risk areas, and
- c. Documented the auditing procedures performed in these significant risk areas.

### ***Concluding on the Review of an Engagement***

.66 For each engagement reviewed, the review team should conclude on its review by documenting whether anything came to its attention that caused it to believe that the engagement was not performed or reported on in conformity with applicable professional standards in all material respects (see interpretations).

.67 The team captain should promptly inform the firm when an engagement is not performed or reported on in conformity with applicable professional standards and remind the firm of its obligation under professional standards to take appropriate actions (see interpretations).

### ***Expansion of Scope***

.68 If, during the peer review, the review team concludes that there was a failure to reach an appropriate conclusion on the application of professional standards in all material respects on one or more of the reviewed engagements, the review team should consider whether the application of additional peer review procedures is necessary. This consideration should be documented in the peer review working papers. The objective of the application of additional procedures would be to determine whether the failure is indicative of a pattern of such failures, whether it is a significant deficiency in the design of the reviewed firm's system of quality control or in its compliance with the system, or whether it is both. In some circumstances, the reviewer may conclude that, because of compensating controls or for other reasons, further procedures are unnecessary. If, however, additional procedures are deemed necessary, they may include an expansion of scope to review all or relevant portions of one or more additional engagements or aspects of functional areas. Additional engagements may be in the same industry, supervised by the same individual in the reviewed firm, or otherwise have characteristics associated with the failure to perform or report in conformity with professional standards.

### **Identifying Matters, Findings, Deficiencies, and Significant Deficiencies**

.69 In understanding the firm's system of quality control, the team captain may note that the system is not designed appropriately. Similarly, the performance of compliance tests may uncover that the system is not being complied with appropriately or may identify a design weakness that was not identified during the planning of the peer review. With any of these items, the team captain has available a set of definitions to assist in classifying the condition noted.

.70 Determining the relative importance of matters noted during the peer review, individually or combined with others, requires professional judgment. Careful consideration is required in forming conclusions. The descriptions that follow, used in conjunction with practice aids (MFC, DMFC, and FFC forms) to document these items when applicable, are intended to assist in aggregating and evaluating the peer review results, concluding on them, and determining the nature of the peer review report to issue:

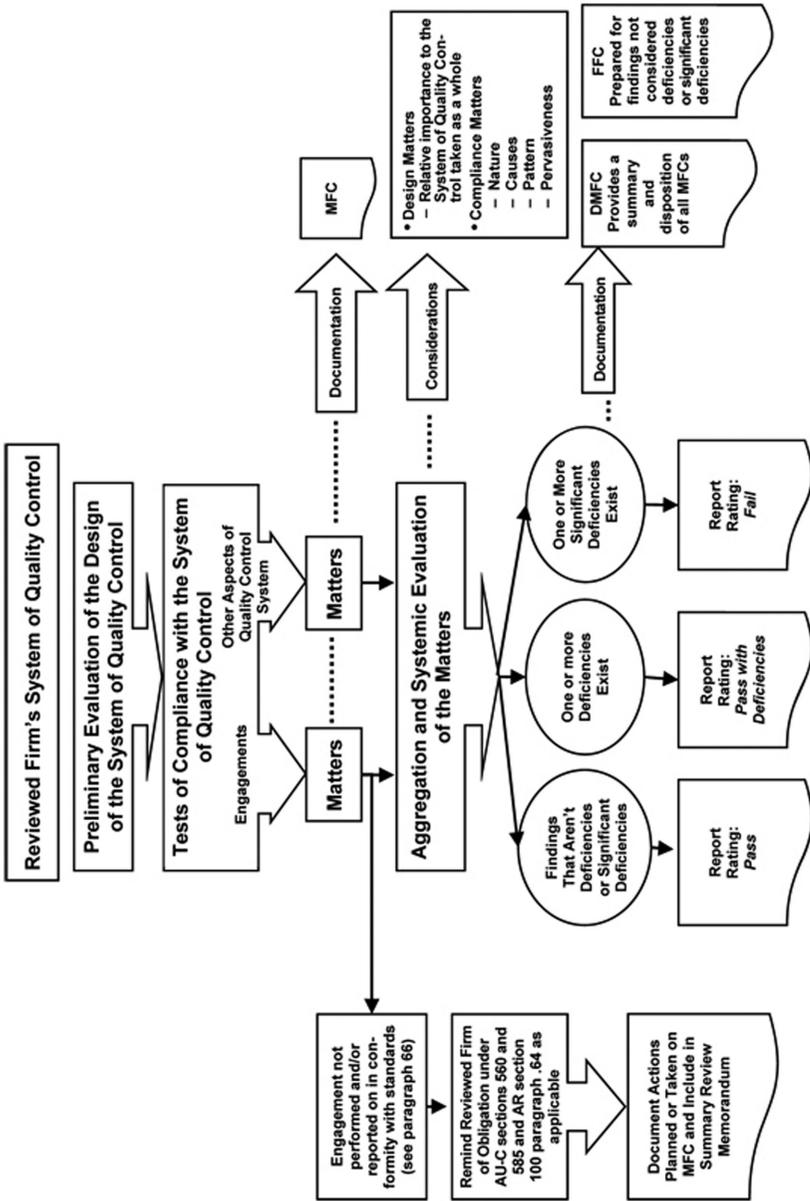
- a. A peer reviewer notes a *matter* as a result of his or her evaluation of the design of the reviewed firm's system of quality control or tests of compliance with it. Tests of compliance include inspection, inquiry, and observation performed by reviewing engagements and testing other aspects of the reviewed firm's system of quality control. Matters are typically one or more "No" answers to questions in peer review questionnaire(s) that a reviewer concludes

warrants further consideration in the evaluation of a firm's system of quality control. A matter is documented on a Matter for Further Consideration (MFC) form.

- b. A *finding* is one or more related matters that result from a condition in the reviewed firm's system of quality control or compliance with it such that there is more than a remote possibility that the reviewed firm would not perform or report in conformity with applicable professional standards. A peer reviewer will conclude whether one or more findings are a deficiency or significant deficiency. If the peer reviewer concludes that no finding, individually or combined with others, rises to the level of deficiency or significant deficiency, a report rating of *pass* is appropriate. A finding not rising to the level of a deficiency or significant deficiency is documented on a Finding for Further Consideration (FFC) form.
- c. A *deficiency* is one or more findings that the peer reviewer has concluded, due to the nature, causes, pattern, or pervasiveness, including the relative importance of the finding to the reviewed firm's system of quality control taken as a whole, could create a situation in which the firm would not have reasonable assurance of performing or reporting in conformity with applicable professional standards in one or more important respects. It is not a significant deficiency if the peer reviewer has concluded that except for the deficiency or deficiencies, the reviewed firm has reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Such deficiencies are communicated in a report with a peer review rating of *pass with deficiencies*.
- d. A *significant deficiency* is one or more deficiencies that the peer reviewer has concluded results from a condition in the reviewed firm's system of quality control or compliance with it such that the reviewed firm's system of quality control taken as a whole does not provide the reviewed firm with reasonable assurance of performing or reporting in conformity with applicable professional standards in all material respects. Such deficiencies are communicated in a report with a peer rating of *fail*.

.71 A broad understanding of the peer review process, from the preliminary evaluation of the design of the system of quality control, to the tests of compliance, to the decision making process of determining whether an item noted during a System Review is a matter, finding, deficiency, or significant deficiency, is shown in exhibit A. The exhibit also illustrates the aggregation of these items, where those items are documented in the practice aids and how they might affect the type of report issued.

Exhibit A



**.72** As described by exhibit A in paragraph .71, depending on the resolution of a matter and the process of aggregating and evaluating peer review results, a matter may develop into a finding. Findings will also be evaluated and, after considering the nature, causes, pattern, pervasiveness, and relative importance to the system of quality control as a whole, may not get elevated to a deficiency. A matter may develop into a finding and get elevated to a deficiency. That deficiency may or may not be further elevated to a significant deficiency.

**.73** A matter is documented on a MFC form. If the matter, after further evaluation, gets elevated to a finding but not a deficiency or significant deficiency, it is documented on a FFC form. The FFC form is a standalone document that includes the reviewer's recommendation and the reviewed firm's response regarding actions planned or taken and the timing of those actions by the firm. MFC and FFC forms are subject to review and oversight by the administering entity, who will evaluate the reviewed firm's FFC form responses for appropriateness and responsiveness (see paragraphs .141–.145) and determine whether any further action is necessary. If the matter documented on the MFC form is instead elevated to a deficiency or significant deficiency, then it is communicated in the report itself, along with the reviewer's recommendation. The firm submits a letter of response regarding actions planned or taken and the timing of those actions by the firm, which is also evaluated for appropriateness and responsiveness (see paragraphs .139–.140).

**.74** In order to document the disposition of all the MFCs, the team captain completes a DMFC form. The DMFC form is part of the working papers and provides a trail of the disposition of the MFCs for the peer reviewer, administering entity, and individuals conducting technical reviews or oversight. All of the MFCs are identified on the DMFC form with an indication after each as to whether it was cleared, discussed with the firm during the exit conference, included on a specific FFC form (individually or combined with other MFCs), or included as a deficiency in a report with a peer review rating of *pass with deficiencies* or as a significant deficiency in a report with a peer review rating of *fail*.

## Aggregating and Systemically Evaluating Matters

**.75** To conclude on the results of a peer review, the review team must aggregate the matters noted during the peer review and determine whether the matters were the result of the design of the reviewed firm's system of quality control or the failure of its personnel to comply with the firm's quality control policies and procedures. The review team should consider their relative importance to the firm's system of quality control as a whole and their nature, causes, pattern, and pervasiveness.

**.76** Use of professional judgment is essential in determining whether the aggregation of the matters noted during the review are findings and whether one or more findings is a deficiency or significant deficiency for purposes of reporting on the results of the peer review.

### Design Matters

**.77** A design matter exists when the reviewed firm's system of quality control is missing a quality control policy or procedure or the reviewed firm's existing quality control policies and procedures, even if fully complied with, would not result in engagements performed or reported on in accordance with professional standards in some respect. To be effective, a system of quality control must be designed properly, and all of the quality control policies and procedures necessary to provide the reviewed firm with reasonable assurance of

performing and reporting in conformity with applicable professional standards in all material respects should be in place. Therefore, the review team will need to determine whether the quality control policies and procedures would be effective if they were complied with. To make this determination, the review team should consider the implications of the evidence obtained during its evaluation of the system of quality control and its tests of compliance, including its reviews of engagements. For example, a pattern of engagement failures to perform or report in conformity with applicable professional standards in all material respects (that is, failures requiring the application of AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*, or AU-C section 585, *Consideration of Omitted Procedures After the Report Release Date*), likely is indicative of a finding pertaining to the design of the reviewed firm's quality control policies and procedures.

**.78** As noted in SQCS No. 8, "The nature of the policies and procedures developed by individual firms to comply with this Statement will depend on various factors such as the size and operating characteristics of the firm." Likewise, the relative importance of design matters noted in the reviewed firm's quality control policies and procedures, individually and in the aggregate, need to be evaluated in the context of the firm's size, organizational structure, and the nature of its practice. For example, a matter noted during the review of a quality control policy or procedures may be particularly or wholly offset by another policy or procedure. In this circumstance, the review team should consider the interrelationships among the elements of quality and weigh the matters noted against compensating policies and procedures to determine whether a finding exists and its relative importance.).

**.79** There may be circumstances in which the reviewer finds few findings in the work performed by the firm and yet may conclude that the design of the firm's system of quality control needs to be improved. For example, a firm that is growing rapidly and adding personnel and clients may not be giving appropriate attention to the policies and procedures necessary in areas such as human resources (hiring, assigning personnel to engagements, and advancement) and acceptance and continuance of clients and engagements. A reviewer might conclude that these conditions could create a situation in which the firm would not have reasonable assurance of performing or reporting in conformity with applicable professional standards in one or more important respects. However, in the absence of findings in the engagements reviewed, the reviewer would ordinarily conclude that the matter should be addressed in a FFC as a finding rather than result in a report with a peer review rating of *pass with deficiencies* or *fail*.

### **Compliance Matters**

**.80** A compliance matter exists when a properly designed quality control policy or procedure does not operate as designed because of the failure of the personnel of the reviewed firm to comply with it. Because a variance in individual performance and professional interpretation will affect the degree of compliance, adherence to all policies and procedures in every case generally is not possible. However, the degree of compliance by the personnel of the reviewed firm with its prescribed quality control policies and procedures should be adequate to provide the reviewed firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.

**.81** In assessing whether the degree of compliance was adequate to provide the required assurance, the review team should consider the nature, causes, pattern, and pervasiveness of the instances of noncompliance noted and their

relative importance to the firm's system of quality control as a whole, not merely their importance in the specific circumstances in which they were observed. As with the evaluation of design matters, compliance matters also need to be evaluated in the context of the firm's size, organizational structure, and the nature of its practice.

.82 To determine the degree of noncompliance, the review team should evaluate the matters of noncompliance, both individually and in the aggregate, recognizing that adherence to certain policies and procedures of the reviewed firm is more critical to the firm obtaining reasonable assurance of performing and reporting in conformity with applicable professional standards than adherence to others. In this context, the review team should consider the likelihood that noncompliance with a given quality control policy or procedure could have resulted in engagements not being performed or reported on in conformity with applicable professional standards in all material respects. The more direct the relationship between a specific quality control policy or procedure and the application of professional standards, the lower the degree of noncompliance necessary to determine whether a matter (or matters) is a finding and whether a finding is a deficiency or significant deficiency.

### ***Determining the Cause for a Finding***

.83 When the review team is faced with an indication that a matter(s) could be a finding, or the firm failed to perform or report in conformity with applicable professional standards in all material respects, the review team's first task in such circumstances is to determine the cause of the finding or failure (see interpretations). Causes that might be systemic and might affect the type of peer review report issued include, but are not limited to, the following:

- a. The failure related to a specialized industry practice, and the firm had no experience in that industry and made no attempt to acquire training in the industry or to obtain appropriate consultation and assistance.
- b. The failure related to an issue covered by a recent professional pronouncement, and the firm had failed to identify, through professional development programs or appropriate supervision, the relevance of that pronouncement to its practice.
- c. The failure should have been detected if the firm's quality control policies and procedures had been followed.
- d. The failure should have been detected by the application of quality control policies and procedures commonly found in firms similar in size or nature of practice. That judgment can often be made by the reviewer based on personal experience or knowledge; in some cases, the reviewer will wish to consult with the administering entity before reaching such a conclusion.

.84 The finding or failure to perform or report in conformity with applicable professional standards in all material respects may be the result of an isolated human error and, therefore, would not necessarily mean that a peer review report with a peer review rating of *pass with deficiencies* or *fail* should be issued (see interpretations). However, if the reviewer believes that the probable cause (for example, a failure to provide or follow appropriate policies for supervision of the work of assistants) of a finding or failure to perform or report in conformity with applicable professional standards in all material respects on an engagement or a finding within a functional area also exists in other engagements or in other functional areas, the reviewer needs to consider carefully the need to issue a peer review report with a peer review rating of *pass with deficiencies* or *fail*.

.85 Although an isolated matter or an instance of noncompliance with the firm's quality control policies and procedures ordinarily would not be included in the report, its nature, cause (if determinable), and relative importance for the firm's system of quality control as a whole should be evaluated in conjunction with the review team's other findings before making a final determination (see interpretations).

### ***The Pattern and Pervasiveness of Matters***

.86 The review team must consider the pattern and pervasiveness of matters and their implications for compliance with the firm's system of quality control as a whole, in addition to their nature, causes, and relative importance in the specific circumstances in which they were observed. As noted in the preceding paragraphs, the review team's first task is to try to determine why the matters occurred. In some cases, the design of the firm's system of quality control may be deficient (for example, when it does not provide for timely involvement in the planning process by a partner of the firm or there is inadequate supervision of engagement planning). In other cases, there may be a pattern of noncompliance with a quality control policy or procedure such as when firm policy requires the completion of a financial statement disclosure checklist but such checklists often were not used or relevant questions or points were incorrectly considered. That increases the possibility that the firm might not perform or report in conformity with applicable professional standards in all material respects, which also means that the reviewer must consider carefully whether the matter(s) individually or in the aggregate is (are) a deficiency or a significant deficiency and whether there is the need to issue a peer review report with a peer review rating of *pass with deficiencies* or *fail*. On the other hand, the types of matters noted may be individually different, not individually significant, and not directly traceable to the design of or compliance with a particular quality control policy or procedure. This may lead the reviewer to the conclusion that the matters were isolated cases of human error that should not result in a peer review report with a peer review rating of *pass with deficiencies* or *fail*.

## **Forming Conclusions on the Type of Report to Issue in a System Review**

.87 The team captain must use professional judgment in determining the type of peer review report to issue. This judgment requires the consideration of several factors, including an understanding of the firm's system of quality control and the nature, causes, pattern, and pervasiveness of matters and their relative importance to the firm's system of quality control taken as a whole, including limitations on the scope of the review.

### ***System Review Report With a Peer Review Rating of Pass***

.88 A report with a peer review rating of *pass* should be issued when the team captain concludes that the firm's system of quality control for the accounting and auditing practice has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. There are no deficiencies or significant deficiencies that affect the nature of the report and, therefore, the report does not contain any deficiencies, significant deficiencies, or recommendations. In the event of a scope limitation, a report with a peer review rating of *pass (with a scope limitation)* is issued.

**System Review Report With a Peer Review Rating of Pass With Deficiencies**

.89 A report with a peer review rating of *pass with deficiencies* should be issued when the team captain concludes that the firm's system of quality control for the accounting and auditing practice has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects with the exception of a certain deficiency or deficiencies that are described in the report. These deficiencies are conditions related to the firm's design of and compliance with its system of quality control that could create a situation in which the firm would have less than reasonable assurance of performing or reporting in conformity with applicable professional standards in one or more important respects due to the nature, causes, pattern, or pervasiveness, including the relative importance of the deficiencies to the quality control system taken as a whole. In the event of a scope limitation, a report with a peer review rating of *pass with deficiencies (with a scope limitation)* is issued.

**System Review Report With a Peer Review Rating of Fail**

.90 A report with a peer review rating of *fail* should be issued when the team captain has identified significant deficiencies and concludes that the firm's system of quality control is not suitably designed to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects or the firm has not complied with its system of quality control to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. In the event of a scope limitation, a report with a peer review rating of *fail (with a scope limitation)* is issued.

**Communicating Conclusions at the Exit Conference**

.91 A firm that has a System Review should respond promptly to questions raised in the review in order to assist the review team in reaching its conclusions. Prior to issuing its report or finalizing FFC form(s), if applicable, the review team should communicate its conclusions to senior members of the reviewed firm at an exit conference (see interpretations). Ordinarily, the team captain should be physically present at the exit conference, unless the System Review is performed at a location other than the reviewed firm's office. The exit conference may also be attended by representatives of the administering entity, the board, AICPA staff, or other board authorized organizations with oversight responsibilities.

.92 The reviewed firm is entitled to be informed at the exit conference about any matters documented on the MFC form(s), findings documented on the FFC form(s), deficiencies or significant deficiencies to be included in the peer review report, and the type of report to be issued. Accordingly, except in rare circumstances that should be explained to the reviewed firm, the exit conference should be postponed if there is any uncertainty about the report to be issued or the deficiencies or significant deficiencies to be included in the report. The review team should also communicate, if applicable, that the firm will be required to respond to the findings documented on the FFC form(s), or the deficiency(ies) or significant deficiencies included in the peer review report. The review team should also communicate that the firm may be required, if applicable, to (1) take certain actions to correct the deficiencies or significant deficiencies noted in the report or (2) complete an implementation plan to address the findings noted in the FFC form(s). The review team should also discuss with the reviewed firm

the implications of these steps on the acceptance and completion of the peer review and the reviewed firm's enrollment in the program. The exit conference is also the appropriate vehicle for providing suggestions to the firm that are not included in the report, FFC form(s), or MFC form(s).

## Addressing Disagreements Between the Reviewer and the Reviewed Firm

.93 Disagreements may arise on the resolution of various issues, for instance, related to the review of particular engagements, the systemic cause for a deficiency, or issues related to a design deficiency. In addition, there could be a disagreement on the appropriate approach to be taken in performing or reporting in conformity with applicable professional standards, or the review team might not believe that the actions planned or taken by the firm, if any, are appropriate (for example, if the reviewed firm believes that it can continue to support a previously issued report and the review team continues to believe that there may be a failure to reach appropriate conclusions in the application of professional standards). Reviewers and reviewed firms should understand that professional judgment often becomes a part of the process and that each party has the right to challenge each other on an issue. Nevertheless, a disagreement on the resolution of an issue may persist in some circumstances. The reviewed firm or reviewer should be aware that they may consult with their administering entity and, if necessary, request that the administering entity's peer review committee resolve the disagreement. If the administering entity's full peer review committee is unable to resolve the disagreement, the administering entity may refer unresolved issues to the board for a final determination. Only the administering entity's peer review committee will be responsible for determining whether a disagreement still exists, or whether the reviewed firm or review team is not cooperating, in order for the administering entity to refer the issue to the board.

## Reporting on System Reviews

### General

.94 The team captain should furnish the reviewed firm with a written report within 30 days of the exit conference date or by the firm's peer review due date, whichever is earlier. A report on a review performed by a firm is to be issued on the letterhead of the firm performing the review. A report by a review team formed by an association of CPA firms is to be issued on the letterhead of the firm of the team captain performing the review. The report in a System Review ordinarily should be dated as of the date of the exit conference. See interpretations for guidance on notification requirements and submission of peer review documentation to the administering entity.

### Preparing the Report in a System Review

.95 The standard form for a report with a peer review rating of *pass* is illustrated in appendix C, "Illustration of a Report With a Peer Review Rating of *Pass* in a System Review." Illustrations of reports with a peer review rating of *pass with deficiencies* and *fail* are presented in appendixes E, "Illustration of a Report With a Peer Review Rating of *Pass With Deficiencies* in a System Review" and I, "Illustration of a Report With a Peer Review Rating of *Fail* in a System Review," respectively. Illustrations of reports with a peer review rating of *pass (with a scope limitation)*, *pass with deficiencies (with a scope limitation)*,

and *fail (with a scope limitation)* are presented in appendixes D, "Illustration of a Report With a Peer Review Rating of *Pass (With a Scope Limitation)* in a System Review;" G, "Illustration of a Report With a Peer Review Rating of *Pass With Deficiencies (With a Scope Limitation)* in a System Review;" and K, "Illustration of a Report With a Peer Review Rating of *Fail (With a Scope Limitation)* in a System Review," respectively.

**.96** The written report in a System Review should:

- a. State at the top of the report the title "System Review Report."
- b. State that the system of quality control for the accounting and auditing practice of the firm was reviewed and include the year-ended covered by the peer review.
- c. State that the peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants.
- d. State that the firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.
- e. State that the reviewer's responsibility is to express an opinion on the design of the system of quality control and the firm's compliance therewith based on the review.
- f. State that the nature, objectives, scope, limitations of, and procedures performed in a System Review are described in the standards.
- g. Include a URL reference to the AICPA website where the standards are located.
- h. Identify engagement types required to be selected by the board in the interpretations, when applicable.
- i. Identify the different peer review ratings that the firm could receive.
- j. In a report with a peer review rating of *pass*:
  - Express an opinion that the system of quality control for the accounting and auditing practice of the reviewed firm in effect for the year-ended has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.
  - State at the end of the opinion paragraph that therefore the firm has received a peer review rating of *pass*.
  - In the event of a scope limitation, include an additional paragraph before the opinion paragraph that describes the relationship of the excluded engagement(s) or functional area(s) to the reviewed firm's practice as a whole, the highest level of service and industry concentration, if any, of the engagement(s) excluded from potential selection, and the effect of the exclusion on the scope and results of the peer review.
  - Reports with a peer review rating of *pass* do not contain any findings, deficiencies, significant deficiencies, or recommendations.

- k. In a report with a peer review rating of *pass with deficiencies*:<sup>14</sup>
- Express an opinion that, except for the deficiencies previously described, the system of quality control for the accounting and auditing practice of the reviewed firm in effect for the year-ended has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.
  - State at the end of the opinion paragraph that therefore the firm has received a peer review rating of *pass with deficiencies*.
  - In the event of a scope limitation, include an additional paragraph before the deficiencies that describes the relationship of the excluded engagement(s) or functional area(s) to the reviewed firm's practice as a whole, the highest level of service and industry concentration, if any, of the engagement(s) excluded from potential selection, and the effect of the exclusion on the scope and results of the peer review.
- l. In a report with a peer review rating of *fail*:
- Express an opinion that as a result of the significant deficiencies previously described, the system of quality control for the accounting and auditing practice of the reviewed firm in effect for the year-ended was not suitably designed or complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.
  - State at the end of the opinion paragraph that therefore the firm has received a peer review rating of *fail*.
  - In the event of a scope limitation, include an additional paragraph before the significant deficiencies that describes the relationship of the excluded engagement(s) or functional area(s) to the reviewed firm's practice as a whole, the highest level of service and industry concentration, if any, of the engagement(s) excluded from potential selection, and the effect of the exclusion on the scope and results of the peer review.
- m. Include, for reports with a peer review rating of *pass with deficiencies* or *fail*, systemically written descriptions of the deficiencies or significant deficiencies and the reviewing firm's recommendations (each of these should be numbered) (See interpretations).
- n. Identify, for any deficiencies or significant deficiencies included in the report with a peer review rating of *pass with deficiencies* or *fail*, any that were also made in the report issued on the firm's previous peer review (see interpretations). This should be determined based on the underlying systemic cause of the deficiencies or significant deficiencies.

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<sup>14</sup> Reference to plural could also apply to a singular item within the standards. For instance, there could be deficiencies or a deficiency. The wording in the peer review report should be tailored as necessary.

- o. Identify the level of service for any deficiencies or significant deficiencies. If the deficiency or significant deficiency included in the report with a peer review rating of *pass with deficiencies* or *fail* is industry specific, also identify the industry.

## Firm Responses in a System Review

**.97** If the reviewed firm receives a report with a peer review rating of *pass with deficiencies* or *fail*, the reviewed firm should respond in writing to the deficiencies or significant deficiencies and related recommendations identified in the report. The letter of response should be addressed to the administering entity's peer review committee and should describe the actions planned (including timing) or taken by the reviewed firm with respect to each deficiency in the report. The reviewed firm should submit a copy of the report, and its letter of response, to the administering entity within 30 days of the date it received the report from the team captain or by the firm's peer review due date, whichever date is earlier. Prior to submitting the response to the administering entity, the reviewed firm should submit the response to the team captain for review, evaluation, and comment (see interpretations).

**.98** If the reviewed firm receives a report with a peer review rating of *pass* or *pass (with a scope limitation)*, a letter of response is not applicable, and the reviewed firm does not submit a copy of the report to the administering entity.

**.99** The reviewed firm should respond to all findings and related recommendations not rising to the level of a deficiency or significant deficiency on the related FFC forms. These responses should describe the plan the reviewed firm has implemented or will implement (including timing) with respect to each finding. The team captain should review and evaluate the responses on the FFC forms before they are submitted to the administering entity (see interpretations).

**.100** If, after a discussion with the team captain, the reviewed firm disagrees with one or more of the findings, deficiencies, or significant deficiencies, the reviewed firm should contact the administering entity for assistance in the matter (see paragraph .93). If the reviewed firm still disagrees with one or more of the findings, deficiencies, or significant deficiencies, its response on either the FFC form or in the letter of response, as applicable, should describe the reasons for the disagreement.

**.101** Illustrations of letters of response by a reviewed firm to reports in a System Review with a peer review rating of *pass with deficiencies* and *fail* are included in appendixes F, "Illustration of a Response by a Reviewed Firm to a Report With a Peer Review Rating of *Pass With Deficiencies* in a System Review;" H, "Illustration of a Response by a Reviewed Firm to a Report With a Peer Review Rating of *Pass With Deficiencies (With a Scope Limitation)* in a System Review;" J, "Illustration of a Response by a Reviewed Firm to a Report With a Peer Review Rating of *Fail* in a System Review;" and L, "Illustration of a Response by a Reviewed Firm to a Report With a Peer Review Rating of *Fail (With a Scope Limitation)* in a System Review."

## Performing Engagement Reviews

### Objectives

**.102** The objective of an Engagement Review is to evaluate whether engagements submitted for review are performed and reported on in conformity

with applicable professional standards in all material respects. An Engagement Review consists of reading the financial statements or information submitted by the reviewed firm and the accountant's report thereon, together with certain background information and representations and the applicable documentation required by professional standards.

.103 Engagement Reviews are not available to firms that perform engagements under the SASs, engagements under *Government Auditing Standards*, examinations under the SSAEs, or engagements performed under PCAOB standards. However, firms eligible to have an Engagement Review may elect to have a System Review (see interpretations).

## Basic Requirements

.104 The criteria for selecting the peer review year-end and the period to be covered by an Engagement Review are the same as those for a System Review (see paragraphs .13–.19). Engagements subject to review ordinarily should be those with periods ending during the year under review, except for financial forecasts or projections and agreed upon procedures. Financial forecasts or projections and agreed upon procedures with report dates during the year under review would be subject to selection. The reviewed firm should provide summarized information showing the number of its compilation, review and preparation engagements performed under SSARS and engagements performed under the SSAEs, classified into industry categories. That information should be provided for each partner, or individual if not a partner, of the firm who is responsible for the issuance of reports on such engagements or the issuance of prepared financial statements with or without disclaimer reports. On the basis of that information, the review captain or the administering entity ordinarily should select the types of engagements to be submitted for review, in accordance with the following guidelines (see interpretations):

- a. One engagement should be selected from each of the following areas of service performed by the firm:
  1. Review of historical financial statements (performed under SSARSs)
  2. Compilation of historical financial statements, with disclosures (performed under SSARSs)
  3. Compilation of historical financial statements that omits substantially all disclosures (performed under SSARS)
  4. Engagements performed under the SSAEs other than examinations
- b. One engagement should be selected from each partner, or individual of the firm if not a partner, responsible for the issuance of reports listed in item *a*.
- c. Selection of preparation engagements should only be made in the following instances:
  1. One preparation engagement with disclosures (performed under SSARS) should be selected when performed by an individual in the firm who does not perform any engagements included in item *a* or when the firm's only engagements with disclosures are preparation engagements.
  2. One preparation engagement that omits substantially all disclosures (performed under SSARS) should be selected when performed by an individual in the firm who does not perform any engagements included in item *a* or when the

firm's only omit disclosure engagements are preparation engagements.

3. One preparation engagement should be selected if needed to meet the requirement in item *d*.
- d*. Ordinarily, at least two engagements should be selected for review.

**.105** The preceding criteria are not mutually exclusive. The objective is to ensure that one engagement is selected for each partner and one engagement is selected from each of the areas of service performed by the firm listed in item *a* in the previous list. Therefore, one of every type of engagement that a partner, or individual if not a partner, responsible for the issuance of the reports listed in item *a* in the previous list performs does not have to be reviewed as long as, for the firm taken as a whole, all types of engagements noted in item *a* in the previous list performed by the firm are covered.

**.106** The review captain should obtain the required representations submitted by the firm (see paragraph .05*f*) and should obtain the firm's prior peer review report, the letter response, if applicable, and the letter accepting those documents, all from the reviewed firm. The review captain should also obtain the prior FFC forms (from the administering entity if the review captain's firm did not perform the prior review).

**.107** For each engagement selected for review, the reviewed firm should submit the appropriate financial statements or information and the accountant's report, masking client identity if it desires, along with specified background information, representations about each engagement and the firm's documentation required by applicable professional standards for each of these engagements. There is a presumption that all engagements otherwise subject to the peer review will be included in the scope of the review. However, in the rare situations when exclusions or other limitations on the scope of the review are being contemplated, a review captain should carefully consider the implications of such exclusion. This includes communicating with the firm and the administering entity the effect on the review and on the ability of the review captain to issue a peer review report.

**.108** The evaluation of each engagement submitted for review includes the following:

- a*. Consideration of the financial statements or information and the related accountant's report on the compilation, review and preparation engagements performed under SSARS and engagements performed under SSAEs (see interpretations)
- b*. Consideration of the documentation on the engagements performed via reviewing background and engagement profile information, representations made by the firm, and inquiries
- c*. Review of all other documentation required by applicable professional standards on the engagements

**.109** An Engagement Review does not include a review of other documentation prepared on the engagements submitted for review (other than the documentation referred to in paragraphs .107–.108), tests of the firm's administrative or personnel files, interviews of selected firm personnel, or other procedures performed in a System Review (see interpretations). Accordingly, an Engagement Review does not provide the review captain with a basis for expressing any form of assurance on the firm's system of quality control for its accounting practice. The review captain's report does indicate, however, whether anything came to the review captain's attention that caused him or her to believe that

the engagements submitted for review were not performed and reported on in conformity with applicable professional standards in all material respects (see interpretations). The review captain should promptly inform the firm when an engagement is not performed or reported on in conformity with applicable professional standards and remind the firm of its obligation under professional standards to take appropriate actions (see interpretations).

## Identifying Matters, Findings, Deficiencies, and Significant Deficiencies

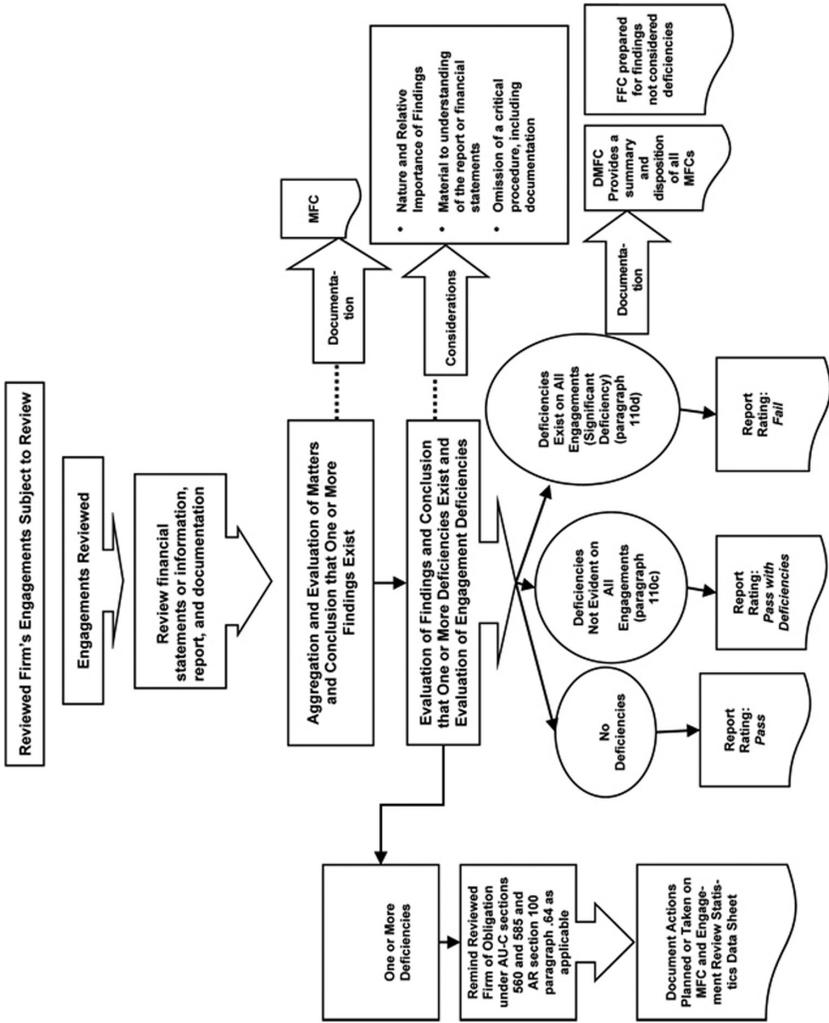
.110 Determining the relative importance of matters noted during the peer review, individually or combined with others, is a matter of professional judgment. Careful consideration is required in forming conclusions. The descriptions that follow, used in conjunction with practice aids (MFC, DMFC, and FFC forms) to document these items, are intended to assist in determining the nature of the peer review report to issue:

- a. A *matter* is noted as a result of evaluating whether an engagement submitted for review was performed or reported on in conformity with applicable professional standards. The evaluation includes reviewing the financial statements or information, the related accountant's reports, and the adequacy of procedures performed, including related documentation. Matters are typically one or more "No" answers to questions in peer review questionnaire(s). A matter is documented on a Matter for Further Consideration (MFC) form.
- b. A *finding* is one or more matters that the review captain has concluded result in financial statements or information, the related accountant's reports submitted for review, or the procedures performed, including related documentation, not being performed or reported on in conformity with the requirements of applicable professional standards. A review captain will conclude whether one or more findings are a deficiency or significant deficiency. If the review captain concludes that no finding, individually or combined with others, rises to the level of deficiency or significant deficiency, a report rating of *pass* is appropriate. A finding not rising to the level of a deficiency or significant deficiency is documented on a Finding for Further Consideration (FFC) form.
- c. A *deficiency* is one or more findings that the review captain concludes are material to the understanding of the financial statements or information or related accountant's reports or that represent omission of a critical procedure, including documentation, required by applicable professional standards. When a deficiency is noted, the review captain concludes that at least one but not all engagements submitted for review were not performed or reported on in conformity with applicable professional standards in all material respects. When the review captain concludes that deficiencies are not evident on all of the engagements submitted for review, such deficiencies are communicated in a report with a peer review rating of *pass with deficiencies*.
- d. A *significant deficiency* exists when the review captain concludes that deficiencies are evident on all of the engagements submitted for review. When a significant deficiency is noted, the review captain concludes that all engagements submitted for review were not performed or reported on in conformity with applicable

professional standards in all material respects. Such significant deficiencies are communicated in a report with a peer review rating of *fail*.

**.111** A broad understanding of the peer review process, from the review of submitted engagements to the decision making process of determining whether an item noted during an Engagement Review is a matter, finding, deficiency, or significant deficiency, is shown in exhibit B on the following page. The exhibit also illustrates the aggregation of these items, where those items are documented in the practice aids, and how they might affect the type of report issued.

Exhibit B



**.112** As described by exhibit B in paragraph .111, depending on the resolution of a matter and the process of aggregating and evaluating peer review results, a matter may develop into a finding. Findings will also be evaluated, and after considering their nature and relative importance, including whether they are material to the understanding of the report or financial statements or represent the omission of a critical procedure including documentation, may not get elevated to a deficiency. Alternatively, a matter may develop into a finding and get elevated to a deficiency. That deficiency may or may not be further elevated to a significant deficiency.

**.113** A matter is documented on a MFC form. If the matter, after further evaluation, gets elevated to a finding, but not a deficiency or significant deficiency, it is documented on a FFC form. The FFC form is a standalone document that includes the reviewer's recommendation and the reviewed firm's response regarding actions planned or taken and the timing of those actions by the firm. MFC and FFC forms are subject to review and oversight by the administering entity, who will evaluate the reviewed firm's FFC form responses for appropriateness and responsiveness (see paragraphs .141–.145). If the matter documented on the MFC form is instead elevated to a deficiency or significant deficiency, then it is communicated in the report itself, along with the reviewer's recommendation. The firm submits a letter of response regarding actions planned or taken and the timing of those actions by the firm, which is also evaluated for appropriateness and responsiveness (see paragraphs .139–.140).

**.114** In order to document the disposition of all the MFCs, the review captain completes a DMFC form. The DMFC form is part of the working papers and provides a trail of the disposition of the MFCs for the peer reviewer, administering entity, and individuals conducting technical reviews or oversight. All of the MFCs are identified on the DMFC form with an indication after each as to whether it was cleared, discussed with the firm, included on a specific FFC form (individually or combined with other MFCs), or included as a deficiency in a report with a peer review rating of *pass with deficiencies* or as a significant deficiency in a report with a peer review rating of *fail*.

**.115** A firm that has an Engagement Review should respond promptly to questions raised in the review, whether those questions are raised orally or in writing. The review captain will contact the firm, before issuing the final peer review report, to resolve questions raised during the peer review and to complete the MFC, DMFC, and FFC forms as applicable. In addition to discussing deficiencies or significant deficiencies and recommendations to be included in a report with a peer review rating of *pass with deficiencies* or *fail*, ordinarily, these should be discussed, along with the content of the letter of response, and agreed upon with the firm prior to the issuance of the final written report. The review captain should also communicate, if applicable, that the firm may be required to (1) take certain actions to correct the deficiencies or significant deficiencies noted in the report or (2) complete an implementation plan to address the findings noted on the FFC form(s). The review team should also discuss with the reviewed firm the implications of these steps on the acceptance and completion of the peer review and the reviewed firm's enrollment in the program. This is also the appropriate opportunity for providing suggestions to the firm that are not included in the report, FFC form(s), or MFC form(s).

## Addressing Disagreements Between the Reviewer and the Reviewed Firm

.116 Disagreements may arise on the resolution of various issues. For instance, there could be a disagreement on the appropriate approach to performing or reporting in conformity with applicable professional standards, or the review team might not believe that the actions planned or taken by the firm, if any, are appropriate (for example, if the reviewed firm believes that it can continue to support a previously issued report and the review team continues to believe that there may be a failure to reach appropriate conclusions in the application of professional standards). Reviewers and reviewed firms should understand that professional judgment often becomes a part of the process and that each party has the right to challenge each other on an issue. Nevertheless, a disagreement on the resolution of an issue may persist in some circumstances. The reviewed firm and reviewer should be aware that they may consult with their administering entity and, if necessary, request that the administering entity's peer review committee resolve the disagreement. If the administering entity's full peer review committee is unable to resolve the disagreement, the administering entity may refer unresolved issues to the board for a final determination. Only the administering entity's peer review committee will be responsible for determining whether a disagreement still exists or whether the reviewed firm or review team is not cooperating in order to refer the issue to the board.

## Reporting on Engagement Reviews

### Forming Conclusions on the Type of Report to Issue in an Engagement Review

#### ***Engagement Review Report With a Peer Review Rating of Pass***

.117 A report with a peer review rating of *pass* is issued when the reviewer concludes that nothing came to his or her attention that caused him or her to believe that the engagements submitted for review were not performed and reported on in conformity with applicable professional standards in all material respects. There are no deficiencies or significant deficiencies that affect the nature of the report and, therefore, the report does not contain any deficiencies, significant deficiencies, or recommendations. In the event of a scope limitation, a report with a peer review rating of *pass (with a scope limitation)* is issued.

#### ***Engagement Review Report With a Peer Review Rating of Pass With Deficiencies***

.118 A report with a peer review rating of *pass with deficiencies* is issued when at least one but not all of the engagements submitted for review contain a deficiency. In the event of a scope limitation, a report with a peer review rating of *pass with deficiencies (with a scope limitation)* is issued.

#### ***Engagement Review Report With a Peer Review Rating of Fail***

.119 A report with a peer review rating of *fail* is issued when the review captain concludes that, as a result of the deficiencies described in the report, the engagements submitted for review were not performed or reported on in conformity with applicable professional standards in all material respects. A report with a peer review rating of *fail* is issued when deficiencies are evident on all of the engagements submitted for review. The review captain should

not expand scope beyond the original selection of engagements in an effort to change the conclusion from a peer review rating of *fail* in these circumstances. In the event of a scope limitation, a report with a peer review rating of *fail* (*with a scope limitation*) is issued.

## General

**.120** In an Engagement Review, the review captain should furnish the reviewed firm with a written report within 30 days of the review of engagements or by the firm's peer review due date, whichever is earlier. A report on a review performed by a firm is to be issued on the letterhead of the firm performing the review. A report by a review team formed by an association of CPA firms is to be issued on the letterhead of the firm of the review captain performing the review. Other reports are issued on the letterhead of the administering entity. The report in an Engagement Review ordinarily should be dated as of the date of the completion of the peer review procedures. See interpretations for guidance on notification requirements and submission of peer review documentation to the administering entity.

### *Illustrations of Reports in an Engagement Review*

**.121** The standard form for a report with a peer review rating of *pass* is illustrated in appendix M, "Illustration of a Report with a Peer Review Rating of *Pass* in an Engagement Review." Illustrations of reports with a peer review rating of *pass with deficiencies* and *fail* are presented in appendixes N, "Illustration of a Report with a Peer Review Rating of *Pass with Deficiencies* in an Engagement Review," and P, "Illustration of a Report with a Peer Review Rating of *Fail* in an Engagement Review," respectively. Additional paragraphs included for scope limitations follow the illustrations for System Reviews with scope limitations (see appendixes D, G, and K).

**.122** The written report in an Engagement Review should:

- a. State at the top of the report the title "Engagement Review Report."
- b. State that the review captain reviewed selected accounting engagements of the firm and include the year-end covered by the peer review.
- c. State that the peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants.
- d. State that the firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects (even though this is an Engagement Review, the statement reflects the responsibility of the firm).
- e. State that the reviewer's responsibility is to evaluate whether the engagements submitted for review were performed and reported on in conformity with applicable professional standards in all material respects.
- f. State that an Engagement Review does not include reviewing the firm's system of quality control and compliance therewith and, accordingly, the reviewers express no opinion or any form of assurance on that system.

- g.* State that the nature, objectives, scope, limitations of, and procedures performed in an Engagement Review are described in the standards.
- h.* Include a URL to the AICPA website where the standards are located.
- i.* Identify the different peer review ratings that the firm could receive.
- j.* In a report with a peer review rating of *pass*, state:
- That nothing came to the review captain's attention that caused the review captain to believe that the engagements submitted for review were not performed and reported on in conformity with applicable professional standards in all material respects.
  - At the end of the second paragraph, that therefore the firm has received a peer review rating of *pass*.
  - In the event of a scope limitation, include an additional paragraph before the last paragraph that describes the relationship of the excluded engagement(s) to the reviewed firm's practice as a whole, the highest level of service and industry concentration, if any, of the engagement(s) excluded from the potential selection, and the effect of the exclusion on the scope and results of the peer review.
  - Reports with a peer review rating of *pass* do not contain any findings, deficiencies, significant deficiencies, or recommendations.
- k.* In a report with a peer review rating of *pass with deficiencies*,<sup>15</sup> state:
- That except for the deficiencies previously described, nothing came to the review captain's attention that caused the review captain to believe that the engagements submitted for review were not performed or reported on in conformity with applicable professional standards in all material respects.
  - At the end of the last paragraph, that therefore the firm has received a peer review rating of *pass with deficiencies*.
  - In the event of a scope limitation, include an additional paragraph before the deficiencies that describes the relationship of the excluded engagement(s) to the reviewed firm's practice as a whole, the highest level of service and industry concentration, if any, of the engagement(s) excluded from the potential selection, and the effect of the exclusion on the scope and results of the peer review.
- l.* In a report with a peer review rating of *fail*, state:
- That as a result of the deficiencies previously described, the review captain believes that the engagements submitted for review were not performed or reported on in conformity with applicable professional standards in all material respects.

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<sup>15</sup> See footnote 14.

- At the end of the last paragraph, that therefore the firm has received a peer review rating of *fail*.
  - In the event of a scope limitation, include an additional paragraph before the significant deficiencies that describes the relationship of the excluded engagement(s) to the reviewed firm's practice as a whole, the highest level of service and industry concentration, if any, of the engagement(s) excluded from the potential selection, and the effect of the exclusion on the scope and results of the peer review.
- m.* Include, for reports with a peer review rating of *pass with deficiencies* or *fail*, descriptions of the deficiencies or significant deficiencies and the reviewing firm's recommendations (each of these should be numbered) (see interpretations).
- n.* Identify, for any deficiencies or significant deficiencies included in the report with a peer review rating of *pass with deficiencies* or *fail*, any that were also made in the report in the firm's previous peer review. However, if the specific types of reporting, presentation, disclosure, or documentation deficiencies or significant deficiencies are not substantially the same on the current review as on the prior review, the deficiencies or significant deficiencies would not be considered a repeat (see interpretations).
- o.* Identify the level of service for any deficiencies or significant deficiencies. If the deficiency or significant deficiency included in the report with a peer review rating of *pass with deficiencies* or *fail* is industry specific, also identify the industry.

## Firm Responses in an Engagement Review

**.123** In an Engagement Review, if the firm receives a report with a peer review rating of *pass with deficiencies* or *fail*, the reviewed firm should respond in writing to the deficiencies or significant deficiencies and related recommendations identified in the report. The letter of response should be addressed to the administering entity's peer review committee and should describe the actions planned (including timing) or taken by the reviewed firm with respect to each deficiency in the report. The reviewed firm should submit a copy of the report, and its letter of response, to the administering entity within 30 days of the date it received the report from the review captain or by the firm's peer review due date, whichever date is earlier. Prior to submitting the letter of response to the administering entity, the reviewed firm should submit the response to the review captain for review, evaluation, and comment (see interpretations).

**.124** If the firm receives a report with a peer review rating of *pass* or *pass (with a scope limitation)*, a letter of response is not applicable, and the reviewed firm does not submit a copy of the report to the administering entity.

**.125** The reviewed firm should respond to all findings and related recommendations not rising to the level of a deficiency or significant deficiency on the related FFC forms. These responses should describe the plan the reviewed firm has implemented or will implement (including timing) with respect to each finding. The review captain should review and evaluate the responses on the FFC forms before they are submitted to the administering entity (see interpretations).

**.126** If, after a discussion with the review captain, the reviewed firm disagrees with one or more of the findings, deficiencies, or significant deficiencies,

the reviewed firm should contact the administering entity for assistance in the matter (see paragraph .116). If the reviewed firm still disagrees with one or more of the findings, deficiencies, or significant deficiencies, its response on either the FFC form or in the letter of response, as applicable, should describe the reasons for such disagreement.

.127 Illustrations of letters of responses by a reviewed firm to reports with a peer review rating of *pass with deficiencies* and *fail* are included in appendixes O, "Illustration of a Response by a Reviewed Firm to a Report With a Peer Review Rating of *Pass With Deficiencies* in an Engagement Review" and Q, "Illustration of a Response by a Reviewed Firm to a Report With a Peer Review Rating of *Fail* in an Engagement Review."

## Administering Peer Reviews

.128 All peer reviews intended to meet the requirements of the program should be carried out in conformity with these standards under the supervision of a state CPA society, group of state CPA societies, the AICPA Peer Review Board's National PRC (see interpretations), or other entity (hereinafter, administering entity) approved by the board to administer peer reviews. This imposes an obligation on reviewed firms to facilitate completion of their peer reviews in compliance with the procedures established by the board, and to cooperate with the peer reviewer, administering entity, and the board in all matters related to the review, that could impact the firm's enrollment in the program.

.129 Entities requesting to administer the program are required to complete and sign a Plan of Administration annually whereby the entity agrees to administer the program in compliance with these standards, interpretations, and other guidance established by the board. Upon receipt of the plans by the AICPA, including jurisdictions not requesting to administer the program for their state, the board annually approves the administering entities for all of the jurisdictions covered by the program.

.130 This imposes an obligation on the administering entities to ensure that their staff, technical reviewers, committee members, and all others involved in the administration of the program and performance of peer reviews comply with these standards, interpretations, and other guidance established by the board. Administering entities shall also cooperate with the board in all matters related to the administration of the program. Failure to comply with these standards, interpretations, and other guidance may result in the revocation of the administering entity's plan by the board. If an administering entity refuses to cooperate or is found to be deficient in administering the program in compliance with these standards or with other guidance, the board may decide pursuant to fair procedures whether the administering entity's plan should be revoked or whether some other action should be taken.

.131 Due to the volume of peer reviews, firms, reviewers, and other contributing factors, the board recognizes that administering entities, and in some situations firms and peer reviewers, may need the flexibility, in specific circumstances, to implement alternate methods of complying with the standards, interpretations, or guidance issued by the board. The board or its staff will consider reasonable requests from administering entities' peer review committees on such matters. The comprehensiveness of the administering entity's oversight policies and procedures will be considered as well as such factors as whether the objectives of the standards, interpretations, or guidance would still be met. Administering entities must submit a request in writing to the board for approval prior to implementing alternative methods of complying with the standards,

interpretations, or other guidance. This request should ordinarily be submitted in conjunction with the submission of its plan.

## Fulfilling Peer Review Committee and Report Acceptance Body Responsibilities

**.132** An administering entity appoints a peer review committee to oversee the administration, acceptance, and completion of peer reviews. The committee may decide to delegate a portion of the report acceptance function to report acceptance bodies (RABs), whose members may be, but are not required to be, members of the committee as well. Members of a committee or a RAB must meet minimum qualification requirements (see interpretations). It is ultimately the committee's responsibility to ensure that it (or a RAB on its behalf) considers the results of peer reviews it administers that are undertaken to meet the requirements of the program. The activities of the committee should be carried out in accordance with administrative procedures and guidance issued by the board. Committee members may not participate in any discussion or have any vote with respect to a reviewed firm if the member lacks independence or has a conflict of interest with the reviewing firm, the reviewer, or the reviewed firm.

**.133** The committee's report acceptance responsibilities include, but are not limited to:

- a. Ensuring that peer reviews are presented to an RAB in a timely manner, ordinarily within 120 days of the later of receipt of the working papers and peer review report from the team captain or review captain or, if applicable, the report with a peer review rating of *pass with deficiencies* or *fail* and the related letter of response from the reviewed firm, or within 60 days for Engagement Reviews meeting certain criteria (see paragraphs .137–.138).
- b. Considering whether the review has been performed in accordance with these standards, interpretations, and related guidance materials.
- c. Considering whether the report, and the response thereto, if applicable, are in accordance with these standards, interpretations, and related guidance materials, including an evaluation of the adequacy of the corrective actions the reviewed firm has represented that it has taken or will take in its letter of response.
- d. Determining whether it should require any remedial, corrective actions related to the deficiencies or significant deficiencies noted in the peer review report, in addition to those described by the reviewed firm in its letter of response. Examples of such corrective actions include, but are not limited to, requiring certain individuals to obtain specified kinds and specified amounts of CPE, requiring the firm to carry out more comprehensive monitoring procedures, or requiring it to engage another CPA to perform pre-issuance or post-issuance reviews of financial statements, reports, and accounting and audit documentation to attempt to strengthen the performance of the firm's personnel.
- e. In relation to FFCs:
  1. Considering whether FFC (and associated MFC and DMFC) forms are prepared in accordance with these standards, interpretations, and related guidance materials, including whether the findings addressed on the FFC forms

should have been included in a report with a peer review rating of *pass with deficiencies* or *fail*.

2. Determining the adequacy of the plan the reviewed firm has represented that it has implemented or will implement in its response on the FFC form(s).
  3. Determining whether it should require an implementation plan in addition to or as an affirmation of the plan described by the reviewed firm in its response to the findings on the FFC form(s).
- f. Ensuring that all corrective actions related to deficiencies or significant deficiencies in the peer review report and all implementation plans related to findings on FFC forms have been completed to the satisfaction of the committee.
- g. Ensuring that all firms within its jurisdiction have timely peer reviews and keeping track of the timing of the completion of corrective actions and implementation plans by all firms that the committee has required, including those that are overdue.

.134 In reaching its conclusions on the preceding items, the committee is authorized to make whatever inquiries or initiate whatever actions it considers necessary in the circumstances, including but not limited to requesting expansion of scope, revisions to the report, or the reviewed firm's response thereto. Such inquiries or actions by the committee should be made with the understanding that the program is intended to be positive and remedial in nature and is based on mutual trust and cooperation.

.135 In the rare event of a disagreement between the administering entity and either the reviewer or the reviewed firm that cannot be resolved by ordinary good-faith efforts, the administering entity may request that the matter be referred to the board for final resolution. Only the approved administering entity's peer review committee will be responsible for determining whether a disagreement still exists in order to refer the matter to the board. In these circumstances, the board may consult with representatives of other AICPA committees or with appropriate AICPA staff.

## Accepting System and Engagement Reviews

.136 Technical reviews are required to be performed by the administering entity on all peer reviews. Technical reviewers must meet minimum qualification requirements (see interpretations).

.137 All System Reviews are required to be presented for committee consideration, but committee consideration is not always required in an Engagement Review. The technical reviewer<sup>16</sup> should be delegated the authority from the committee to accept Engagement Reviews in certain circumstances (see interpretations).

.138 Engagement Reviews that do not require committee consideration are required to be accepted by the technical reviewer within 60 days of receipt of the working papers and report from the review captain. If the committee does not delegate the authority to the technical reviewer to accept Engagement Reviews under the specific criteria indicated previously, the review is required to be presented to the committee within 60 days of receipt of the working papers and report from the review captain.

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<sup>16</sup> The responsibilities and the role of technical reviewers are included in the AICPA Peer Review Program Report Acceptance Body Handbook, which is provided to all administering entities.

**.139** In deciding on the need for and nature of any corrective actions, the committee should consider the nature and significance (and for System Reviews, the causes, pattern, pervasiveness, and relative importance to the system of quality control as a whole) of the deficiencies or significant deficiencies. It should evaluate whether the recommendations of the review team appear to address those deficiencies or significant deficiencies adequately and whether the reviewed firm's responses to those recommendations appear comprehensive, genuine, and feasible.

**.140** If the peer review committee determines that corrective actions related to the deficiencies or significant deficiencies noted in the peer review report, in addition or as an affirmation of those described by the firm in its letter of response, are appropriate, the firm will be required to evidence its agreement to perform these corrective action(s) in writing before the report is accepted and complete the action(s) as a condition of cooperation with the administering entity and the board.

## Cooperating in a Peer Review

**.141** Paragraph .05*h* of the standards noted that firms (and individuals) enrolled in the program have the responsibility to cooperate with the peer reviewer, administering entity, and the board in all matters related to the peer review, that could impact the firm's enrollment in the program, including taking remedial, corrective actions or implementing FFC plans as needed.

**.142** In deciding on the need for and nature of any implementation plan in addition to that described by the firm in its response on the FFC form, the committee should consider the nature and significance (and for System Reviews, the causes, pattern, pervasiveness, and relative importance to the system of quality control as a whole) of the findings. It should evaluate whether the recommendations of the review team appear to address those findings adequately and whether the reviewed firm's responses to those recommendations appear comprehensive, genuine, and feasible.

**.143** If the peer review committee determines, as part of its deliberations regarding the peer review, that an implementation plan in addition to or as an affirmation of those described by the firm in its responses on the FFC form are warranted, the firm will be required to evidence its agreement to perform this FFC implementation plan in writing and complete the plan as a condition of cooperation with the administering entity and the board (see interpretations). Although agreeing to and completing such a plan is not tied to the acceptance of the peer review, if a firm fails to cooperate, the firm would be subject to fair procedures that could result in the firm's enrollment in the program being terminated (see interpretations). The resulting MFC, DMFC, and FFC forms, as well as any correspondence relating to the implementation plan to be followed by the firm related to these documents, are outside of the reporting and acceptance process.

**.144** If a reviewed firm refuses to cooperate, fails to correct deficiencies or significant deficiencies, or is found to be so seriously deficient in its performance that education and remedial, corrective actions or implementation plans are not adequate, the board may decide, pursuant to fair procedures that it has established, to appoint a hearing panel to consider whether the firm's enrollment in the program should be terminated or whether some other action should be taken. A firm that receives peer reviews with recurring deficiencies or significant deficiencies that are not corrected may be deemed as a firm refusing to cooperate. In addition, a firm that fails to correct deficiencies or significant

deficiencies after consecutive corrective actions requested by the committee may also be deemed as a firm refusing to cooperate.

**.145** If a decision is made by the hearing panel to terminate a firm's enrollment in the program, the firm will have the right to appeal to the AICPA Joint Trial Board for a review of the hearing panel's findings. The fact that a firm's enrollment in the program has been terminated shall be published in such form and manner as the AICPA Council may prescribe.

## Publicizing Peer Review Information

**.146** The reviewed firm should not publicize the results of the review or distribute copies of the peer review report to its personnel, clients, or others until it has been advised that the report has been accepted (see interpretations) by the administering entity as meeting the requirements of the program. Neither the administering entity nor the AICPA shall make the results of the review available to the public, except as authorized or permitted by the firm under certain circumstances (see interpretations). The administering entity and the AICPA may disclose the following information:

- a. The firm's name and address
- b. The firm's enrollment in the program
- c. The date of acceptance and the period covered by the firm's most recently accepted peer review
- d. If applicable, whether the firm's enrollment in the program has been dropped or terminated

## Peer Reviewers' Performance and Cooperation

**.147** A team captain, review captain, or reviewer (hereinafter, reviewer) has a responsibility to perform a review in a timely, professional manner. This relates not only to the initial submission of the report and materials on the review, but also to the timely completion of any additional actions necessary to complete the review, such as completing any omitted documentation of the work performed on the review and resolving questions raised by the committee or technical reviewer accepting the review as well as the board and AICPA staff.

**.148** In considering peer review documents for acceptance, the committee evaluates the reviewer's performance on the peer review. In addition to the committee's evaluation, the board and AICPA staff also evaluate and track reviewers' performance on peer reviews. If serious weaknesses in the reviewer's performance are noted on a particular review, or if a pattern of poor performance by a particular reviewer is noted, then the board or committee, depending on the particular circumstances, will consider the need to impose corrective actions on the service of the reviewer.

**.149** In situations in which one or more of such actions is imposed, the administering entity will inform the board and may request that the board ratify the action(s) to be recognized by other administering entities.

**.150** Any condition imposed on a reviewer will generally apply to the individual's service as a team captain, review captain, team member, or QCM reviewer unless the condition is specific to the individual's service as only a team captain, review captain, team member, or QCM reviewer.

**.151** If a reviewer refuses to cooperate with the committee or board, fails to revise peer review documents as requested by the committee or board, fails

to correct the poor performance, or is found to be deficient in his or her performance, and education or other corrective or monitoring actions are not considered adequate to correct the poor performance, the committee may recommend to the board that the reviewer be prohibited from performing peer reviews in the future. In such situations imposed by a committee, the board shall appoint a hearing panel to consider ratifying the action(s) taken by the committee for the reviewer's name to be removed from the list of qualified reviewers or if some other action should be taken. The board may decide, with or without committee recommendation pursuant to fair procedures that it has established, to consider whether the reviewer should be prohibited from performing peer reviews or whether some other action should be taken.

**.152** Corrective or other action(s) can only initially be appealed to the committee that imposed the action(s). For actions previously appealed to the committee or imposed or ratified by the board, if the reviewer disagrees with the corrective action(s), he or she may appeal the decision by writing the board and explaining why he or she believes that the action(s) are unwarranted. The board will review and consider the request upon its receipt.

**.153** If a reviewer has a corrective or other action(s) imposed on him or her by the committee or board, and the reviewer had previously been approved to perform a peer review that has either begun or has yet to begin, then the committee or board will need to consider whether the review should be performed by another reviewer, or if the review should be overseen by a member of the committee at the reviewer's expense, or other actions, if any (whether or not the reviewer has filed an appeal with the committee or board). If the reviewer has completed the fieldwork on one or more peer reviews prior to the imposition of the corrective action, then the committee or board will consider what action, if any, to take regarding those peer reviews based on the facts and circumstances.

## Performing and Reporting on Reviews of Quality Control Materials (QCM)

### Introduction

**.154** Quality control materials (QCM) are materials that are suitable for adoption by a firm as an integral part of that firm's system of quality control. Such materials provide guidance to assist firms in performing and reporting in conformity with professional standards and may include, but are not limited to, such items as engagement aids, including accounting and auditing manuals, checklists, questionnaires, work programs, computer-aided accounting and auditing tools, and similar materials intended for use by accounting and auditing engagement teams.

**.155** Organizations (hereinafter referred to as *providers*) may sell or otherwise distribute to CPA firms (hereinafter referred to as *user firms*) QCM that they have developed.

**.156** Providers may elect voluntarily or be required to have an independent review of their system of quality control for the development and maintenance of the QCM they have developed, and of the resultant materials (see paragraph .159). The reasons for having such a review are:

- a. Providing reasonable assurance to user firms that the provider's system of quality control to develop and maintain QCM is appropriately designed and complied with, and that the resultant materials are reliable aids to assist them in conforming with all those

components which are integral to the professional standards the materials purport to encompass.

- b. Providing more cost-effective peer reviews for firms that use such materials by allowing the peer reviewers of user firms to place reliance on the results of the QCM review in evaluating the design of the user firm's system of quality control.
- c. Ensuring that independence and objectivity on peer reviews of user firms is maintained when such peer reviews are performed by providers.

.157 A summary of the nature, objectives, scope, limitations of, and procedures performed on QCM reviews is included in appendix A.

## Objectives of a QCM Review

.158 The objectives of a review of QCM developed by a provider are determining:

- a. Whether the provider's system for the development and maintenance of the QCM was suitably designed and was being complied with during the period under review to provide user firms with reasonable assurance that the materials are reliable aids.
- b. Whether the resultant materials are reliable aids to assist user firms in conforming with all those components which are integral to the professional standards the materials purport to encompass.

## Applicability

.159 Generally, there are two categories of providers:

- a. A CPA firm or its affiliate or related entity (see interpretations) that develops and maintains QCM (collectively, a provider firm). A provider firm is ordinarily permitted to perform the peer review of a user firm if an independent review of both the provider firm's system of quality control for the development and maintenance of the QCM and the provider firm's resultant materials (the QCM review) is performed as a safeguard of independence.
- b. Any other type of organization that does not fall under the description of a provider firm (voluntary provider), including an association of CPA firms providing QCM or a third party organization that provides QCM as a primary function of its business.

All QCM reviews are administered by the National PRC and performed in accordance with these standards.

.160 With respect to a provider firm, the initial QCM review is due within six months of the elected year-end date. The initial QCM review is required to be completed before the provider firm can be scheduled to perform the peer review of a user firm. A provider firm's subsequent QCM review has a due date of three years and six months from the year-end of the previous QCM review. The due date for a QCM review is the date by which the QCM review report, letter of response (if applicable), and the QCM reviewer's working papers are to be submitted to the National PRC. If the QCM review working papers are not submitted by the due date, the provider firm will no longer be independent to perform peer reviews of user firms after that date (that is, the necessary independence safeguard was not implemented timely, which is considered non-cooperation).

**.161** Subsequent to the QCM review, if there are substantial changes in either the system for the development and maintenance of the materials or in the resultant materials themselves, the provider firm should consult with the National PRC to determine whether an accelerated QCM review is required.

**.162** In addition, a provider firm that will perform the peer review of a user firm is required to have its own firm's subsequent peer reviews administered by the National PRC (from the point of scheduling the QCM review onward) (see interpretations).

**.163** Voluntary providers of QCM that elect (but are not required) to have a QCM review should consult with the National PRC. Reviews of providers that voluntarily elect to have a QCM review under these standards must comply with the standards in all respects.

**.164** Materials relating to the PCAOB standards are not within the scope of these standards.

**.165** The National PRC will administer reviews of QCM based on the standards and the RAB Handbook. When not otherwise addressed in this section, QCM reviewers and providers should refer to the other sections of the Standards for Performing and Reporting on Peer Reviews for additional guidance on performing, reporting on, and accepting QCM reviews.

## Qualifications for Serving as a QCM Reviewer

**.166** The National PRC establishes minimum requirements to qualify as a QCM reviewer. In addition to the peer reviewer qualifications set forth in the paragraphs under "Organizing the System or Engagement Review Team" and "Qualifying for Service as a Peer Reviewer" (see paragraphs .26–.35) and in the interpretations, the National PRC will consider other factors in determining whether a potential QCM reviewer is qualified (see interpretations). Members of the QCM review team must be approved by the National PRC prior to the commencement of the review. Final approval of QCM review teams is at the National PRC's discretion.

## Procedures for Planning and Performing QCM Reviews

**.167** A QCM review should include procedures to plan and perform the review. The provider should identify the specific materials subject to the QCM review that will be opined upon in the report. Procedures to test the provider's system of quality control should be determined based on the specific materials included in the scope of the review.

**.168** Once materials are identified for review purposes, they cannot be subsequently excluded from the scope of the review without resulting in a scope limitation. If the QCM review is required because the provider firm plans to peer review user firms, ordinarily all of the provider firm's materials should be included in the scope of the QCM review. If specific materials are excluded from the scope of the QCM review, then the provider firm will not be independent of firms that use those specific materials excluded from the scope of the QCM review.

### *Planning Considerations*

**.169** The QCM reviewer should obtain the prior QCM report, the letter of response (if applicable), and the acceptance letter from the provider. The QCM reviewer should also obtain the prior FFC forms (if applicable) from the National PRC. The QCM reviewer should consider whether the issues discussed

in those documents require additional emphasis in the current review, and evaluate the provider's actions in response to the prior report.

**.170** In addition, the QCM review team should assess the risk associated with QCM reviews. This is the risk that the QCM review team:

- a. Fails to identify significant weaknesses in the provider's system of quality control for the development and maintenance of its quality control materials, its lack of compliance with that system, or a combination thereof.
- b. Fails to identify significant weaknesses in the materials.
- c. Issues an inappropriate opinion on the provider's system of quality control for the development and maintenance of its quality control materials, its compliance with that system, or a combination thereof.
- d. Issues an inappropriate opinion on the materials.
- e. Reaches an inappropriate decision about the matters to be included in, or excluded from, the report.

**.171** QCM review risk consists of:

- a. The risk (consisting of inherent risk and control risk) that the quality control materials are not reliable aids, that the provider's system of quality control will not prevent such failure, or both.
- b. The risk (detection risk) that the review team will fail to detect and report on design or compliance deficiencies or significant deficiencies in the provider's system of quality control or in the resultant materials.

**.172** In planning the review, the QCM review team should assess and document the relevant inherent and control risk factors, and how the combined risks affect detection risk and, therefore, the scope of review procedures. This assessment should include but is not limited to consideration of the nature and environment of the provider (including economic and competitive pressures); experience with developing and maintaining QCM; the level of risk; complexity and change inherent in the industries and professional standards covered by the QCM; prior findings on previously-issued materials and the disposition of those findings; and any investigations, allegations, or restrictions on authors and technical reviewers (including outside and guest authors or technical reviewers).

### ***Understanding the Provider's System of Quality Control***

**.173** A provider's system of quality control for the development and maintenance of the materials normally should include:

- a. A requirement that the provider's system of quality control be documented.
- b. A requirement that the provider perform on-going monitoring of its system of quality control.
- c. A requirement that the materials be developed and maintained by individuals qualified in the subject matter.
- d. A requirement that the materials be reviewed for technical accuracy by a qualified person(s) other than the developer(s).
- e. Procedures to ensure that the individuals who develop, maintain, or review the materials for technical accuracy are appropriately qualified in the subject matter.

- f.* Procedures to ensure that the materials are current and address the relevant professional standards and industry guidance.
- g.* Procedures for soliciting and evaluating feedback from users of the materials.
- h.* Procedures for communicating the period and, where appropriate, the professional standards encompassed by the materials.
- i.* Procedures (if any) regarding the issuance of updates to the materials and, if a policy exists, the method of updating. If the provider's policy is not to provide updates to the materials between versions, then include the procedures for communicating this policy to users.
- j.* Procedures for ensuring that the materials are updated in accordance with the provider's policy when it has undertaken to update them.
- k.* Procedures for ensuring that the system of quality control as designed is operating effectively.

**.174** A study and evaluation of the system for the development and maintenance of the materials normally should include the following procedures:

- a.* Reviewing and evaluating the procedures established for monitoring the system of quality control, and assessing how any findings or issues were resolved.
- b.* Reviewing and evaluating the procedures established for developing and maintaining the materials.
- c.* Reviewing and evaluating the procedures established for updating (including distributing) the materials to ensure that the materials remain current and relevant when the provider has undertaken the responsibility for updating the materials.
- d.* Reviewing the technical competence of the developers and updaters (if applicable) of the materials.
- e.* Obtaining evidence that the materials were reviewed for technical accuracy by qualified person(s) other than the developers or updaters.
- f.* Determining whether the provider has appropriately communicated its policy regarding the period covered by the materials, the professional standards the materials purport to encompass, and the provider's policy regarding updating the materials.
- g.* Reviewing the system developed for soliciting and evaluating feedback from users of the materials.

### ***Performing Tests of the Materials***

**.175** The scope of the QCM review includes all of the materials identified by the provider and covered in the opinion (see paragraph .167). The extent to which individual manuals, guides, checklists, practice aids, and so on are reviewed is subject to the QCM review team's judgment and should be documented in the risk assessment (see interpretations). For QCM reviews of provider firms, all materials should be within the scope of the review. A QCM review team should review the resultant materials, to the extent deemed necessary, to evaluate whether the materials are reliable aids to assist user firms in conforming with all those components which are integral to the professional standards the materials purport to encompass.

**.176** For all of the materials tested, the QCM review team should assess whether or not the materials are reliable aids. This includes evaluating whether

the materials can assist users in conforming with all those components which are integral to the professional standards that the materials purport to encompass. The QCM review team performs this evaluation by assessing the level of instructions and explanatory guidance in the materials, and determining whether the methodology inherent in the materials is appropriate (see interpretations).

## Identifying Matters, Findings, Deficiencies, and Significant Deficiencies

.177 In evaluating the provider's system of quality control, the QCM review team may note that the system is not appropriately designed or complied with. Similarly, the tests of the provider's materials may uncover that design weaknesses or lack of compliance with the system resulted in one or more materials that do not reach the threshold of reliable aids. With any of these items, the QCM review team has available a set of definitions to assist in classifying the condition noted.

.178 Determining the relative importance of matters noted during the QCM review, individually or combined with others, requires professional judgment. Careful consideration is required in forming conclusions. The descriptions that follow are intended to assist in aggregating and evaluating the QCM review results, concluding on them, and determining the nature of the QCM review report to issue:

- a. A *matter* is noted as a result of
  - i. the QCM reviewer's evaluation of the design of and compliance with the provider's system of quality control. Matters can be one or more "no" answers to questions in QCM review questionnaire(s) that a QCM reviewer concludes warrants further consideration in the evaluation of a provider's system of quality control.
  - ii. the QCM reviewer's evaluation of whether the materials submitted for review are reliable aids. Matters can arise from either the QCM reviewer's comments based on tests of the materials, or one or more "no" answers to questions in QCM review questionnaire(s) that the QCM reviewer concludes warrants further consideration by the provider in the evaluation of the materials.

A matter is documented on a MFC form.

- b. A *finding* is one or more matters that result from
  - i. a condition in the provider's system of quality control or compliance with it such that there is more than a remote possibility that the provider would not develop or maintain reliable aids, or
  - ii. the QCM reviewer's conclusion that one or more of the materials tested do not encompass some portion of the components of the professional standards that the materials purport to encompass.

A QCM reviewer will conclude whether one or more findings are a deficiency or significant deficiency. If the QCM reviewer concludes that no finding, individually or combined with others, rises to the level of deficiency or significant deficiency, a report rating of *pass* is appropriate. A finding not rising to the level of a deficiency or significant deficiency is documented on a FFC form.

- c. A *deficiency* is one or more findings that
- i. the QCM reviewer has concluded, due to the nature, causes, pattern, or pervasiveness, could create a situation in which the provider would not have reasonable assurance of developing or maintaining reliable aids, or
  - ii. affects the reliability of one or more of the materials tested, such that one or more of the materials do not encompass the components which are integral to the professional standards that the materials purport to encompass.

This includes the relative importance of the deficiency to either the provider's system of quality control taken as a whole, or any of the materials tested (individually or collectively). It is not a significant deficiency if the QCM reviewer has concluded that except for the deficiency or deficiencies the provider has reasonable assurance of developing and maintaining reliable aids or that the nature of the deficiency or deficiencies is limited to a small number of the total materials reviewed. Such deficiencies are communicated in a report with a QCM review rating of *pass with deficiencies*.

- d. A *significant deficiency* is one or more deficiencies that the QCM reviewer has concluded results from a condition in the provider's system of quality control when the system taken as a whole does not provide reasonable assurance of developing or maintaining reliable aids, and it has affected the reliability of one or more of the materials reviewed.

Such deficiencies are communicated in a report with a QCM rating of *fail*.

## Aggregating and Evaluating Matters in the Provider's System

**.179** The QCM review team must aggregate matters noted during the review of the provider's system of quality control to develop and maintain the materials in order to conclude on the opinion of the provider's system. This entails determining whether any matters noted were the result of the design of the provider's system of quality control or the failure of its personnel to comply with the provider's quality control policies and procedures. The QCM review team should consider their relative importance to both the provider's system of quality control as a whole and the impact on the materials (individually and collectively), and their nature, causes, pattern, and pervasiveness.

**.180** The use of professional judgment is essential in determining whether matters should be aggregated as findings, and whether one or more findings is a deficiency or significant deficiency.

### **Design Matters**

**.181** A design matter in a QCM review exists when the provider's system of quality control is missing a quality control policy or procedure or when the provider's existing quality control policies and procedures (even if fully complied with) would not result in the development or maintenance of reliable aids in one or more respects. To be effective, a system of quality control must be designed properly, and all of the quality control policies and procedures necessary to provide the provider with reasonable assurance of developing and maintaining reliable aids should be in place. Therefore, the QCM review team will need to determine whether the quality control policies and procedures would be effective if they were complied with. To make this determination, the

QCM review team should consider the implications of the evidence obtained during its evaluation of the system of quality control and its tests of compliance, including its review of the materials.

.182 The relative importance of design matters noted in the provider's quality control policies and procedures, individually and in the aggregate, need to be evaluated in the context of the provider's organizational structure, the nature of its practice, the number of users, and so on. For example, a matter noted during the review of a quality control policy or procedure may be partially or wholly offset by another policy or procedure. In this circumstance, the QCM review team should consider the interrelationships among the elements of quality control and weigh the matters noted against compensating policies and procedures to determine whether a finding exists and its relative importance.

.183 There may be circumstances in which the QCM reviewer finds few findings in the materials developed and maintained by the provider, yet he or she still concludes that the design of the provider's system of quality control needs to be improved. For example, a provider that has a rapidly growing customer base may not have appropriately revised its policies and procedures to solicit user feedback. However, this type of finding may not result in less than reasonable assurance of developing or maintaining reliable aids. The QCM reviewer should exercise judgment in determining whether this matter should be addressed in a FFC as a finding rather than result in a report with a QCM review rating of *pass with deficiencies* or *fail*.

### **Compliance Matters**

.184 A compliance matter exists when a properly designed quality control policy or procedure does not operate as designed because of the failure of the personnel of the provider to comply with it. Because a variance in individual performance will affect the degree of compliance, adherence to all policies and procedures in every case generally is not possible. However, the degree of compliance by the personnel of the provider with its prescribed quality control policies and procedures should be adequate to give the provider reasonable assurance of developing and maintaining reliable aids.

.185 In assessing whether the degree of compliance was adequate to provide the required assurance, the QCM review team should consider the nature, causes, pattern, and pervasiveness of the instances of noncompliance noted and their relative importance to the provider's system of quality control as a whole, as well as their importance in the specific circumstances in which they were observed. As with the evaluation of design matters, compliance matters also need to be evaluated in the context of the provider's organizational structure, the nature of its practice, the number of users, and so on.

.186 To determine the degree of noncompliance, the QCM review team should evaluate the matters of noncompliance, both individually and in the aggregate, recognizing that adherence to certain policies and procedures of the provider is more critical to the provider obtaining reasonable assurance of developing and maintaining reliable aids. In this context, the QCM review team should consider the likelihood that noncompliance with a given quality control policy or procedure could have resulted in materials that are not reliable aids. The more direct the relationship between a specific quality control policy or procedure and the reliability of the aids, the lower the degree of noncompliance necessary to determine whether a matter (or matters) is a finding and whether a finding is a deficiency or significant deficiency.

## Aggregating and Evaluating Matters in the Provider's Materials

.187 The QCM review team must also aggregate matters noted during the QCM review in order to conclude on the separate opinion on the reliability of the materials. Any design or compliance matters will usually be addressed in the consideration of the provider's system. However, all matters that impact the system also have to be evaluated for their impact and relative importance on the individual materials reviewed and opined upon in the report. The use of professional judgment is essential in determining whether matters should be aggregated as findings, and whether one or more findings is a deficiency. One or more deficiencies in the materials is indicative of a deficiency or significant deficiency in the provider's system of quality control.

.188 The QCM review team should consider whether design matters noted in the review of the provider's quality control system, individually and in the aggregate, impact the reliability of the materials. For example, a provider may not specify in its policies and procedures that authors must have a certain level of professional experience or expertise. In this circumstance, the QCM review team should consider whether this design matter resulted in a potentially inexperienced or otherwise unqualified author writing portions of the materials, and whether those portions of the materials are technically accurate, to determine the impact on the reliability of the materials, and whether a finding or deficiency exists with respect to the materials.

.189 Similarly, the QCM review team should consider whether compliance matters noted in either the review of the provider's quality control system or in the tests of the materials impact the reliability of the aids. For example, personnel that performed technical review on a particular industry manual may not have obtained the appropriate type or amount of CPE for that industry in compliance with the provider's policies and procedures. In this circumstance, the QCM review team should consider if this compliance matter resulted in a failure to include new or recent changes in professional standards or industry guidance, or other omissions, to determine whether a finding or deficiency exists with respect to the materials.

## Reporting on QCM Reviews

### *General*

.190 The QCM review team should furnish the provider with a written report and the final FFC forms within 30 days of the date of the exit conference or by the provider's review due date, whichever is earlier. A report on a QCM review performed by a firm is to be issued on the letterhead of the firm performing the review. A report by a QCM review team formed by an association of CPA firms is to be issued on the letterhead of the firm of the team captain performing the review. The report in a QCM review ordinarily should be dated as of the date of the exit conference. See interpretations for guidance on notification requirements and submission of peer review documentation to the administering entity.

### *Forming Conclusions on the Type of Report to Issue in a QCM Review*

.191 The following circumstances ordinarily would be considered deficiencies or significant deficiencies:

- a. The scope of the review is limited by conditions that preclude the application of one or more review procedures considered necessary (that is, a scope limitation).

- b. The provider's system of quality control for the development and maintenance of QCM, as designed, did not provide reasonable assurance that reliable aids had been developed or maintained.
- c. The degree of compliance with the provider's system of quality control for the development and maintenance of QCM was not sufficient to provide user firms with reasonable assurance that reliable aids had been developed or maintained.
- d. The resultant QCM are not reliable aids to assist user firms in conforming with the components integral to the professional standards the materials purport to encompass (generally resulting from the condition described in items *b* or *c*).

**.192** In those instances in which the QCM review team determines that a report with a review rating of *pass with deficiencies* or *fail* is required, all the reasons should be disclosed, and the QCM review team should consult with the National PRC prior to the issuance of the report.

### **Preparing the Report in a QCM Review**

**.193** The standard forms for a QCM review report with a review rating of *pass*, *pass with deficiencies*, and *fail* are included in appendixes R, "Illustration of a Report With a Review Rating of *Pass* in a Review of Quality Control Materials;" S, "Illustration of a Report with a Review Rating of *Pass with Deficiencies* in a Review of Quality Control Materials;" and T, "Illustration of a Report with a Review Rating of *Fail* in a Review of Quality Control Materials," respectively.

**.194** A QCM report with a rating of *pass*, *pass with deficiencies*, or *fail* contains elements similar to those in a System Review report. As such, the written report in a QCM System Review should:

- a. State at the top of the page the title "Quality Control Materials Review Report."
- b. State that the system of quality control for the development and maintenance of the materials and the resultant materials in effect at the year-end covered by the QCM review were reviewed.
- c. State that the review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants.
- d. State that the provider is responsible for designing a system of quality control and complying with it to provide users of the materials with reasonable assurance that the materials are reliable aids to assist them in performing and reporting in conformity with the components which are integral to the professional standards that the materials purport to encompass.
- e. State that the reviewer's responsibility is to express an opinion on the design of the system of quality control, the provider's compliance with that system, and the reliability of the resultant materials based on the review.
- f. State that the nature, objectives, scope, limitations of, and procedures performed in a Quality Control Materials review are described in the standards.
- g. Include a URL reference to the AICPA website where the standards are located.
- h. State that the users of the materials are responsible for implementing, tailoring, and augmenting the materials as appropriate.

- i. State that there may be important elements of a quality control system in accordance with Statements on Quality Control Standards that are not part of the materials that have been subject to this QCM review.
- j. Identify the different peer review ratings that the provider could receive.
- k. In a report with a peer review rating of *pass*:
  - Express an opinion that the system of quality control for the development and maintenance of the quality control materials was suitably designed and was being complied with during the year ended to provide reasonable assurance that the materials are reliable aids.
  - Express an opinion that the quality control materials were reliable aids to assist users in conforming with the components which are integral to the professional standards the materials purport to encompass at year-end.
  - State at the end of the opinion paragraph that therefore the report reflects a peer review rating of *pass*.
  - Reports with a peer review rating of *pass* do not contain any findings, deficiencies, significant deficiencies, or recommendations.
- l. In a report with a review rating of *pass with deficiencies*:<sup>17</sup>
  - Express an opinion that, except for the deficiencies described previously, the system of quality control for the development and maintenance of the quality control materials was suitably designed and was being complied with during the year ended to provide reasonable assurance that the materials are reliable aids or
  - Express an opinion that, except for the deficiencies described previously, the quality control materials were reliable aids to assist users in conforming with the components which are integral to the professional standards the materials purport to encompass at year-end.
  - State at the end of the opinion paragraph that therefore the report reflects a review rating of *pass with deficiencies*.
- m. In a report with a peer review rating of *fail*:
  - Express an opinion that as a result of the significant deficiencies described previously, the system of quality control for the development and maintenance of the quality control materials was not suitably designed and being complied with during the year ended and, therefore, cannot provide reasonable assurance that the materials are reliable aids.
  - Express an opinion that also, as a result of the significant deficiencies described previously, the quality control materials are not reliable aids and do not assist users in conforming with the components which are integral to the professional standards the materials purport to encompass at year-end.

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<sup>17</sup> See footnote 14.

- State at the end of the opinion paragraph that therefore the provider has received a peer review rating of *fail*.
- n. Include, for reports with a review rating of *pass with deficiencies* or *fail*, written descriptions of the deficiencies or significant deficiencies and the reviewing firm's recommendations (each of these should be numbered).
- o. Identify, for any deficiencies or significant deficiencies included in the report with a review rating of *pass with deficiencies* or *fail* any that were also made in the report issued on the provider's previous QCM review. This should be determined based on the underlying systemic cause of the deficiencies or significant deficiencies.

## Provider Responses on QCM Reviews

**.195** If the provider receives a report with a review rating of *pass with deficiencies* or *fail*, then the provider should respond in writing to the deficiencies and significant deficiencies and related recommendations identified in the report, if applicable. The letter of response should be addressed to the National PRC and should describe the action(s) planned (including timing) or taken by the provider with respect to each deficiency in the report. If the provider disagrees with one or more of the deficiencies or significant deficiencies, its response should describe the reasons for such disagreement. In the event that a material error or omission in the materials is uncovered by the QCM review team, the response also should describe the provider's plan for notifying known users of that error or omission. The provider should submit the letter of response for review and comment to the QCM reviewer prior to submitting the response to the National PRC.

**.196** The provider should submit a copy of the report and its letter of response to the National PRC within 30 days of the date it received the report or by the provider's review due date, whichever date is earlier. Prior to submitting the response to the National PRC, the provider should submit the response to the QCM reviewer for review, evaluation, and comment. If the provider receives a report with a review rating of *pass*, a letter of response is not applicable, and the provider does not submit a copy of the report to the National PRC.

**.197** The provider should also respond on the FFC forms, if any are developed, to findings and related recommendations. These responses should describe the plan (including timing) the provider has implemented or will implement with respect to each finding. They should be submitted to the QCM reviewer no later than two weeks after the exit conference or by the review's due date, whichever is earlier. FFC forms are submitted by the QCM reviewer with the applicable working papers to the National PRC.

**.198** If, after a discussion with the QCM reviewer, the provider disagrees with one or more of the findings, deficiencies, or significant deficiencies, the provider should contact the National PRC for assistance in the matter (see paragraph .93). If the provider still disagrees with one or more of the findings, deficiencies, or significant deficiencies, its response on either the FFC form or in the letter of response, as applicable, should describe the reasons for such disagreement.

## Cooperating in a QCM Review

**.199** Providers that undertake to have a QCM review under these standards have a responsibility to cooperate with the QCM review team, the National PRC, and the board in all matters related to the QCM review.

**.200** If a provider firm fails to cooperate during the course of a QCM review, the provider firm's independence with respect to user firms may be impaired (see interpretations).

### **QCM Reviewers' Performance and Cooperation**

**.201** A QCM reviewer has a responsibility to perform a QCM review in a timely, professional manner. This relates not only to the initial submission of the report and materials on the review, but also to the timely completion of any additional actions necessary to complete the review, such as resolving questions raised by the National PRC, as well as the board and AICPA staff.

**.202** In considering QCM review documents for acceptance, the National PRC evaluates the QCM reviewer's performance on the QCM review. In addition to the National PRC's evaluation, the board and AICPA staff also evaluate and track reviewers' performance on both peer reviews and QCM reviews.

**.203** If weaknesses in a QCM reviewer's performance are noted on a particular QCM review (for example, submitting incomplete review documentation, not performing sufficient review procedures, a failure to resolve questions raised by the committee or technical reviewer, and so on), or if the QCM reviewer refuses to cooperate with the National PRC at any time during the review process, the QCM reviewer will be required to comply with the actions described in paragraphs .148–.153. In addition, the National PRC has the discretion to no longer approve that individual to perform future QCM reviews or other peer reviews.

### **Publicizing QCM Review Information**

**.204** The provider should not publicize the results of the review or distribute copies of the QCM report to its personnel, users, or others until it has been advised that the report has been accepted by the National PRC.

**.205** Providers that elect or are required to have a QCM review under these standards agree that the National PRC and the AICPA may disclose the following information to allow peer reviewers of user firms to easily obtain this information for consideration during the user firm's peer review:

- a.* The provider's name
- b.* The results of the QCM review (that is, report, letter of response (LOR) (if applicable), and so on)
- c.* The date of acceptance and the year covered by the provider's most recently accepted QCM review

### **Effective Date**

**.206** The effective date for these standards is for peer reviews commencing on or after January 1, 2009 and QCM reviews commencing on or after January 1, 2011. Early implementation is permitted for QCM reviews, but not for peer reviews.



## Appendix A

### Summary of the Nature, Objectives, Scope, Limitations of, and Procedures Performed in System and Engagement Reviews and Quality Control Materials Reviews (as Referred to in a Peer Review Report)

(Effective for Peer Reviews Commencing on or After January 1, 2009)

1. Firms (and individuals) enrolled in the AICPA Peer Review Program are required to have a peer review, once every three years, of their accounting and auditing practice related to non-Security and Exchange Commission (SEC) issuers covering a one-year period. The peer review is conducted by an independent evaluator, known as a peer reviewer. The AICPA oversees the program, and the review is administered by an entity approved by the AICPA to perform that role.
2. The peer review helps to monitor a CPA firm's accounting and auditing practice (*practice monitoring*). The goal of the practice monitoring, and the program itself, is to promote quality in the accounting and auditing services provided by the AICPA members and their CPA firms. This goal serves the public interest and enhances the significance of AICPA membership.
3. There are two types of peer reviews: System Reviews and Engagement Reviews. System Reviews focus on a firm's system of quality control and Engagement Reviews focus on work performed on particular selected engagements. As noted in paragraphs .04 and .157, a further description of System and Engagement Reviews, and Quality Control Materials (QCM) Reviews, as well as a summary of the nature, objectives, scope, limitations of, and procedures performed on them, is provided in the following sections.

#### System Reviews

4. A System Review is a type of peer review that is a study and appraisal by an independent evaluator(s), known as a peer reviewer, of a CPA firm's system of quality control to perform accounting and auditing work. The system represents the policies and procedures that the CPA firm has designed, and is expected to follow, when performing its work. The peer reviewer's objective is to determine whether the system is designed to ensure conformity with professional standards and whether the firm is complying with its system appropriately.
5. Professional standards are literature, issued by various organizations, that contain the framework and rules that a CPA firm is expected to comply with when designing its system and when performing its work. Professional standards include but are not limited to the Statements on Quality Control Standards issued by the American Institute of Certified Public Accountants (AICPA) that pertain to leadership responsibilities for quality within the firm (the "tone at the top"); relevant ethical requirements (such

as independence, integrity and objectivity); acceptance and continuance of client relationships and specific engagements; human resources; engagement performance; and monitoring.

6. To plan a System Review, a peer reviewer obtains an understanding of (1) the firm's accounting and auditing practice, such as the industries of its clients, and (2) the design of the firm's system, including its policies and procedures and how the firm checks itself that it is complying with them. The reviewer assesses the risk levels implicit within different aspects of the firm's practice and its system. The reviewer obtains this understanding through inquiry of firm personnel and review of documentation on the system, such as firm manuals.
7. Based on the types of engagements firms perform, they may also have their practices reviewed or inspected on a periodic basis by regulatory or governmental entities, including but not limited to the Department of Health and Human Service, the Department of Labor, and the PCAOB. The team captain obtains an understanding of those reviews or inspections, and he or she considers their impact on the nature and extent of the peer review procedures performed.
8. Based on the peer reviewer's planning procedures, the reviewer looks at a sample of the CPA firm's work, individually called engagements. The reviewer selects engagements for the period covered by the review from a cross section of the firm's practice with emphasis on higher risk engagements. The engagements selected include those performed under *Government Auditing Standards*, audits of employee benefit plans, audits of depository institutions (with assets of \$500 million or greater), audits of carrying broker-dealers, and examinations of service organizations (SOC 1 and SOC 2 engagements) when applicable. The scope of a peer review only covers accounting and auditing engagements performed under U.S. professional standards; it does not include the firm's SEC issuer practice, nor does it include tax or consulting services. The reviewer will also look at administrative elements of the firm's practice to test the elements listed previously from the Statements on Quality Control Standards.
9. The reviewer examines engagement working paper files and reports, interviews selected firm personnel, reviews representations from the firm, and examines selected administrative and personnel files. The objectives of obtaining an understanding of the system and then testing the system forms the basis for the reviewer's conclusions in the peer review report.
10. When a CPA firm receives a report from the peer reviewer with a peer review rating of *pass*, the report means that the system is appropriately designed and being complied with by the CPA firm in all material respects. If a CPA firm receives a report with a peer review rating of *pass with deficiencies*, this means the system is designed and being complied with appropriately by the CPA firm in all material respects, except in certain situations that are explained in detail in the peer review report. When a firm receives a report with a peer review rating of *fail*, the peer reviewer has determined that the firm's system is not suitably designed or being complied with, and the reasons why are explained in detail in the report.

11. There are inherent limitations in the effectiveness of any system and, therefore, noncompliance with the system may occur and not be detected. A peer review is based on selective tests. It is directed at assessing whether the design of and compliance with the firm's system provides the firm with reasonable, not absolute, assurance of conforming to applicable professional standards. Consequently, it would not necessarily detect all weaknesses in the system or all instances of noncompliance with it. It does not provide assurance with respect to any individual engagement conducted by the firm or that none of the financial statements audited by the firm should be restated. Projection of any evaluation of a system to future periods is subject to the risk that the system may become inadequate because of changes in conditions or because the degree of compliance with the policies or procedures may deteriorate.

#### Engagement Reviews

12. An Engagement Review is a type of peer review that is a study and appraisal by an independent evaluator(s), known as a peer reviewer, of a sample of a CPA firm's actual accounting work, including accounting reports issued and documentation prepared by the CPA firm, as well as other procedures that the firm performed.
13. By definition, CPA firms undergoing Engagement Reviews do not perform audits or other similar engagements but do perform other accounting work including reviews and compilations, which are a lower level of service than audits. The peer reviewer's objective is to evaluate whether the CPA firm's reports are issued and procedures performed appropriately in accordance with applicable professional standards. Therefore, the objective of an Engagement Review is different from the objectives of a System Review, which is more system oriented and involves determining whether the system is designed in conformity with applicable professional standards and whether the firm is complying with its system appropriately.
14. Professional standards represent literature, issued by various organizations, that contain the framework and rules that a CPA firm is expected to follow when performing accounting work.
15. The reviewer looks at a sample of the CPA firm's work, individually called engagements. The scope of an Engagement Review only covers accounting engagements; it does not include tax or consulting services. An Engagement Review consists of reading the financial statements or information submitted by the reviewed firm and the accountant's report thereon, together with certain background information and representations from the firm and, except for certain compilation engagements, the documentation required by applicable professional standards.
16. When the CPA firm receives a report with a peer review rating of *pass*, the peer reviewer has concluded that nothing came to his or her attention that the CPA firm's work was not performed and reported on in conformity with applicable professional standards in all material respects. A report with a peer review rating of *pass with deficiencies* is issued when the reviewer concludes that nothing came to his or her attention that the work was not performed and reported on in conformity with applicable professional standards in all material respects, except in certain situations that are

explained in detail in the report. A report with a peer review rating of *fail* is issued when the reviewer concludes that as a result of the situations described in the report, the work was not performed or reported on in conformity with applicable professional standards in all material respects.

17. An Engagement Review does not provide the reviewer with a basis for expressing any assurance as to the firm's system of quality control for its accounting practice, and no opinion or any form of assurance is expressed on that system.

#### Quality Control Materials Reviews

18. An organization (hereinafter referred to as provider) may sell or otherwise distribute quality control materials (QCM or materials) that it has developed to CPA firms (hereinafter referred to as user firms). QCM may be all or part of a user firm's documentation of its system of quality control, and it may include manuals, guides, programs, checklists, practice aids (forms and questionnaires) and similar materials intended for use in conjunction with a user firm's accounting and auditing practice. User firms rely on QCM to assist them in performing and reporting in conformity with the professional standards covered by the materials (as described in the preceding paragraphs).
19. A QCM review is a study and appraisal by an independent evaluator (known as a QCM reviewer) of a provider's materials, as well as the provider's system of quality control to develop and maintain the materials (hereinafter referred to as provider's system). The QCM reviewer's objective is to determine whether the provider's system is designed and complied with and whether the materials produced by the provider are appropriate so that user firms can rely on the materials. The scope of a QCM review only covers materials related to accounting and auditing engagements under U.S. professional standards. The scope does not include SEC or PCAOB guidance, nor does it cover materials for tax or consulting services.
20. To plan a QCM review, a QCM reviewer obtains an understanding of (1) the provider's QCM, including the industries and professional standards that they cover, and (2) the design of the provider's system, including the provider's policies and procedures and how it ensures that they are being complied with. The QCM reviewer assesses the risk levels implicit within different aspects of the provider's system and materials. The QCM reviewer obtains this understanding through inquiry of provider personnel, review of documentation on the provider's system, and review of the materials.
21. Based on the planning procedures, the QCM reviewer looks at the provider's QCM, including the instructions, guidance, and methodology therein. The scope of a QCM review encompasses those materials which the provider elects to include in the QCM review report; QCM designed to aid user firms with tax or other non-attest services are outside of the scope of this type of review. The QCM reviewer will also look at the provider's system and will test elements including, but not limited to, requirements regarding the qualifications of authors and developers, procedures for ensuring that the QCM are current, procedures for reviewing the technical accuracy of the materials, and procedures for soliciting

feedback from users. The extent of a provider's policies and procedures and the manner in which they are implemented will depend upon a variety of factors, such as the size and organizational structure of the provider and the nature of the materials provided to users. Variance in individual performance and professional interpretation affects the degree of compliance with prescribed quality control policies and procedures. Therefore, adherence to all policies and procedures in every case may not be possible. The objectives of obtaining an understanding of the provider's system and the materials forms the basis for the QCM reviewer's conclusions in the QCM review report.

22. When a provider receives a QCM review report from an approved QCM reviewer with a review rating of *pass*, this means the provider's system is designed and being complied with and the materials produced by the provider are appropriate so that user firms can rely on the QCM to assist them in performing and reporting in conformity with the professional standards covered by the materials. If a provider receives a QCM review report with a review rating of *pass with deficiencies*, this means the provider's system is designed and being complied with and the materials produced by the provider are appropriate so that user firms can rely on the QCM to assist them in performing and reporting in conformity with the professional standards covered by the materials, except in certain situations that are explained in detail in the review report. When a provider receives a report with a review rating of *fail*, the QCM reviewer has determined that the provider's system is not suitably designed or being complied and the materials produced by the provider are not appropriate, and the reasons why are explained in detail in the report.
23. There are inherent limitations in the effectiveness of any system and, therefore, noncompliance with the system may occur and not be detected. A QCM review is based on the review of the provider's system and its materials. It is directed at assessing whether the provider's system is designed and complied with and whether the QCM produced by the provider are appropriate so that user firms have reasonable, not absolute, assurance that they can rely on the materials to assist them in performing and reporting in conformity with the professional standards covered by the materials. Consequently, a QCM review would not necessarily detect all weaknesses in the provider's system, all instances of noncompliance with it, or all aspects of the materials that should not be relied upon. Projection of any evaluation of a system or the materials to future periods is subject to the risk that the system or materials may become inadequate because of changes in conditions or because the degree of compliance with the policies or procedures may deteriorate.

## Appendix B

### Considerations and Illustrations of Firm Representations

1. The team captain or review captain obtains written representations from management of the reviewed firm to describe matters significant to the peer review in order to assist in the planning and performance of and the reporting on the peer review. In connection with System and Engagement Reviews, specific representations should relate to the following matters, although the firm is not prohibited from making additional representations, and the firm may tailor the representation letter as it deems appropriate, as long as the minimum applicable representations are made to the team captain or review captain (see interpretations):
  - a. Situations or a summary of situations where management is aware that the firm or its personnel has not complied with the rules and regulations of state board(s) of accountancy or other regulatory bodies (including applicable firm and individual licensing requirements in each state in which it practices for the year under review) and, if applicable, how the firm has or is addressing and rectifying situations of noncompliance (see interpretations).
  - b. Communications or summary of communications from regulatory, monitoring, or enforcement bodies relating to allegations or investigations of deficiencies in the conduct of an accounting, audit, or attestation engagement performed and reported on by the firm, whether the matter relates to the firm or its personnel, within the three years preceding the firm's current peer review year-end and through the date of the exit conference. The information should be obtained in sufficient detail to consider its effect on the scope of the peer review (see interpretations). In addition, the reviewer may inquire if there are any other issues that may affect the firm's practice.
  - c. Restrictions or limitations on the firm's or its personnel's ability to practice public accounting by regulatory, monitoring, or enforcement bodies within three years preceding the current peer review year-end.
  - d. Completeness of the engagement listing provided to the reviewer, including, but not limited to, inclusion of all engagements performed, whether issued or not, under *Government Auditing Standards*, audits of employee benefit plans, audits performed under FDICIA, audits of carrying broker-dealers, examinations of service organizations SOC 1 and SOC 2 engagements, as applicable, and availability of the engagements with periods ending during the year under review, except financial forecasts or projections and agreed upon procedures. Financial forecasts or projections and agreed upon procedures with report dates during the year under review would be subject to selection.



**Illustration of a Representation Letter That has No Significant Matters to Report to the Team Captain or Review Captain**

(The firm may tailor the language in this illustration and may refer to attachments to the letter as long as adequate representations pertaining to the matters previously discussed, as applicable, are included to the satisfaction of the team captain or review captain.)

October 31, 20XX

To the Team Captain or Review Captain

We are providing this letter in connection with the peer review of [*name of firm*] as of the date of this letter and for the year ended June 30, 20XX.

We understand that we are responsible for complying with the rules and regulations of state boards of accountancy and other regulators. We confirm, to the best of our knowledge and belief, that there are no known situations in which [*name of firm*] or its personnel have not complied with the rules and regulations of state board(s) of accountancy or other regulatory bodies, including applicable firm and individual licensing requirements in each state in which it practices for the year under review.

We have also provided a list of all engagements to the [*team captain, review captain, or administering entity*] with periods ending during the year under review whether issued or not. This list included, but was not limited to, all engagements performed under *Government Auditing Standards*, audits of employee benefit plans, audits performed under FDICIA, audits of carrying broker-dealers, and examinations of service organizations SOC 1 and SOC 2 engagements, as applicable. For financial forecasts or projections and agreed upon procedures, the list included those engagements with report dates during the year under review. We understand that failure to properly include these engagements on the list could be deemed as failure to cooperate. We also understand this may result in termination from the Peer Review Program and, if termination occurs, will result in referral of the matter to the AICPA Professional Ethics Division for investigation of a possible violation of the AICPA *Code of Professional Conduct*.

We have also provided the [*team captain or review captain*] with any other information requested, including communications by regulatory, monitoring, or enforcement bodies relating to allegations or investigations in the conduct of its accounting, audit, or attestation engagements performed and reported on by the firm, whether the matter relates to the firm or its personnel, within three years preceding the current peer review year-end. In addition, there are no known restrictions or limitations on the firm's or its personnel's ability to practice public accounting by regulatory, monitoring, or enforcement bodies within three years preceding the current peer review year-end.

We understand the intended uses and limitations of the quality control materials we have developed or adopted. We have tailored and augmented the materials as appropriate such that the quality control materials encompass guidance which is sufficient to assist us in conforming with professional standards (including the Statements on Quality Control Standards) applicable to our accounting and auditing practice in all material respects. We have also

discussed the content of our PCAOB inspection report with the [*team captain or review captain*] (if applicable).

Sincerely,

[*Signature(s)*<sup>1</sup>]

### **Illustration of a Representation Letter That Has Been Tailored to Report to the Team Captain a Matter of Noncompliance With a Regulatory Requirement**

(The firm may tailor the language in this illustration and may refer to attachments to the letter as long as adequate representations pertaining to the matters previously discussed, as applicable, are included to the satisfaction of the team captain or review captain.)

October 31, 20XX

To the Team Captain or Review Captain

We are providing this letter in connection with the peer review of [*name of firm*] as of the date of this letter and for the year ended June 30, 20XX.

We understand that we are responsible for complying with the rules and regulations of state boards of accountancy and other regulators. Other than the firm not having a practice unit license during the year under review in one state where the firm practices (which has been subsequently obtained), we confirm, to the best of our knowledge and belief, that there are no known situations in which [*name of firm*] or its personnel have not complied with the rules and regulations of state board(s) of accountancy or other regulatory bodies, including applicable firm and individual licensing requirements in each state in which it practices for the year under review.

We have also provided a list of all engagements to the [*team captain, review captain, or administering entity*] with periods ending during the year under review whether issued or not. This list included, but was not limited to, all engagements performed under *Government Auditing Standards*, audits of employee benefit plans, audits performed under FDICIA, audits of carrying broker-dealers, and examinations of service organizations SOC 1 and SOC 2 engagements, as applicable. For financial forecasts or projections and agreed upon procedures, the list included those engagements with report dates during the year under review. We understand that failure to properly include these engagements on the list could be deemed as failure to cooperate. We also understand this may result in termination from the Peer Review Program and, if termination occurs, will result in referral of the matter to the AICPA Professional Ethics Division for investigation of a possible violation of the AICPA *Code of Professional Conduct*.

We have also provided the [*team captain*] with any other information requested, including communications by regulatory, monitoring, or enforcement bodies relating to allegations or investigations in the conduct of its accounting, audit, or attestation engagements performed and reported on by the firm, whether the matter relates to the firm or its personnel, within three years preceding the current peer review year-end. In addition, there are no known restrictions or limitations on the firm's or its personnel's ability to practice public accounting within three years preceding the current peer review year-end.

We understand the intended uses and limitations of the quality control materials we have developed or adopted. We have tailored and augmented the

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<sup>1</sup> Members of management as noted in section 3 of appendix B, "Considerations and Illustrations of Firm Representations."

materials as appropriate such that the quality control materials encompass guidance which is sufficient to assist us in conforming with professional standards (including the Statements on Quality Control Standards) applicable to our accounting and auditing practice in all material respects. We have also discussed the content of our PCAOB inspection report with the team captain (if applicable).

Sincerely,

[*Signature(s)*<sup>2</sup>]

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<sup>2</sup> Members of management as noted in section 3 of appendix B, "Considerations and Illustrations of Firm Representations."

## Appendix C

### Illustration of a Report With a Peer Review Rating of *Pass* in a System Review

[Firm letterhead for a firm-on-firm review; team captain's firm letterhead for an association formed review team.]

#### System Review Report

October 31, 20XX

To the Partners of [or other appropriate terminology]

XYZ & Co.

and the Peer Review Committee of the [insert the name of the applicable administering entity]<sup>1</sup>

We<sup>2</sup> have reviewed the system of quality control for the accounting and auditing practice of XYZ & Co. (the firm)<sup>3</sup> in effect for the year ended June 30, 20XX. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. As a part of our peer review, we considered reviews by regulatory entities, if applicable, in determining the nature and extent of our procedures. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to express an opinion on the design of the system of quality control and the firm's compliance therewith based on our review. The nature, objectives, scope, limitations of, and the procedures performed in a System Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

As required by the standards, engagements selected for review included (engagements performed under *Government Auditing Standards*; audits of employee benefit plans, audits performed under FDICIA, audits of carrying broker-dealers, and examinations of service organizations [SOC 1 and SOC 2 engagements].)<sup>4</sup>

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<sup>1</sup> The report of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the Partners of [or appropriate terminology] XYZ & Co. and the National Peer Review Committee.

<sup>2</sup> The report should use the plural *we*, *us*, and *our* even if the review team consists of only one person. The singular *I*, *me*, and *my* are appropriate only if the reviewed firm has engaged another firm to perform its review and the reviewing firm is a sole practitioner.

<sup>3</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

<sup>4</sup> If the firm performs audits of employee benefit plans, engagements performed under *Government Auditing Standards*, audits of depository institutions with total assets of \$500 million or greater at the beginning of its fiscal year, audits of carrying broker-dealers, examinations of service organizations (SOC 1 and SOC 2), or other engagements required to be selected by the board in interpretations, the engagement type(s) selected for review should be identified in the report using this paragraph, tailored as applicable. For SOC engagements, the paragraph should be tailored to reflect the type(s) selected for review. If the firm does not perform such engagements, this paragraph is not applicable and not included in the report.

In our opinion, the system of quality control for the accounting and auditing practice of XYZ & Co.<sup>5</sup> in effect for the year ended June 30, 20XX, has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency(ies)* or *fail*. XYZ & Co. has received a peer review rating of *pass*.

Smith, Jones and Associates

[*Name of team captain's firm*]

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<sup>5</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

## Appendix D

### Illustration of a Report With a Peer Review Rating of *Pass* (With a Scope Limitation) in a System Review

#### Limitation on Scope of Review

A report with a scope limitation should be issued when the scope of the review is limited by conditions (including those discussed in the standards) that preclude the application of one or more peer review procedure(s) considered necessary in the circumstances and the review team cannot accomplish the objectives of those procedures through alternate procedures. For example, a review team may be able to apply appropriate alternate procedures if one or more engagements have been excluded from the scope of the review. Ordinarily, however, the team would be unable to apply alternate procedures if the firm's only engagement in an industry that must be selected is unavailable for review and there isn't an earlier issued engagement that may be able to replace it, or when a significant portion of the firm's accounting and auditing practice during the year reviewed had been divested before the review began (see interpretation). A scope limitation may be included in a report with a peer review rating of *pass*, *pass with deficiency(ies)* or *fail*. In this example, the scope limitation was included in a report with a peer review rating of *pass*.

[Firm letterhead for a firm-on-firm review; team captain's firm letterhead for an association formed review team.]

#### System Review Report

October 31, 20XX

To the Partners of [or other appropriate terminology]

XYZ & Co.

and the Peer Review Committee of the [insert the name of the applicable administering entity]<sup>1</sup>

We<sup>2</sup> have reviewed the system of quality control for the accounting and auditing practice of XYZ & Co. (the firm)<sup>3</sup> in effect for the year ended June 30, 20XX. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. As a part of our peer review, we considered reviews by regulatory entities, if applicable, in determining the nature and extent of our procedures. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to express an opinion on the design of the system of quality control and the

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<sup>1</sup> The report of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the Partners of [or appropriate terminology] XYZ & Co. and the National Peer Review Committee.

<sup>2</sup> The report should use the plural *we*, *us*, and *our* even if the review team consists of only one person. The singular *I*, *me*, and *my* are appropriate only if the reviewed firm has engaged another firm to perform its review and the reviewing firm is a sole practitioner.

<sup>3</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

firm's compliance therewith based on our review. The nature, objectives, scope, limitations of, and the procedures performed in a System Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

As required by the standards, engagements selected for review included (engagements performed under *Government Auditing Standards*; audits of employee benefit plans, audits performed under FDICIA, audits of carrying broker-dealers, and examinations of service organizations [SOC 1 and SOC 2 engagements]).<sup>4</sup>

In performing our review, the firm notified us that we would be unable to review the engagements performed by one of its former partners who left the firm during the peer review year. Accordingly, we were unable to include in our engagement selection any of the divested engagements. That partner's responsibility was concentrated in the construction industry. The engagements excluded from our engagement selection process included audit engagements and comprised approximately 15 percent of the firm's audit and accounting practice during the peer review year.

In our opinion, except for any deficiencies or significant deficiencies that might have come to our attention had we been able to review divested engagements, as previously described, the system of quality control for the accounting and auditing practice of XYZ & Co.<sup>5</sup> in effect for the year ended June 30, 20XX, has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency(ies)* or *fail*. XYZ & Co. has received a peer review rating of *pass (with a scope limitation)*.

Smith, Jones and Associates

[Name of team captain's firm]

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<sup>4</sup> If the firm performs audits of employee benefit plans, engagements performed under *Government Auditing Standards*, audits of depository institutions with total assets of \$500 million or greater at the beginning of its fiscal year, audits of carrying broker-dealers, examinations of service organizations (SOC 1 and SOC 2) or other engagements required to be selected by the board in interpretations, the engagement type(s) selected for review should be identified in the report using this paragraph, tailored as applicable. For SOC engagements, the paragraph should be tailored to reflect the type(s) selected for review. If the firm does not perform such engagements, this paragraph is not applicable and not included in the report.

<sup>5</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

## Appendix E

### Illustration of a Report With a Peer Review Rating of *Pass With Deficiencies* in a System Review

The deficiencies and related recommendations provided are examples provided for illustrative purposes only. Any one or more of the deficiencies, based on the relative importance of the deficiency to the system of quality control as a whole, could result in a report with a peer review rating of *pass with deficiencies* or *fail*.

[*Firm letterhead for a firm-on-firm review; team captain's firm letterhead for an association formed review team.*]

#### System Review Report

August 31, 20XX

To the Partners of [*or other appropriate terminology*]

XYZ & Co.

and the Peer Review Committee of the [*insert the name of the applicable administering entity*]<sup>1</sup>

We<sup>2</sup> have reviewed the system of quality control for the accounting and auditing practice of XYZ & Co. (the firm)<sup>3</sup> in effect for the year ended June 30, 20XX. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. As a part of our peer review, we considered reviews by regulatory entities, if applicable, in determining the nature and extent of our procedures. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to express an opinion on the design of the system of quality control and the firm's compliance therewith based on our review. The nature, objectives, scope, limitations of, and the procedures performed in a System Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

As required by the standards, engagements selected for review included (engagements performed under *Government Auditing Standards*; audits of employee benefit plans, audits performed under FDICIA, audits of carrying broker-dealers, and examinations of service organizations [SOC 1 and SOC 2 engagements]).<sup>4</sup>

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<sup>1</sup> The report of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the Partners of [or appropriate terminology] XYZ & Co. and the National Peer Review Committee.

<sup>2</sup> The report should use the plural *we*, *us*, and *our* even if the review team consists of only one person. The singular *I*, *me*, and *my* are appropriate only if the reviewed firm has engaged another firm to perform its review and the reviewing firm is a sole practitioner.

<sup>3</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

<sup>4</sup> If the firm performs audits of employee benefit plans, engagements performed under *Government Auditing Standards*, audits of depository institutions with total assets of \$500 million or greater

(continued)

We noted the following deficiencies during our review:

1. **Deficiency**—The firm's quality control policies and procedures do not provide its staff with a means of ensuring that all necessary procedures are performed on review and compilation engagements. As a result, the firm's review and compilation working papers did not include documentation of all procedures required by professional standards, in particular relating to accounts and notes payable. We were able to satisfy ourselves that, in each case, sufficient procedures had been performed, and the firm subsequently prepared the appropriate documentation.

**Recommendation**—The firm's quality control policies and procedures should be revised to ensure documentation of all procedures performed as required by professional standards. Although not required by professional standards, the firm should consider using the practice aids in the reference manuals available in the firm's library in order to accomplish this step.

2. **Deficiency**—The firm's quality control policies and procedures do not require partner involvement in the planning stage of audit engagements. Generally accepted auditing standards permit the auditor with final responsibility for the engagement to delegate some of this work to assistants, but the standards emphasize the importance of proper planning to the conduct of the engagement. We found several audits performed in which, as a result of a lack of involvement including timely supervision by the engagement partner in planning the audit, the work performed on contracts, contract provisions, and related receivables did not support the firm's opinion on the financial statements. The firm has subsequently performed the necessary additional procedures to provide a satisfactory basis for its opinion.

**Recommendation**—The firm's quality control policies and procedures should be revised to provide, at a minimum, for timely audit partner review of the preliminary audit plan and the audit program. The firm should ensure that this is addressed as part of its ongoing monitoring procedures.

3. **Deficiency**—The firm's quality control policies and procedures require that financial statement reporting and disclosure checklists appropriate to the industry of the engagement being performed be completed. Our review noted that these checklists were not being used on all audit engagements. As a result, on certain audit engagements in the construction industry, the financial statements were missing several significant disclosures specific to the industry as required by generally accepted accounting principles. The subject reports have been recalled, and the financial statements are being revised.

**Recommendation**—The firm should conduct a training session for all personnel to review the firm's policies and procedures for utilizing financial statement reporting and disclosure checklists that

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*(footnote continued)*

at the beginning of its fiscal year, audits of carrying broker-dealers, examinations of service organizations (SOC 1 and SOC 2) or other engagements required to be selected by the board in interpretations, the engagement type(s) selected for review should be identified in the report using this paragraph, tailored as applicable. For SOC engagements, the paragraph should be tailored to reflect the type(s) selected for review. If the firm does not perform such engagements, this paragraph is not applicable and not included in the report.

are appropriate to the industry of an engagement. The engagement partner should carefully review these checklists at the completion of an engagement to ensure that the appropriate checklists are utilized and to ensure their proper completion as required by firm policy. This can be accomplished by adding a procedure to the firm's engagement review checklist requiring the engagement partner to document his or her review of these checklists.

In our opinion, except for the deficiencies previously described, the system of quality control for the accounting and auditing practice of XYZ & Co.<sup>5</sup> in effect for the year ended June 30, 20XX, has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency(ies)*, or *fail*. XYZ & Co has received a peer review rating of *pass with deficiencies*.

Smith, Jones and Associates

[Name of team captain's firm]

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<sup>5</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

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## Appendix F

### Illustration of a Response by a Reviewed Firm to a Report With a Peer Review Rating of *Pass With Deficiencies* in a System Review

The purpose of a letter of response is to describe the actions the firm has taken or will take, including the timing of the planned actions, to prevent a recurrence of each deficiency discussed in the report. If the reviewed firm disagrees with one or more of the deficiencies or recommendations in the report, the reviewed firm should contact the administering entity for assistance. If the firm still disagrees after contacting the administering entity, the firm's response should describe the reasons for such disagreement. For more information related to disagreements, see paragraph .93 of the standards. The letter of response should be carefully prepared because of the important bearing it may have on the decisions reached in connection with acceptance of the report on the review (see paragraphs .136–.140, "Accepting System and Engagement Reviews"). The letter of response should be submitted to the team captain for review and comment prior to the firm submitting the response to the administering entity.

*[Reviewed firm's letterhead]*

September 21, 20XX

*[Addressed to the peer review committee of the administering entity]*<sup>1</sup>

Ladies and Gentlemen:

This letter represents our<sup>2</sup> response to the report issued in connection with the peer review of the firm's system of quality control for the accounting and auditing practice in effect for the year ended June 30, 20XX. The corrective actions discussed in this letter will be monitored to ensure that they are effectively implemented as part of our system of quality control.

- 1.<sup>3</sup> The firm modified its quality control policies and procedures to require the use of practice aids to document procedures performed on review and compilation engagements, especially for accounts and notes payable. Partners were instructed to ensure that these aids were being utilized appropriately when reviewing engagements. This policy was discussed in a recent training session held in connection with a recent firm-wide staff meeting.
2. The firm also modified its quality control policies and procedures to place a greater emphasis on partner involvement in the planning stage of all audit engagements. The revised policies and procedures require the engagement owner to document his or her timely involvement in the planning process in the planning section of the written work program. The importance of proper planning, including timely partner involvement, to quality work was emphasized in the training session previously referred.

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<sup>1</sup> The response of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the National Peer Review Committee.

<sup>2</sup> The response should use the singular *I*, *me*, and *my* only when the reviewed firm is a sole practitioner.

<sup>3</sup> The numbering of responses, to coincide with the numbered comments in the report, is optional.

3. In addition, at that training session, the importance of proper use of the firm's reporting and disclosure checklists appropriate to the industry of the engagement being performed was discussed. We discussed the proper resolution of points or topics unfamiliar to the individual completing the checklist or those reviewing its completion. The firm's CPE plan for partners and managers now includes annual updates on industry specific disclosure issues.

As previously mentioned, these corrective actions will also be emphasized in our monitoring procedures and internal inspection.

We believe these actions are responsive to the findings of the review.

Sincerely,

*[Name of Firm]*<sup>4</sup>

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<sup>4</sup> Signed by an authorized partner of the firm.

## Appendix G

### Illustration of a Report With a Peer Review Rating of *Pass With Deficiencies (With a Scope Limitation)* in a System Review

The deficiencies and related recommendations provided are examples provided for illustrative purposes only. Any one or more of the deficiencies, based on the relative importance of the deficiency to the system of quality control as a whole, could result in a report with a peer review rating of *pass with deficiencies* or *fail*.

#### Limitation on Scope of Review

A report with a scope limitation should be issued when the scope of the review is limited by conditions (including those discussed in the standards) that preclude the application of one or more peer review procedure(s) considered necessary in the circumstances and the review team cannot accomplish the objectives of those procedures through alternate procedures. For example, a review team may be able to apply appropriate alternate procedures if one or more engagements have been excluded from the scope of the review. Ordinarily, however, the team would be unable to apply alternate procedures if the firm's only engagement in an industry that must be selected is unavailable for review and there isn't an earlier issued engagement that may be able to replace it, or when a significant portion of the firm's accounting and auditing practice during the year reviewed had been divested before the review began (see interpretation). A scope limitation may be included in a report with a peer review rating of *pass*, *pass with deficiency(ies)*, or *fail*. In this example, the scope limitation was included in a report with a peer review rating of *pass with deficiencies*, where one of the deficiencies related to the circumstances of the scope limitation.

[*Firm letterhead for a firm-on-firm review; team captain's firm letterhead for an association formed review team.*]

System Review Report

October 31, 20XX

To the Partners of [or *other appropriate terminology*]

XYZ & Co.

and the Peer Review Committee of the [insert the name of the applicable administering entity]<sup>1</sup>

We<sup>2</sup> have reviewed the system of quality control for the accounting and auditing practice of XYZ & Co. (the firm)<sup>3</sup> in effect for the year ended June 30, 20XX. Except as subsequently described, our peer review was conducted in accordance

<sup>1</sup> The report of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the Partners of [or appropriate terminology] XYZ & Co. and the National Peer Review Committee.

<sup>2</sup> The report should use the plural *we*, *us*, and *our* even if the review team consists of only one person. The singular *I*, *me*, and *my* are appropriate only if the reviewed firm has engaged another firm to perform its review and the reviewing firm is a sole practitioner.

<sup>3</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. As a part of our peer review, we considered reviews by regulatory entities, if applicable, in determining the nature and extent of our procedures. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to express an opinion on the design of the system of quality control and the firm's compliance therewith based on our review. The nature, objectives, scope, limitations of, and the procedures performed in a System Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

As required by the standards, engagements selected for review included (audits of employee benefit plans, audits performed under FDICIA, audits of carrying broker-dealers, and examinations of service organizations [SOC 1 and SOC 2 engagements]).<sup>4</sup>

In performing our review, the firm notified us that we would be unable to select its only audit subject to *Government Auditing Standards* (Yellow Book). As a result, we were unable to review all of the types of engagements required to be selected by the standards established by the Peer Review Board of the AICPA.

We noted the following deficiencies during our review:

1. **Deficiency**—The firm's quality control policies and procedures do not require partner involvement in the planning stage of audit engagements. Generally accepted auditing standards permit the auditor with final responsibility for the engagement to delegate some of this work to assistants, but the standards emphasize the importance of proper planning to the conduct of the engagement. We found several audits performed in which, as a result of a lack of involvement, including timely supervision by the engagement partner in planning the audit, the work performed on contracts, contract provisions, and related receivables did not support the firm's opinion on the financial statements. The firm has subsequently performed the necessary additional procedures to provide a satisfactory basis for its opinion.

**Recommendation**—The firm's quality control policies and procedures should be revised to provide, at a minimum, for timely audit partner review of the preliminary audit plan and the audit program. The firm should ensure that this is addressed as part of its ongoing monitoring procedures.

2. **Deficiency**—As previously noted, in performing our review, the firm notified us that we would be unable to select its only audit subject to *Government Auditing Standards* (Yellow Book). As a result, the firm was not in compliance with the Yellow Book peer review engagement selection requirements.

**Recommendation**—We recommend that the firm consider the importance of adhering to the Yellow Book requirements and the possible consequences of noncompliance.

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<sup>4</sup> If the firm performs audits of employee benefit plans, engagements performed under *Government Auditing Standards*, audits of depository institutions with total assets of \$500 million or greater at the beginning of its fiscal year, audits of carrying broker-dealers, examinations of service organizations (SOC 1 and SOC 2) or other engagements required to be selected by the board in interpretations, the engagement type(s) selected for review should be identified in the report using this paragraph, tailored as applicable. For SOC engagements, the paragraph should be tailored to reflect the type(s) selected for review. If the firm does not perform such engagements, this paragraph is not applicable and not included in the report.

In our opinion, except for the effects of the deficiency previously described and any additional deficiencies or significant deficiencies that might have come to our attention had we been able to review the engagement as previously described, the system of quality control for the accounting and auditing practice of XYZ & Co.<sup>5</sup> in effect for the year ended June 30, 20XX, has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency(ies)*, or *fail*. XYZ & Co has received a peer review rating of *pass with deficiencies (with a scope limitation)*.

Smith, Jones and Associates

[Name of team captain's firm]

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<sup>5</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

## Appendix H

### Illustration of a Response by a Reviewed Firm to a Report With a Peer Review Rating of *Pass With Deficiencies (With a Scope Limitation)* in a System Review

The purpose of a letter of response is to describe the actions the firm has taken or will take, including the timing of the planned actions, to prevent a recurrence of each deficiency discussed in the report. If the reviewed firm disagrees with one or more of the deficiencies or recommendations in the report, the reviewed firm should contact the administering entity for assistance. If the firm still disagrees after contacting the administering entity, the firm's response should describe the reasons for such disagreement. For more information related to disagreements, see paragraph .93 of the standards. The letter of response should be carefully prepared because of the important bearing it may have on the decisions reached in connection with acceptance of the report on the review (see paragraphs .136–.140, "Accepting System and Engagement Reviews"). The letter of response should be submitted to the team captain for review and comment prior to the firm submitting the response to the administering entity.

[Reviewed firm's letterhead]

November 30, 20XX

[Addressed to the peer review committee of the administering entity]<sup>1</sup>

Ladies and Gentlemen:

This letter represents our<sup>2</sup> response to the report issued in connection with the peer review of the firm's system of quality control for the accounting and auditing practice in effect for the year ended June 30, 20XX.

- <sup>3</sup> The firm also modified its quality control policies and procedures to place a greater emphasis on partner involvement in the planning stage of all audit engagements. The revised policies and procedures require the engagement owner to document his or her timely involvement in the planning process in the planning section of the written work program. The importance of proper planning, including timely partner involvement, to quality work was emphasized in a recent training session held in conjunction with a recent firm-wide staff meeting.
- Due to circumstances that we deemed appropriate, we notified the peer reviewer that he would be unable to select our only audit subject to *Government Auditing Standards* in the peer review. This is the only governmental audit the firm has performed,

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<sup>1</sup> The response of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the National Peer Review Committee.

<sup>2</sup> The response should use the singular *I*, *me*, and *my* only when the reviewed firm is a sole practitioner.

<sup>3</sup> The numbering of responses, to coincide with the numbered comments in the report, is optional.

so there were no previous audits for the reviewer to select. We suggested selecting an audit engagement in a different industry. We have considered the consequences of noncompliance related to this matter.

Sincerely,

*[Name of Firm]*<sup>4</sup>

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<sup>4</sup> Signed by an authorized partner of the firm.

## Appendix I

### Illustration of a Report With a Peer Review Rating of *Fail* in a System Review

The deficiencies and related recommendations provided are examples provided for illustrative purposes only. Any one or more of the deficiencies, based on the relative importance of the deficiency to the system of quality control as a whole, could result in a report with a peer review rating of *pass with deficiencies* or *fail*.

[*Firm letterhead for a firm-on-firm review; team captain's firm letterhead for an association formed review team.*]

#### System Review Report

October 31, 20XX

To the Partners of [or other appropriate terminology]

XYZ & Co.

and the Peer Review Committee of the [insert the name of the applicable administering entity]<sup>1</sup>

We<sup>2</sup> have reviewed the system of quality control for the accounting and auditing practice of XYZ & Co. (the firm)<sup>3</sup> in effect for the year ended June 30, 20XX. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. As a part of our peer review, we considered reviews by regulatory entities, if applicable, in determining the nature and extent of our procedures. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to express an opinion on the design of the system of quality control and the firm's compliance therewith based on our review. The nature, objectives, scope, limitations of, and the procedures performed in a System Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

As required by the standards, engagements selected for review included (engagements performed under *Government Auditing Standards*; audits of employee benefit plans, audits performed under FDICIA, audits of carrying broker-dealers, and examinations of service organizations [SOC 1 and SOC 2 engagements]).<sup>4</sup>

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<sup>1</sup> The report of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the Partners of [or appropriate terminology] XYZ & Co. and the National Peer Review Committee.

<sup>2</sup> The report should use the plural *we*, *us*, and *our* even if the review team consists of only one person. The singular *I*, *me*, and *my* are appropriate only if the reviewed firm has engaged another firm to perform its review and the reviewing firm is a sole practitioner.

<sup>3</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

<sup>4</sup> If the firm performs audits of employee benefit plans, engagements performed under *Government Auditing Standards*, audits of depository institutions with total assets of \$500 million or greater

(continued)

We noted the following significant deficiencies<sup>5</sup> during our review:

1. **Deficiency**—The firm's quality control policies and procedures do not require written audit programs as required by professional standards. As a result, we noted several instances in which audit procedures were not adequately performed and documented in the areas of investments and expenses. As a result, the audit work performed for several audits did not support the opinion issued and was not performed in conformity with applicable professional standards. The firm has subsequently performed the omitted procedures to support the audit opinions.

**Recommendation**—The firm's quality control policies and procedures should require the use of audit programs on all audits. All audit programs should be retained with the engagement working papers.

2. **Deficiency**—The firm's quality control policies and procedures require consultation based upon the following factors: materiality, experience in a particular industry or functional area, and familiarity with the accounting principles or auditing requirements in a specialized area. We noted instances in which the firm did not consult during the year, either by use of the firm's technical reference material or by requesting assistance from outside the firm. As a result, financial statements on audits for development stage companies did not conform with applicable professional standards. The firm was not aware of the unique disclosure and statement presentations required until it was brought to its attention during the peer review. The firm intends to recall and reissue the financial statements and reports.

**Recommendation**—The firm should emphasize its consultation policies and procedures on those engagements that are new to the experience level of the firm's accounting and auditing personnel.

3. **Deficiency**—The firm's quality control policies and procedures do not provide its personnel with a means of ensuring that all necessary procedures are performed on Employee Retirement Income Security Act (ERISA) engagements. During our review, we noted that the firm failed to adequately perform, including appropriately documenting, procedures related to benefit payments on ERISA engagements. The firm has subsequently performed the testing and documented its procedures.

**Recommendation**—The firm should review and implement the requirements of specialized industries. This can be accomplished by the purchase and use of practice aids tailored to the industry.

4. **Deficiency**—The firm's quality control policies and procedures require that financial statement reporting and disclosure checklists be completed for all engagements. Our review noted that these checklists were not being used on all engagements. As a result,

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*(footnote continued)*

at the beginning of its fiscal year, audits of carrying broker-dealers, examinations or service organizations (SOC 1 and SOC 2) or other engagements required to be selected by the board in interpretations, the engagement type(s) selected for review should be identified in the report using this paragraph, tailored as applicable. For SOC engagements, the paragraph should be tailored to reflect the type(s) selected for review. If the firm does not perform such engagements, this paragraph is not applicable and not included in the report.

<sup>5</sup> When considered together, the deficiencies rise to the level of significant deficiencies.

the reviewed financial statements in the construction industry were missing several significant disclosures as required by generally accepted accounting principles. The subject reports have been recalled, and the financial statements are being revised.

Recommendation—The firm should conduct a training session for all personnel to review the firm's policies and procedures for utilizing financial statement reporting and disclosure checklists specific to the industry of the engagement, when available. The engagement partner should carefully review these checklists at the completion of an engagement to ensure their proper completion as required by firm policy. This can be accomplished by adding a procedure to the firm's engagement review checklist requiring the engagement partner to document his or her review of these checklists.

In our opinion, as a result of the significant deficiencies previously described, the system of quality control for the accounting and auditing practice of XYZ & Co.<sup>6</sup> in effect for the year ended June 30, 20XX, was not suitably designed or complied with to provide the firm with reasonable assurance of performing or reporting in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency(ies)*, or *fail*. XYZ & Co has received a peer review rating of *fail*.

Smith, Jones and Associates

[Name of team captain's firm]

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<sup>6</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

## Appendix J

### Illustration of a Response by a Reviewed Firm to a Report With a Peer Review Rating of *Fail* in a System Review

The purpose of a letter of response is to describe the actions the firm has taken or will take, including the timing of the planned actions, to prevent a recurrence of each of the significant deficiencies discussed in the report. If the reviewed firm disagrees with one or more of the significant deficiencies or recommendations in the report, the reviewed firm should contact the administering entity for assistance. If the firm still disagrees after contacting the administering entity, the firm's response should describe the reasons for such disagreement. For more information related to disagreements, see paragraph .93 of the standards. The letter of response should be carefully prepared because of the important bearing it may have on the decisions reached in connection with acceptance of the report on the review (see paragraphs .136–.140, "Accepting System and Engagement Reviews"). The letter of response should be submitted to the team captain for review and comment prior to the firm submitting the response to the administering entity.

November 30, 20XX

*[Addressed to the peer review committee of the administering entity]*<sup>1</sup>

Ladies and Gentlemen:

This letter represents our<sup>2</sup> response to the report issued in connection with the peer review of the firm's system of quality control for the accounting and auditing practice in effect for the year ended June 30, 20XX. All issues have been brought to the attention of personnel at a meeting held on November 22, 20XX. In addition, steps have been added to our monitoring procedures to review the deficiencies noted in the report so that they will not happen again.

- <sup>3</sup> Several of the deficiencies noted by the review team included missing or incomplete audit and review documentation. All individuals with responsibility for managing audit and accounting engagements have been reminded of their responsibility to ensure the applicable professional standards for performing and documenting engagements are followed. In addition, we have implemented a concurring partner review on all audit and review engagements, and the quality of audit documentation will be a focus of the concurring partner's review.
- The firm has contacted two other accounting firms with expertise in Employee Retirement Income Security Act (ERISA) audits, development stage companies, and other industries that are similar to ours. We have implemented a plan for consultation with these firms for guidance in situations with which we are unfamiliar.

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<sup>1</sup> The response of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the National Peer Review Committee.

<sup>2</sup> The response should use the singular *I*, *me*, and *my* only when the reviewed firm is a sole practitioner.

<sup>3</sup> The numbering of responses, to coincide with the numbered comments in the report, is optional.

3. We have purchased practice aids that are specific to the industries of our clients and have instructed staff and partners on their use.
4. At the staff meeting previously mentioned, the importance of proper use of the firm's reporting and disclosure checklist was discussed, including the use of checklists for specialized industries. We discussed the proper resolution of points or topics unfamiliar to the individual completing the checklist or those reviewing its completion. The firm's CPE plan for partners and managers now includes annual updates on disclosure issues.

The firm is committed to strengthening its monitoring policies and procedures, especially as they relate to a timely post-issuance review of engagements. We have acquired quality control materials to guide the firm, and supervision of the monitoring process has been assigned to a partner. Additionally, outside assistance (as previously mentioned) has been sought, and this individual will be available for consultation and guidance.

Sincerely,

*[Name of Firm]*<sup>4</sup>

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<sup>4</sup> Signed by an authorized partner of the firm.

## Appendix K

### Illustration of a Report With a Peer Review Rating of *Fail* (With a Scope Limitation) in a System Review

The deficiencies and related recommendations provided are examples provided for illustrative purposes only. Any one or more of the deficiencies, based on the relative importance of the deficiency to the system of quality control as a whole, could result in a report with a peer review rating of *pass with deficiencies* or *fail*.

#### Limitation on Scope of Review

A report with a scope limitation should be issued when the scope of the review is limited by conditions (including those discussed in the standards) that preclude the application of one or more peer review procedure(s) considered necessary in the circumstances and the review team cannot accomplish the objectives of those procedures through alternate procedures. For example, a review team may be able to apply appropriate alternate procedures if one or more engagements have been excluded from the scope of the review. Ordinarily, however, the team would be unable to apply alternate procedures if the firm's only engagement in an industry that must be selected is unavailable for review and there is not an earlier issued engagement that may be able to replace it, or when a significant portion of the firm's accounting and auditing practice during the year reviewed had been divested before the review began (see interpretation). A scope limitation may be included in a report with a peer review rating of *pass*, *pass with deficiency(ies)*, or *fail*. In this example, the scope limitation was included in a report with a peer review rating of *fail*.

[*Firm letterhead for a firm-on-firm review; team captain's firm letterhead for an association formed review team.*]

System Review Report

October 31, 20XX

To the Partners of [or other appropriate terminology]

XYZ & Co.

and the Peer Review Committee of the [insert the name of the applicable administering entity]<sup>1</sup>

We<sup>2</sup> have reviewed the system of quality control for the accounting and auditing practice of XYZ & Co. (the firm)<sup>3</sup> in effect for the year ended June 30, 20XX. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. As a part of

<sup>1</sup> The report of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the Partners of [or appropriate terminology] XYZ & Co. and the National Peer Review Committee.

<sup>2</sup> The report should use the plural *we*, *us*, and *our* even if the review team consists of only one person. The singular *I*, *me*, and *my* are appropriate only if the reviewed firm has engaged another firm to perform its review and the reviewing firm is a sole practitioner.

<sup>3</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

our peer review, we considered reviews by regulatory entities, if applicable, in determining the nature and extent of our procedures. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to express an opinion on the design of the system of quality control and the firm's compliance therewith based on our review. The nature, objectives, scope, limitations of, and the procedures performed in a System Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

As required by the standards, engagements selected for review included (engagements performed under *Government Auditing Standards*; audits of employee benefit plans, audits performed under FDICIA, audits of carrying broker-dealers, and examinations of service organizations [SOC 1 and SOC 2 engagements]).<sup>4</sup>

In performing our review, the firm notified us that we would be unable to review the engagements performed by one of the firm's four offices that divested from the firm during the peer review year. As a result, we were unable to include within our engagement selection any engagements issued by that office. The engagements excluded from our engagement selection process included audit engagements and composed approximately 20 percent of the firm's audit and accounting hours during the peer review year.

In addition, we noted the following significant deficiencies<sup>5</sup> during our review:

1. **Deficiency**—The firm's quality control policies and procedures do not require written audit programs as required by professional standards. As a result, we noted several instances in which audit procedures were not adequately performed and documented in the areas of investments and expenses. As a result, the audit work performed for several audits did not support the opinion issued and was not performed in conformity with applicable professional standards. The firm has subsequently performed the omitted procedures to support the audit opinions.

**Recommendation**—The firm's quality control policies and procedures should require the use of audit programs on all audits. All audit programs should be retained with the engagement working papers.

2. **Deficiency**—The firm's quality control policies and procedures require consultation based upon the following factors: materiality, experience in a particular industry or functional area, and familiarity with the accounting principles or auditing requirements in a specialized area. We noted instances in which the firm did not consult during the year, either by use of the firm's technical reference material or by requesting assistance from outside the firm. As a result, financial statements on audits for development stage companies did not conform with applicable professional standards. The firm was not aware of the unique disclosure

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<sup>4</sup> If the firm performs audits of employee benefit plans, engagements performed under *Government Auditing Standards*, audits of depository institutions with total assets of \$500 million or greater at the beginning of its fiscal year, audits of carrying broker-dealers, examinations of service organizations (SOC 1 and SOC 2) or other engagements required to be selected by the board in interpretations, the engagement type(s) selected for review should be identified in the report using this paragraph, tailored as applicable. For SOC engagements, the paragraph should be tailored to reflect the type(s) selected for review. If the firm does not perform such engagements, this paragraph is not applicable and not included in the report.

<sup>5</sup> When considered together, the deficiencies rise to the level of significant deficiencies.

and statement presentations required until it was brought to its attention during the peer review. The firm intends to recall and reissue the financial statements and reports.

Recommendation—The firm should emphasize its consultation policies and procedures on those engagements that are new to the experience level of the firm's accounting and auditing personnel.

3. Deficiency—The firm's quality control policies and procedures do not provide its personnel with a means of ensuring that all necessary procedures are performed on Employee Retirement Income Security Act (ERISA) engagements. During our review, we noted that the firm failed to adequately perform, including appropriately documenting, procedures related to benefit payments on ERISA engagements. The firm has subsequently performed the testing and documented its procedures.

Recommendation—The firm should review and implement the requirements of specialized industries. This can be accomplished by the purchase and use of practice aids tailored to the industry.

4. Deficiency—The firm's quality control policies and procedures require that financial statement reporting and disclosure checklists be completed for all engagements. Our review noted that these checklists were not being used on all engagements. As a result, the reviewed financial statements in the construction industry were missing several significant disclosures as required by generally accepted accounting principles. The subject reports have been recalled and the financial statements are being revised.

Recommendation—The firm should conduct a training session for all personnel to review the firm's policies and procedures for utilizing financial statement reporting and disclosure checklists specific to the industry of the engagement, when available. The engagement partner should carefully review these checklists at the completion of an engagement to ensure their proper completion as required by firm policy. This can be accomplished by adding a procedure to the firm's engagement review checklist requiring the engagement partner to document his or her review of these checklists.

In our opinion, as a result of the significant deficiencies previously described, and any additional significant deficiencies that might have come to our attention had we been able to review engagements from the divested office as previously described, the system of quality control for the accounting and auditing practice of XYZ & Co.<sup>6</sup> in effect for the year ended June 30, 20XX was not suitably designed or complied with to provide the firm with reasonable assurance of performing or reporting in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency(ies)*, or *fail*. XYZ & Co has received a peer review rating of *fail (with a scope limitation)*.

Smith, Jones and Associates

[Name of team captain's firm]

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<sup>6</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

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## Appendix L

### Illustration of a Response by a Reviewed Firm to a Report With a Peer Review Rating of *Fail (With a Scope Limitation)* in a System Review

The purpose of a letter of response is to describe the actions the firm has taken or will take including the timing of the planned actions, to prevent a recurrence of each of the significant deficiencies discussed in the report. If the reviewed firm disagrees with one or more of the significant deficiencies, or recommendations in the report, the reviewed firm should contact the administering entity for assistance. If the firm still disagrees after contacting the administering entity, the firm's response should describe the reasons for such disagreement. For more information related to disagreements, see paragraph .93 of the standards. The letter of response should be carefully prepared because of the important bearing it may have on the decisions reached in connection with acceptance of the report on the review (see paragraphs .136–.140, "Accepting System and Engagement Reviews"). The letter of response should be submitted to the team captain for review and comment prior to the firm submitting the response to the administering entity.

November 30, 20XX

*[Addressed to the peer review committee of the administering entity]*<sup>1</sup>

Ladies and Gentlemen:

This letter represents our<sup>2</sup> response to the report issued in connection with the peer review of the firm's system of quality control for the accounting and auditing practice in effect for the year ended June 30, 20XX. All issues have been brought to the attention of the personnel at a meeting held on November 22, 20XX. In addition, steps have been added to our monitoring procedures to review the deficiencies noted in the report so that they will not happen again.

We notified our peer reviewer that he would be unable to review the engagements performed by one of our firm's four offices that divested from our firm during the peer review year. We have considered the consequences of this scope limitation on the results of our peer review.

- <sup>3</sup> Several of the deficiencies noted by the review team included missing or incomplete audit and review documentation. All individuals with responsibility for managing audit and accounting engagements have been reminded of their responsibility to ensure the applicable professional standards for performing and documenting engagements are followed. In addition, we have implemented a concurring partner review on all audit and review engagements, and the quality of audit documentation will be a focus of the concurring partner's review.

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<sup>1</sup> The response of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the National Peer Review Committee.

<sup>2</sup> The response should use the singular *I*, *me*, and *my* only when the reviewed firm is a sole practitioner.

<sup>3</sup> The numbering of responses, to coincide with the numbered comments in the report, is optional.

2. The firm has contacted two other accounting firms with expertise in Employee Retirement Income Security Act (ERISA) audits, development stage companies, and other industries that are similar to ours. We have implemented a plan for consultation with these firms for guidance in situations with which we are unfamiliar.
3. We have purchased practice aids that are specific to the industries of our clients and have instructed staff and partners on their use.
4. At the staff meeting previously mentioned, the importance of proper use of the firm's reporting and disclosure checklist was discussed, including the use of checklists for specialized industries. We discussed the proper resolution of points or topics unfamiliar to the individual completing the checklist or those reviewing its completion. The firm's CPE plan for partners and managers now includes annual updates on disclosure issues.

The firm is committed to strengthening its monitoring policies and procedures, especially as they relate to a timely post-issuance review of engagements. We have acquired quality control materials to guide the firm, and supervision of the monitoring process has been assigned to a partner. Additionally, outside assistance (as previously mentioned) has been sought, and this individual will be available for consultation and guidance.

Sincerely,

[*Name of Firm*]<sup>4</sup>

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<sup>4</sup> Signed by an authorized partner of the firm.

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## Appendix M

### Illustration of a Report With a Peer Review Rating of *Pass* in an Engagement Review

In the event of a scope limitation, include an additional paragraph (as described in paragraph .122*j* of the standards), and follow the illustrations for System Reviews with scope limitations (see appendixes D, G, and K).

*[Administering entity letterhead for a committee-appointed review team review; firm letterhead for a firm-on-firm review; review captain's firm letterhead for an association formed review team]*

#### Engagement Review Report

September 30, 20XX

To the Partners of *[or other appropriate terminology]*

XYZ & Co.

and the Peer Review Committee of the *[insert the name of the applicable administering entity]*<sup>1</sup>

We<sup>2</sup> have reviewed selected accounting engagements of XYZ & Co. (the firm)<sup>3</sup> issued with periods ending during the year ended June 30, 20XX. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to evaluate whether the engagements submitted for review were performed and reported on in conformity with applicable professional standards in all material respects. An Engagement Review does not include reviewing the firm's system of quality control and compliance therewith and, accordingly, we express no opinion or any form of assurance on that system. The nature, objectives, scope, limitations of, and the procedures performed in an Engagement Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

Based on our review, nothing came to our attention that caused us to believe that the engagements submitted for review by XYZ & Co.<sup>4</sup> issued with periods ending during the year ended June 30, 20XX, were not performed and reported on in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency(ies)*, or *fail*. XYZ & Co has received a peer review rating of *pass*.

Smith, Jones and Associates

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<sup>1</sup> The report of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the Partners of *[or appropriate terminology]* XYZ & Co. and the National Peer Review Committee.

<sup>2</sup> The report should use the plural *we*, *us*, and *our* even if the review team consists of only one person. The singular *I*, *me*, and *my* are appropriate only if the reviewed firm has engaged another firm to perform its review and the reviewing firm is a sole practitioner.

<sup>3</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

<sup>4</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

*[Name of review captain's firm on firm-on-firm review or association formed review team]*

*[or]*

John Brown, Review Captain

*[Committee-appointed review team review]*

## Appendix N

### Illustration of a Report With a Peer Review Rating of *Pass With Deficiencies* in an Engagement Review

This illustration assumes the review captain concludes that deficiencies are not evident on all of the engagements submitted for review. Otherwise, this firm would have received a peer review rating of *fail*.

In the event of a scope limitation, include an additional paragraph (as described in paragraph .122j of the standards), and follow the illustrations for System Reviews with scope limitations (see appendixes D, G, and K).

*[Administering entity letterhead for a committee-appointed review team review; firm letterhead for a firm-on-firm review; review captain's firm letterhead for an association formed review team]*

#### Engagement Review Report

September 30, 20XX

To the Partners of *[or other appropriate terminology]*

XYZ & Co.

and the Peer Review Committee of the *[insert the name of the applicable administering entity]*<sup>1</sup>

We<sup>2</sup> have reviewed selected accounting engagements of XYZ & Co. (the firm)<sup>3</sup> issued with periods ending during the year ended June 30, 20XX. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to evaluate whether the engagements submitted for review were performed and reported on in conformity with applicable professional standards in all material respects. An Engagement Review does not include reviewing the firm's system of quality control and compliance therewith and, accordingly, we express no opinion or any form of assurance on that system. The nature, objectives, scope, limitations of, and the procedures performed in an Engagement Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

We noted the following deficiencies<sup>4</sup> during our review:

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<sup>1</sup> The report of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the Partners of *[or appropriate terminology]* XYZ & Co. and the National Peer Review Committee.

<sup>2</sup> The report should use the plural *we*, *us*, and *our* even if the review team consists of only one person. The singular *I*, *me*, and *my* are appropriate only if the reviewed firm has engaged another firm to perform its review and the reviewing firm is a sole practitioner.

<sup>3</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

<sup>4</sup> The deficiencies and related recommendations provided are examples provided for illustrative purposes only.

1. Deficiency—On one review engagement of a manufacturing client, we noted that the accompanying accountant's report was not appropriately modified. The financial statements did not appropriately present or disclose matters in accordance with industry standards. The firm discussed the departure with the client and decided to recall its report and restate the accompanying financial statements in order to report in conformity with applicable professional standards in all material respects.

Recommendation—We recommend that the firm establish a means of ensuring that financial statements present or disclose matters in accordance with industry standards. Such means might include continuing professional education in the industries of the firm's engagements and, although not required by professional standards, use of a comprehensive reporting and disclosure checklist on accounting engagements that is tailored for specialized industries, where applicable, or a cold review of reports and financial statements prior to issuance.

2. Deficiency—On a review engagement we reviewed, we noted that the firm failed to obtain a management representation letter, and its working papers failed to document the matters covered in the accountant's inquiry and analytical procedures. These deficiencies were identified on the firm's previous review.

Recommendation—The firm should review and implement the requirements for obtaining management representation letters and the content of the accountant's working papers on review engagements.

Based on our review, except for the deficiencies previously described, nothing came to our attention that caused us to believe that the engagements submitted for review by XYZ & Co.<sup>5</sup> issued with periods ending during the year ended June 30, 20XX, were not performed and reported on in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency(ies)*, or *fail*. XYZ & Co. has received a peer review rating of *pass with deficiencies*.

Smith, Jones and Associates

[Name of review captain's firm on firm-on-firm review or association formed review team]

[or]

John Brown, Review Captain

[Committee-appointed review team review]

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<sup>5</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

## Appendix O

### Illustration of a Response by a Reviewed Firm to a Report With a Peer Review Rating of *Pass With Deficiencies* in an Engagement Review

The purpose of a letter of response is to describe the actions the firm has taken or will take including the timing of the planned actions to prevent the recurrence of each deficiency discussed in the report. If the reviewed firm disagrees with one or more of the deficiencies or recommendations in the report, the reviewed firm should contact the administering entity for assistance in the matter. If the firm still disagrees after contacting the administering entity, the firm's response should describe the reasons for such disagreement. For additional guidance on disagreements, see paragraph .116 of standards. The letter of response should be carefully prepared because of the important bearing it may have on the decisions reached in connection with acceptance of the report on the review (see paragraphs .136–.140, "Accepting System and Engagement Reviews"). The letter of response should be submitted to the reviewer for review and comment prior to the firm submitting the response to the administering entity.

October 31, 20XX

*[Addressed to the peer review committee of the administering entity]*<sup>1</sup>

Ladies and Gentlemen:

This letter represents our<sup>2</sup> response to the report on the Engagement Review of our firm's accounting practice for engagements submitted for review with periods ending during the year ended June 30, 20XX.

- 1.<sup>3</sup> As recommended by the reviewer, the entire staff has participated in continuing professional education related to reporting and disclosures, with a particular focus on areas specific to the industries that we are engaged in. We will be performing a pre-issuance review by a partner not associated with the engagement to make sure that the accountant's report is appropriately modified when the financial statements depart from applicable professional standards.
2. Management representation letters will be obtained for all future review engagements issued by the firm. The firm has required that a manager review each engagement to ensure that the management representation letter is obtained and that all the required documentation, including the matters covered in the

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<sup>1</sup> The response of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the National Peer Review Committee.

<sup>2</sup> The response should use the singular *I*, *me*, and *my* only when the reviewed firm is a sole practitioner.

<sup>3</sup> The numbering of responses, to coincide with the numbered comments in the report, is optional.

accountant's inquiry and analytical procedures, is included in the working papers.

We believe these actions address the matters noted by the reviewer.

Sincerely,

*[Name of firm]*<sup>4</sup>

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<sup>4</sup> Signed by an authorized partner of the firm.

## Appendix P

### Illustration of a Report With a Peer Review Rating of *Fail* in an Engagement Review

The deficiencies in this illustration represent various examples and are not intended to suggest that the peer review would include this many engagements in the scope or require this number of deficiencies to warrant a report with a peer review rating of *fail*. However, each of the engagements reviewed would have one or more deficiencies in a report with a peer review rating of *fail*.

In the event of a scope limitation, include an additional paragraph (as described in paragraph .122j of the standards), and follow the illustrations for System Reviews with scope limitations (see appendixes D, G, and K).

*[Administering entity letterhead for a committee-appointed review team review; firm letterhead for a firm-on-firm review; review captain's firm letterhead for an association formed review team]*

#### Engagement Review Report

September 30, 20XX

To the Partners of *[or other appropriate terminology]*

XYZ & Co.

and the Peer Review Committee of the *[insert the name of the applicable Administering Entity]*<sup>1</sup>

We<sup>2</sup> have reviewed selected accounting engagements of XYZ & Co. (the firm)<sup>3</sup> issued with periods ending during the year ended June 30, 20XX. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to evaluate whether the engagements submitted for review were performed and reported on in conformity with applicable professional standards in all material respects. An Engagement Review does not include reviewing the firm's system of quality control and compliance therewith and, accordingly, we express no opinion or any form of assurance on that system. The nature, objectives, scope, limitations of, and the procedures performed in an Engagement Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

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<sup>1</sup> The report of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the Partners of *[or appropriate terminology]* XYZ & Co. and the National Peer Review Committee.

<sup>2</sup> The report should use the plural *we*, *us*, and *our* even if the review team consists of only one person. The singular *I*, *me*, and *my* are appropriate only if the reviewed firm has engaged another firm to perform its review and the reviewing firm is a sole practitioner.

<sup>3</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

We noted the following significant deficiencies<sup>4</sup> during our review:

1. Deficiency—Our review disclosed several failures to adhere to applicable professional standards in reporting on material departures from generally accepted accounting principles (GAAP) and in conforming to standards for accounting and review services. Specifically, the firm did not disclose in certain compilation and review reports failures to conform with GAAP in accounting for leases, in accounting for revenue from construction contracts, and in disclosures made in the financial statements or the notes thereto concerning various matters important to an understanding of those statements. The compilation and review engagements were in the construction and manufacturing industries, respectively. In addition, the firm did not obtain management representation letters on review engagements.

Recommendation—We recommend the firm establish a means of ensuring its conformity with applicable professional standards. In addition, we recommend the firm review and implement the requirements for obtaining management representation letters on review engagements. The firm should either participate in continuing professional education in financial statement disclosures, use a reporting and disclosure checklist on accounting engagements (tailored if the financial statements are in a specialized industry), or conduct a pre-issuance review of the engagement by an individual not associated with the engagement prior to issuance.

2. Deficiency—During our review, we noted the firm did not modify its compilation reports on financial statements when neither the financial statements nor the footnotes noted that the statements were presented using a special purpose framework<sup>5</sup>. This deficiency was noted in the firm's previous peer reviews.

Recommendation—We recommend that the firm review the reports issued during the last year and identify those reports that should have been modified to reflect the use of a special purpose framework. A memorandum should then be prepared highlighting the changes to be made in the current year and placed in the files of the client for whom a report must be changed.

3. Deficiency—In the construction industry compilation engagements that we reviewed, disclosures of material lease obligations as required by generally accepted accounting principles were not included in the financial statements, and the omissions were not disclosed in the accountant's reports.

Recommendation—We recommend the firm review and disseminate information regarding the disclosure requirements on specialized industries to all staff involved in reviewing or compiling financial statements. In addition, we recommend that the firm establish appropriate policies to ensure that all lease obligations are disclosed in financial statements reported on by the firm. For

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<sup>4</sup> The deficiencies and related recommendations provided are examples provided for illustrative purposes only.

<sup>5</sup> The cash, tax, regulatory, and other bases of accounting that utilize a definite set of logical, reasonable criteria that are applied to all material items appearing in financial statements are commonly referred to as other comprehensive bases of accounting.

example, a step might be added to compilation and review work programs requiring that special attention be given to these areas.

4. Deficiency—During our review of the financial statements for a compilation engagement prepared under Statement on Standards for Accounting and Review Services No. 8, for management use only, we noted that the engagement letter did not include all of the information required by applicable professional standards.

Recommendation—The firm should review the professional standards governing the information to be included in engagement letters for financial statements prepared for management use only and make sure it conforms to those standards.

As a result of the deficiencies previously described, we believe that the engagements submitted for review by XYZ & Co.<sup>6</sup> issued with periods ending during the year ended June 30, 20XX, were not performed and reported on in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency(ies)*, or *fail*. XYZ & Co has received a peer review rating of *fail*.

Smith, Jones and Associates

[Name of review captain's firm on firm-on-firm review or association formed review team]

[or]

John Brown, Review Captain

[Committee-appointed review team review]

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<sup>6</sup> The report of a firm who is required to be registered with and inspected by the PCAOB should be tailored here to add "applicable to engagements not subject to PCAOB permanent inspection."

## Appendix Q

### Illustration of a Response by a Reviewed Firm to a Report With a Peer Review Rating of *Fail* in an Engagement Review

The purpose of a letter of response is to describe the actions the firm has taken or will take including the timing of the planned actions to prevent the recurrence of each of the significant deficiencies. If the reviewed firm disagrees with one or more of the significant deficiencies or recommendations in the report, the reviewed firm should contact the administering entity for assistance. If the firm still disagrees after contacting the administering entity, the firm's response should describe the reasons for such disagreement. For additional guidance on disagreements, see paragraph .116 of the standards. The letter of response should be carefully prepared because of the important bearing it may have on the decisions reached in connection with acceptance of the report on the review (see paragraphs .136–.140, "Accepting System and Engagement Reviews"). The letter of response should be submitted to the reviewer for review and comment prior to the firm submitting the response to the administering entity.

October 31, 20XX

*[Addressed to the peer review committee of the administering entity]*<sup>1</sup>

Ladies and Gentlemen:

This letter represents our<sup>2</sup> response to the report on the Engagement Review of our firm's accounting practice for engagements submitted for review with periods ending during the year ended June 30, 20XX.<sup>3</sup>

To prevent the recurrence of the deficiencies noted by the reviewer and to prevent other such deficiencies from occurring, we will review the professional standards related to the deficiencies and ensure that the professional standards will be complied with on all future engagements.

Specifically, we have strengthened the engagement review to ensure that management representation letters are obtained for all review engagements performed by the firm.

All personnel who work on accounting engagements will be participating in continuing professional education in disclosures and reporting by December 31, 20XX, to address the disclosure and reporting deficiencies noted by the reviewer. In addition, we have started using a third-party reporting and disclosure checklist to ensure all reporting and disclosure matters are appropriately addressed. The reporting and disclosure checklist is tailored to specialized industries, where applicable.

The firm is now using third-party practice aids for guidance in compilations of financial statements for management use only, and this includes

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<sup>1</sup> The response of a firm whose review is administered by the National Peer Review Committee should be addressed as follows: To the National Peer Review Committee.

<sup>2</sup> The response should use the singular *I*, *me*, and *my* only when the reviewed firm is a sole practitioner.

<sup>3</sup> The numbering of responses, to coincide with the numbered comments in the report, is optional.

engagement letters that conform to professional standards to document the client's understanding with respect to these engagements. We believe these actions are responsive to the deficiencies noted on the review.

Sincerely,

*[Name of firm]*<sup>4</sup>

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<sup>4</sup> Signed by an authorized partner of the firm.

## Appendix R

### Illustration of a Report With a Review Rating of *Pass* in a Review of Quality Control Materials

Quality Control Materials Review Report

April 30, 20XX

Executive Board of XYZ Organization  
and the National Peer Review Committee

We have reviewed the system of quality control for the development and maintenance of [*identify each item covered by the opinion or refer to an attached listing*] (hereafter referred to as *materials*) of XYZ Organization (the provider) and the resultant materials in effect at December 31, 20XX. Our quality control materials review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. The provider is responsible for designing and complying with a system of quality control that provides reasonable assurance that the materials are reliable aids to assist users in conforming with the components which are integral to the professional standards that the materials purport to encompass. Our responsibility is to express an opinion on the design of the system, the provider's compliance with that system, and the reliability of the resultant materials, based on our review. The nature, objectives, scope, limitations of, and the procedures performed in a Quality Control Materials Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

Users of the materials and this report should carefully consider the scope of this review. They should also understand the intended uses and limitations of the materials as reflected in their user instructions and related information, as well as the level of explanatory guidance provided by the materials. Users of the materials are responsible for evaluating their suitability and implementing, tailoring, and augmenting the materials as appropriate. Therefore, the reliability of the materials is also dependent on the effectiveness of these actions and could vary from user to user. Further, there may be important elements of a quality control system in accordance with the Statements on Quality Control Standards that are not included in the materials that have been subject to this review.

In our opinion, the system of quality control for the development and maintenance of the quality control materials of the XYZ Organization was suitably designed and was being complied with during the year ended December 31, 20XX, to provide users of the materials with reasonable assurance that the materials are reliable aids. Also, in our opinion, the quality control materials previously referred to are reliable aids to assist users in conforming with the components which are integral to the professional standards the materials purport to encompass at December 31, 20XX. Providers can receive a rating of *pass*, *pass with deficiency(ies)*, or *fail*. XYZ Organization has received a review rating of *pass*.

ABC & Co.<sup>1</sup>

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<sup>1</sup> The report should be signed in the name of the team captain's firm for firm-on-firm reviews or association formed review teams.

## Appendix S

### Illustration of a Report With a Review Rating of *Pass With Deficiencies* in a Review of Quality Control Materials

Quality Control Materials Review Report

April 30, 20XX

Executive Board of XYZ Organization  
and the National Peer Review Committee

We have reviewed the system of quality control for the development and maintenance of [identify each item covered by the opinion or refer to an attached listing] (hereafter referred to as *materials*) of XYZ Organization (the provider) and the resultant materials in effect at December 31, 20XX. Our quality control materials review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. The provider is responsible for designing and complying with a system of quality control that provides reasonable assurance that the materials are reliable aids to assist users in conforming with the components which are integral to the professional standards that the materials purport to encompass. Our responsibility is to express an opinion on the design of the system, the provider's compliance with that system, and the reliability of the resultant materials, based on our review. The nature, objectives, scope, limitations of, and the procedures performed in a Quality Control Materials Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

Users of the materials and this report should carefully consider the scope of this review. They should also understand the intended uses and limitations of the materials as reflected in their user instructions and related information, as well as the level of explanatory guidance provided by the materials. Users of the materials are responsible for evaluating their suitability and implementing, tailoring, and augmenting the materials as appropriate. Therefore, the reliability of the materials is also dependent on the effectiveness of these actions and could vary from user to user. Further, there may be important elements of a quality control system in accordance with the Statements on Quality Control Standards that are not included in the materials that have been subject to this review.

We noted the following deficiencies<sup>1</sup> during our review:

1. **Deficiency**—The provider's policies and procedures for the development and maintenance of quality control materials state that feedback on the materials is obtained by means of a questionnaire provided with the materials. The provider's policies and procedures do not specify the procedures to be followed for reviewing and analyzing returned questionnaires. As a result, our review of the questionnaires received by the provider during the review period indicated that several questionnaires that had significant feedback as to the accuracy of the information of certain materials were not being read, summarized, or analyzed to determine

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<sup>1</sup> The deficiencies and related recommendations provided are examples provided for illustrative purposes only.

whether the quality control materials require change. During our review we noted an error in the provider's interpretation of a recently issued professional standard in the *How To Perform Employee Benefit Plan Audits* manual. This error was also noted on several of the feedback questionnaires. However, the error was not of such significance that it affected the reliability of the aid. Our review did not note any similar issues in the other materials.

Recommendation—The provider should revise its policies and procedures to include procedures for reviewing, summarizing, and analyzing the feedback received on its quality control materials in order to determine whether the materials require change(s) to provide reasonable assurance that the materials are reliable aids. In addition, the provider may wish to consider using external technical reviewers to confirm its understanding of new professional standards.

2. Deficiency—The organization's policies and procedures require that a technical review of all quality control materials be performed by a qualified person other than the developer to ensure that the materials are reliable aids to assist users in conforming to those professional standards the materials purport to encompass. During our review, we noted that such a technical review was performed on all of the materials we reviewed except for the current edition of the General Financial Statement Disclosure and Reporting checklist, Construction Contractor Disclosure checklist, and the Personal Financial Statements checklist, which had cold reviews performed by the developer. However, we were satisfied that the checklists are reliable aids.

Recommendation—The organization should remind its personnel of the importance of complying with its technical review policy. In addition, the organization may wish to implement other controls to ensure compliance with this policy.

In our opinion, except for the deficiencies previously described, the system of quality control for the development and maintenance of the quality control materials of the XYZ Organization was suitably designed and was being complied with during the year ended December 31, 20XX, to provide users of the materials with reasonable assurance that the materials are reliable aids. Also, in our opinion, the quality control materials previously referred to are reliable aids to assist users in conforming with the components which are integral to the professional standards the materials purport to encompass at December 31, 20XX. Providers can receive a rating of *pass*, *pass with deficiency(ies)*, or *fail*. XYZ Organization has received a review rating of *pass with deficiencies*.

ABC & Co.<sup>2</sup>

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<sup>2</sup> The report should be signed in the name of the team captain's firm for firm-on-firm reviews or association formed review teams.

## Appendix T

### Illustration of a Report With a Review Rating of *Fail* in a Review of Quality Control Materials

The deficiencies and related recommendations provided are examples for illustrative purposes only. Any one or more of the deficiencies, based on the relative importance of the deficiency to the system of quality control as a whole, could result in a report with a peer review rating of *fail*.

#### Quality Control Materials Review Report

October 31, 20XX

Executive Board of XYZ Organization  
and the National Peer Review Committee

We have reviewed the system of quality control for the development and maintenance of [*identify each item covered by the opinion or refer to an attached listing*] (hereafter referred to as *materials*) of XYZ Organization (the provider) and the resultant materials in effect at December 31, 20XX. Our quality control materials review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. The provider is responsible for designing and complying with a system of quality control that provides reasonable assurance that the materials are reliable aids to assist users in conforming with the components which are integral to the professional standards that the materials purport to encompass. Our responsibility is to express an opinion on the design of the system, the provider's compliance with that system, and the reliability of the resultant materials, based on our review. The nature, objectives, scope, limitations of, and the procedures performed in a Quality Control Materials Review are described in the standards at [www.aicpa.org/prsummary](http://www.aicpa.org/prsummary).

Users of the materials and this report should carefully consider the scope of this review. They should also understand the intended uses and limitations of the materials as reflected in their user instructions and related information, as well as the level of explanatory guidance provided by the materials. Users of the materials are responsible for evaluating their suitability and implementing, tailoring, and augmenting the materials as appropriate. Therefore the reliability of the materials is also dependent on the effectiveness of these actions and could vary from user to user. Further, there may be important elements of a quality control system in accordance with the Statements on Quality Control Standards that are not included in the materials that have been subject to this review.

We noted the following significant deficiencies<sup>1</sup> during our review:

1. **Deficiency**—The organization's policies and procedures for the development and maintenance of quality control materials state that feedback on the materials is obtained by means of a questionnaire provided with the materials. The organization's policies and procedures do not specify the procedures to be followed for reviewing and analyzing returned questionnaires. As a result, our

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<sup>1</sup> When considered together, the deficiencies rise to the level of significant deficiencies.

review of the questionnaires received by the organization during the review period indicated that several questionnaires that had significant feedback as to the accuracy of the information of certain materials were not being read, summarized, or analyzed to determine whether the quality control materials require change. During our review we noted errors in the provider's interpretation of recently issued professional standards in the *How To Perform Employee Benefit Plan Audits*, *How To Perform Audits of Small Businesses* and *How To Perform Construction Contractor Reviews* manuals. The errors were identified on several of the feedback questionnaires. As a result, these specific materials were inaccurate and, thus, were not reliable aids.

Recommendation—The organization should revise its policies and procedures to include procedures for reviewing, summarizing, and analyzing the feedback received on its quality control materials in order to determine whether the materials require change(s) to provide reasonable assurance that the materials are reliable aids. In addition, the provider may wish to consider using external technical reviewers to confirm its understanding of new professional standards.

2. Deficiency—The organization's policies and procedures require that a technical review of all quality control materials be performed by a qualified person other than the developer to ensure that the materials are reliable aids to assist users in conforming to the professional standards the materials purport to encompass. During our review, we noted that such a technical review was not performed on the *How To Perform Single Audits* and *How To Perform HUD Audits* manuals. As a result, these materials were not up-to-date or were inaccurate, and thus were not reliable aids.

Recommendation—The organization should remind its personnel of the importance of complying with its technical review policy. In addition, the organization may wish to implement other controls to ensure compliance with this policy.

In our opinion, as a result of the deficiencies previously described, the system of quality control for the development and maintenance of the quality control materials of XYZ Organization was not suitably designed or complied with during the year ended December 31, 20XX, to provide the users of the materials with reasonable assurance that the materials are reliable aids. Also, in our opinion, the quality control materials previously referred to are not reliable aids and do not assist users in conforming with the components which are integral to the professional standards the materials purport to encompass at December 31, 20XX. Providers can receive a rating of *pass*, *pass with deficiency(ies)*, or *fail*. XYZ Organization has received a review rating of *fail*.

ABC & Co.<sup>2</sup>

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<sup>2</sup> The report should be signed in the name of the team captain's firm for firm-on-firm reviews or association formed review teams.

## PR Section 9100

# ***Standards for Performing and Reporting on Peer Reviews: Interpretations of Section 100***

[Originally issued March 2008; revised December 2008, revised December 2009; revised December 2011; revised January 2013; revised June 2014; revised February 2015; revised May 2015.]

### **NOTICE TO READERS**

Interpretations of the AICPA *Standards for Performing and Reporting on Peer Reviews* (sec. 100) are developed in open meetings by the AICPA Peer Review Board for peer reviews of firms enrolled in the AICPA Peer Review Program. Interpretations need not be exposed for comment and are not the subject of public hearings. These interpretations are applicable to firms (and individuals) enrolled in the program; individuals and firms who perform and report on peer reviews; entities approved to administer the peer reviews; associations of CPA firms, whose members are also AICPA members, authorized by the board to assist its members in forming review teams; and AICPA program staff. Interpretations are effective upon issuance unless otherwise indicated.

The prefix of each interpretation refers first to the paragraph number in the standards and second to the number of the interpretation relating to that paragraph. For example, Interpretation No. 5-3 would be the third interpretation of paragraph .05 of the standards. Not every paragraph of the standards has an interpretation, and thus there could be gaps in the numbering sequence of the interpretations. If more than one paragraph of the standards refers to a particular interpretation, then the interpretation's prefix will refer to the first instance in the standards, and the interpretation would note what other paragraphs refer to the interpretation. Interpretations have been grouped by topic for reference purposes. For example, there are paragraph Interpretation Nos. 3-1 and 3-2 under the interpretation related to "Individual Enrollment in the Program."

To the extent that new interpretations are added before the next version of the standards is issued, an interpretation may not be referred to in the standards with the phrase (see interpretations).

## **Use of the Standards**

**1-1 Question**—Paragraph .01 of the standards discusses that the standards are provided for those enrolled in the program. Who else may use these standards and who determines who enrolls in the program?

*Interpretation*—Although the standards are currently intended for AICPA members and their firms, state CPA societies, or other organizations that are approved by the AICPA Peer Review Board (board) to administer the program,

AICPA members may also use these standards, as applicable,<sup>1</sup> in administering peer reviews of non-AICPA firms (and individuals).

The board determines who is eligible for enrollment in the program.

There are professional organizations with peer review programs to assist government audit organizations in meeting their *Government Auditing Standards* peer review requirements. For example, the Presidents Council on Integrity and Efficiency (PCIE) peer review program arranges reviews for the Federal Inspector General; the National Association of State Auditors, Comptrollers and Treasurers (NASACT) program arranges reviews for state auditors; and the Association of Local Government Auditors (ALGA) program arranges reviews for local government auditors. Each of these programs have established their own set of standards for conducting peer reviews and should be contacted for additional information when a peer reviewer is considering performing a peer review for one of their members because these standards are not intended for those purposes.

**1-2 Question**—Who is currently eligible to enroll in the program, which is administered by the National Peer Review Committee (National PRC), state CPA societies, or other organizations approved by the board?

*Interpretation*—CPA firms in which at least one partner is a member of the AICPA and, in certain circumstances, individual AICPA members may enroll.

**1-3 Question**—What other guidance is available to those who use the standards?

*Interpretation*—Users of the standards have a number of other sources of guidance they can refer to, depending on their role in the program. The standards are principles based and form the foundation for more detailed guidance, encompassed in these interpretations, other guidance in the *AICPA Peer Review Program Manual* (including Supplemental Guidance and the Report Acceptance Manual), the Oversight Handbook, Administrative Manual, and Peer Review Alerts. There is no hierarchical structure to the standards, interpretations, and other guidance; guidance in each is equally significant. However, in the event of a conflict in interpreting and implementing these sources of guidance, the standards and interpretations take precedence.

Peer review course manuals, conference materials, and other miscellaneous items are also available for reference purposes.

**1-4 Question**—Can state CPA societies or other organizations that are approved by the board to administer the program use the standards, as applicable, to administer peer reviews of non-AICPA firms?

*Interpretation*—Yes, except for firms required to be registered with and subject to permanent inspection by the PCAOB or firms that perform engagements under PCAOB standards. Those firms are required to be administered by the National PRC. This would also require that at least one owner of the firm be a member of the AICPA.

## Individual Enrollment in the Program

**3-1 Question**—AICPA bylaws require individual CPAs (not the firm) to enroll in the program if they perform compilation services in firms or organizations not eligible to enroll in such a program. To reflect this requirement, paragraphs

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<sup>1</sup> Although peer reviews performed under these circumstances are permissible, they are not currently considered as being performed under the auspices of the program and such firms are not enrolled in the program because they are not subject to certain AICPA directed activities, including oversight and "fair procedures."

.03 and .05 of the standards refer to "firms and individuals in the program." What is meant by "firms or organizations not eligible to enroll," and can any AICPA member enroll in the program as an individual?

*Interpretation*—Under the "Council Resolution Concerning the Form of Organization and Name Rule" (ET appendix B), when the majority of the ownership of a firm, in terms of financial interests and voting rights, belongs to CPAs, it must enroll in the program. A firm or organization without CPA majority ownership (a non-CPA owned entity) would not be eligible to enroll in the program. The characteristics of such a firm are discussed in ET appendix B. Where the firm or organization is not eligible to enroll, such as due to a lack of majority ownership by CPAs, and where the individual AICPA member performs compilation services in the firm or organization, the AICPA member is required to enroll individually in the program. Only AICPA members meeting these criteria are able to enroll individually. Individual AICPA members who are only practicing with a firm that is eligible to enroll in the program may not enroll in the program individually.

**3-2 Question**—The standards, interpretations, and guidance materials for the program use the term *firm* throughout the materials. When an individual is appropriately enrolled in the program, how does the term *firm* apply to the enrolled individual, and are there any situations in which the standards, interpretations, or guidance materials are intended to be directed at the actual firm or organization that was not eligible to enroll?

*Interpretation*—As an alternative to rewriting all of the standards to reflect individual enrollment, the term *firm* as it appears in the standards should be applied to the enrolled individual and not the firm or organization in which the individual is practicing public accounting that was not eligible to enroll. Under the characteristics of a firm not eligible to enroll in the program, there must be a CPA who has ultimate responsibility for any financial statement compilation services; non-CPA owners cannot assume ultimate responsibility for any such services. In addition, any compilation report must be signed individually by a CPA and may not be signed in the name of the firm or organization.

**3-3 Question**—When performing the peer review of an enrolled individual in the program, what type of peer review would be required, what peer review materials would be used, and what changes would be necessary to the peer review report?

*Interpretation*—As with any peer review, the types of engagements performed dictate the type of peer review required. Because the enrolled individual could only be performing compilation services, this would only require an Engagement Review, although the individual could undergo a System Review. The current peer review materials can still be used as long as the peer reviewer indicates that the peer review was that of an enrolled individual and not of a firm or organization. Similarly, the report and, if applicable, the letter of response, as well as other peer review documents and correspondences, should be tailored so that it is very clear that only the individual is being peer reviewed and not the firm or organization.

**3-4 Question**—If an individual enrolled in the program receives a report with a peer review rating of *pass* on his or her Engagement Review and meets all other individual qualifications for service as a peer reviewer including independence considerations, can that individual perform peer reviews?

*Interpretation*—Yes. However, the individual alone would be the peer reviewer and not the firm or organization that was not eligible to enroll in the program. The peer reviewer should make this fact evident.

**3-5 Question**—As discussed in paragraph .144 of the standards, can a hearing panel decide to terminate an individual's enrollment in the program?

*Interpretation*—Yes. The fair procedures related to hearings and appeals to the AICPA Joint Trial Board for individuals enrolled in the program would parallel the process for enrolled firms, including publication of termination in such form and manner as the AICPA Council may prescribe. If a hearing panel decides to terminate an individual's enrollment in the program, that individual can appeal to the AICPA Joint Trial Board. When the fact that an individual's enrollment has been terminated is published, the name of the firm or organization that was not eligible to enroll in the program with which the individual was practicing is not published.

## Acquisitions and Divestitures and Their Effect on Peer Review Scope

**5c-1 Question**—Paragraph .05(c) of the standards requires that enrolled firms have independent peer reviews of their accounting and auditing practices. What is the effect on the scope of a firm's peer review when there has been an acquisition of another practice or portion thereof, or a divestiture of a significant portion of the firm's practice, during or subsequent to the firm's peer review year?

*Interpretation*—When a reviewed firm has had an acquisition of another practice or a portion thereof or a divestiture of a significant portion of its practice during or subsequent to its peer review year, the reviewer, the reviewed firm, or both, should consult with AICPA staff prior to the commencement of the review to consider the appropriate scope of the review or other actions that should be taken.

A divestiture of a portion of the practice of a reviewed firm during the year under review may have to be reported as a scope limitation if the review team is unable to assess compliance with the system of quality control for reports issued under the firm's name during that year. If the review team is able to review engagements of the divested portion of the reviewed firm's practice, then the review team should review such engagements considered necessary to obtain an appropriate scope for the peer review. In such circumstances, an appropriate scope is one where a reasonable cross section of the firm's practice is covered and the review covers all partners and significant industry areas that existed before the divestiture. The review team should carefully assess the effects the divestiture has on the scope of the peer review. A team captain or review captain who is considering whether a peer review report should be issued with an additional paragraph for a scope limitation due to a divestiture should consult with the administering entity.

Illustrations of System Review reports with a peer review rating of *pass (with a scope limitation)*, *pass with deficiencies (with a scope limitation)*, and *fail (with a scope limitation)* are presented in appendix D, *Illustration of a Report With a Peer Review Rating of Pass (With a Scope Limitation) in a System Review*; appendix G, *Illustration of a Report With a Peer Review Rating of Pass With Deficiencies (With a Scope Limitation) in a System Review*; and appendix K, *Illustration of a Report With a Peer Review Rating of Fail (With a Scope Limitation) in a System Review*. Additional paragraphs included for scope limitations for Engagement Review reports follow the illustrations for System Reviews with scope limitations.

## Resignations From and Reenrollment in the Program

**5g-1 Question**—Paragraph .05(g) of the standards discusses an enrolled firm's responsibility to understand the board's guidance on resignations from the program. Under what conditions may a firm resign from the program?

*Interpretation*—A firm whose peer review has not commenced may resign from the program by submitting a letter of resignation to the board. However, once a peer review commences, and until its completion (see Interpretation No. 25-2), a firm will not be able to resign from the program except as stated in the following paragraph. A peer review commences when the review team begins field work, ordinarily at the reviewed firm's office in a System Review, or begins the review of engagements in an Engagement Review. The submission by the firm of a request to resign from the program once its peer review has commenced but has not been completed is considered a failure to cooperate with the administering entity and may lead to the termination of the firm's enrollment in the program by a hearing panel of the board.

A firm will be permitted to resign once its peer review has commenced but has not been completed when the firm submits a letter pleading guilty, acknowledging its noncooperation with the program, waiving its right to a hearing, and agreeing to allow the AICPA to publish, in such form and manner as the AICPA Council may prescribe, the fact that the firm has resigned from the program before completion of its peer review, evidencing noncooperation with the program. In addition, if (a) the firm has been notified of the reviewer's or administering entity's intent to issue or require a report with a peer review rating of *pass with deficiencies* or *fail* or (b) the reviewer or administering entity has knowledge of the discovery of an engagement that was not conducted in accordance with professional standards on which the firm must take, or would likely be required to take, action in accordance with professional standards, then the fact that the situation in items (a) or (b) of the preceding existed would also be published.

If the firm does not sign the letter pleading guilty and waiving its right to a hearing, the firm will be referred to a Peer Review Board hearing panel. The panel will consider terminating the firm's enrollment due to noncooperation.

A firm that has been terminated from the program may reenroll in the program once it completes the delinquent action that caused the firm to be terminated. Similarly, a firm that has resigned by pleading guilty, or after the completion of its peer review but before the completion of its implementation plan, may reenroll in the program once it completes the delinquent action. The administering entity and the board make the determination of whether the action is satisfactorily completed. If the firm is past its next peer review due date, the firm will be required to complete its subsequent peer review within 90 days of reenrolling.

## Cooperating in a Peer Review

**5h-1 Question**—Paragraph .05(h) of the standards notes that firms (and individuals) enrolled in the program have the responsibility to cooperate with the peer reviewer, administering entity, and the board in all matters related to the peer review, that could impact the firm's enrollment in the program, including arranging, scheduling, and completing the review and taking remedial, corrective actions as needed (paragraph .143 of the standards). Under what circumstances will a firm (or individual) be not cooperating, and what actions can be taken by the board for noncooperation?

*Interpretation*—The board has issued a resolution regarding dropping a firm's enrollment from the program that is as follows:

**AICPA Peer Review Board Resolution**

**(Adopted April 29, 1996 with amendments through January 1, 2009, May 3, 2011, January 30, 2014, September 30, 2014, and November 30, 2014)**

WHEREAS, a firm enrolled in the AICPA Peer Review Program is required to have a peer review once every three years performed in conformity with the AICPA *Standards for Performing and Reporting on Peer Reviews*; and

WHEREAS, a firm enrolled in the AICPA Peer Review Program is required under the AICPA *Standards for Performing and Reporting on Peer Reviews* to cooperate with the peer reviewer, administering entity and the AICPA Peer Review Board in all matters related to the review, that could impact the firm's enrollment in the program;

NOW, THEREFORE, BE IT RESOLVED: A firm's enrollment in the AICPA Peer Review Program will be dropped by the AICPA Peer Review Board, without a hearing, thirty days after the AICPA Peer Review Program notifies the firm by certified mail, or other delivery method providing proof of receipt that the firm has failed to:

- (1) Timely file requested information with the entity administering the firm's peer review concerning the arrangement or scheduling of that peer review, prior to the commencement of the peer review,
- (2) Timely submit requested information to the reviewer necessary to plan or perform the firm's peer review, prior to the commencement of the peer review,
- (3) Have a peer review by the required date,
- (4) Accurately represent its accounting and auditing practice, as defined by the AICPA *Standards for Performing and Reporting on Peer Reviews*, after notifying its administering entity that it does not perform engagements that require the firm to have a peer review,
- (5) Timely pay in full the fees and expenses of the review team formed by an administering entity, or
- (6) Timely pay fees related to the administration of the program that have been authorized by the governing body of an administering entity.

The AICPA Peer Review Board may at its discretion decide to hold a hearing. Whether a hearing is held or not, a firm enrolled in the AICPA Peer Review Program has the right to appeal to the AICPA Joint Trial Board within 30 calendar days of being notified that the firm's enrollment has been dropped.

If a firm's enrollment is dropped for not accurately representing its accounting and auditing practice as defined by the AICPA *Standards for Performing and Reporting on Peer Reviews*, or subsequent failure to submit a peer review by a required due date, the matter will result in referral to the AICPA Professional Ethics Division for investigation of a possible violation of the AICPA *Code of Professional Conduct*. If a firm's enrollment is dropped for such an omission or misrepresentation, re-enrollment will be subject to approval by a hearing panel.

*Interpretation*—The AICPA Peer Review Board has issued a resolution regarding terminating a firm's enrollment from the AICPA Peer Review Program that is as follows:

**AICPA Peer Review Board Resolution**

**(Adopted April 29, 1996 with amendments through January 1, 2009, May 3, 2011, August 8, 2012, January 30, 2014, and September 30, 2014)**

WHEREAS, a firm enrolled in the AICPA Peer Review Program is required to have a peer review once every three years performed in conformity with the AICPA *Standards for Performing and Reporting on Peer Reviews*; and

WHEREAS, a firm enrolled in the AICPA Peer Review Program is required under the AICPA *Standards for Performing and Reporting on Peer Reviews* to cooperate with the peer reviewer, administering entity and the AICPA Peer Review Board in all matters related to the review, that could impact the firm's enrollment in the program;

NOW, THEREFORE, BE IT RESOLVED: A firm is deemed as failing to cooperate by actions including but not limited to:

- Not responding to inquiries once the review has commenced,
- Withholding information significant to the peer review, for instance but not limited to:
  1. failing to discuss communications received by the reviewed firm relating to allegations or investigations in the conduct of accounting, auditing, or attestation engagements from regulatory, monitoring, or enforcement bodies;
  2. omission or misrepresentation of information relating to its accounting and auditing practice as defined by the AICPA *Standards for Performing and Reporting on Peer Reviews*, including, but not limited to, engagements performed under *Government Auditing Standards*; audits of employee benefit plans, audits performed under FDICIA, audits of carrying broker-dealers, and examinations of service organizations (SOC 1 and SOC 2 engagements),
- Not providing documentation including but not limited to the representation letter, quality control documents, engagement working papers, all aspects of functional areas,
- Not responding to MFCs or FFCs timely,
- Limiting access to offices, personnel or other once the review has commenced,
- Not facilitating the arrangement for the exit conference on a timely basis,
- Failing to timely file the report and the response thereto related to its peer review, if applicable,
- Failing to cooperate during oversight, or
- Failing to timely acknowledge and complete required corrective actions or implementation plans.

The firm will be advised by certified mail that the AICPA Peer Review Board will appoint a hearing panel to consider whether the firm's enrollment in the AICPA Peer Review Program should be terminated. A firm enrolled in the AICPA Peer Review Program that has been notified that it is the subject of such a hearing may not resign until the matter causing the hearing has been resolved. After a hearing is held, a firm whose enrollment in the AICPA Peer Review Program has been terminated has the right to appeal the panel's decision to the AICPA Joint Trial Board within 30 calendar days of the hearing; and

If a firm omits or misrepresents information relating to its accounting and auditing practice as defined by the AICPA *Standards for Performing and Reporting on Peer Reviews* that results in a material departure<sup>2</sup> in the firm's most recently accepted peer review, acceptance of the peer review documents will be recalled. A hearing panel will determine whether the firm's enrollment in the AICPA Peer Review Program should be terminated. If the hearing panel determines that the firm's enrollment will not be terminated, at a minimum the hearing panel will require that the firm have a replacement review submitted to the administering entity by the due date which will be approximately 60 days after the hearing panel's decision.

Firms that voluntarily notify the administering entity of an omission or misrepresentation resulting in a material departure will not be subject to a hearing panel. This notification from the firm must be prior to the AICPA or administering entity being otherwise notified of or discovering the omission or misrepresentation and prior to the firm receiving notification from another regulatory or monitoring agency. Acceptance of the peer review documents will be recalled and the firm will be required to submit a replacement review to its administering entity by the due date which will be approximately 90 days after the firm's notification to the administering entity.

If a firm's enrollment is terminated for omission or misrepresentation of information relating to its accounting and auditing practice as defined by the AICPA *Standards for Performing and Reporting on Peer Reviews* or subsequent failure to submit a replacement review by the due date established by a hearing panel, the matter will result in referral to the AICPA Professional Ethics Division for investigation of a possible violation of the AICPA *Code of Professional Conduct*. If a firm's enrollment is terminated for such an omission or misrepresentation, re-enrollment will be subject to approval by a hearing panel.

**BE IT FURTHER RESOLVED:** That a firm's failure to cooperate with the administering entity would also include failing to receive a pass report rating subsequent to receiving notification via certified mail, or other delivery method providing proof of receipt, after a peer review rating of pass with deficiencies or fail that a consecutive peer review rating of pass with deficiencies or fail may be considered a failure to cooperate with the administering entity.

**BE IT FURTHER RESOLVED:** The administering entity has the authority to determine if a firm's response is substantive. If the administering entity determines that a response is not substantive, and the firm does not revise its response or submits additional responses that are not substantive as determined by the administering entity, this would also be deemed as a firm's failure to cooperate.

**BE IT FURTHER RESOLVED:** The administering entity has the authority to determine if erroneously provided or omitted information by a firm that results in a significant change in the planning, performance, evaluation of results, or peer review report is a matter of noncooperation. The firm's failure to provide substantive responses during the process of resolving such a matter may also be deemed as a firm's failure to cooperate.

**BE IT FURTHER RESOLVED:** That a firm's failure to cooperate with the administering entity would also include failing to timely notify the administering entity that it is performing a type of engagement(s) or engagement(s) in an industry in which the firm had previously represented by written communication to the administering entity that it was no longer performing and had no plans to perform, in response to a related corrective action or implementation plan wherein the corrective action or implementation plan was eliminated by the administering entity based on the representation.

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<sup>2</sup> Material departure is defined in the Report Acceptance Body Handbook, Chapter 3, Section VII, Recall of Peer Review Documents.

BE IT FURTHER RESOLVED: A firm's enrollment in the AICPA Peer Review Program will be terminated for failure to cooperate in any of the preceding situations, without a hearing, upon receipt of a plea of guilty from the firm; and BE IT FURTHER RESOLVED: That pursuant to the AICPA *Standards for Performing and Reporting on Peer Reviews*, the fact that a firm's enrollment in the AICPA Peer Review Program has been terminated, whether with or without a hearing, will be published in such form and manner as the AICPA Council may prescribe.

## Compilations Performed When the Compiled Financial Statements Are Not Expected to Be Used by a Third Party (Management Use Only), Where No Compilation Report Is Issued

**6-1 Question**—Statement on Standards for Accounting and Review Services (SSARS) No. 19, *Compilation and Review Engagements* (AR sec. 80), includes compilations of financial statements where in very specific situations the accountant may document his or her understanding with the entity through the use of an engagement letter instead of issuing a compilation report. This approach is only available when the accountant submits unaudited financial statements to his or her client that are not expected to be used by a third party (in other words, compilation for management's use only). AICPA bylaws state that firms (or individuals in certain situations) are only required to enroll in the program if they perform services that are within the scope of the AICPA's practice-monitoring standards and issue reports purporting to be in accordance with AICPA *Professional Standards*. Therefore, for purposes of individual AICPA membership admission and retention, firms (or individuals) that only perform these types of compilations, where no report is issued and no other engagements within the scope of peer review as discussed in paragraph .06 of the standards, would not be required to enroll in the program. Would the compilations for management's use only be subject to peer review when the firm is already enrolled in the program because, for example, it performs services and issues reports on other engagements that are within the scope of the standards?

*Interpretation*—Yes. For firms enrolled in the program, compilations for management's use only would fall within the scope of peer review. The standards (and Statement on Quality Control Standards No. 8, *A Firm's System of Quality Control* [AICPA, *Professional Standards*, QC sec. 10]) include, within the definition of an accounting and auditing practice, all engagements covered by SSARSs except where SSARSs provide an exemption from those standards.

**6-2 Question**—The current standards and guidance materials are written referring to *reports* throughout and do not consider an engagement performed when the compiled financial statements are not expected to be used by a third party (management use only) where a compilation report is not issued. What general guidance should be followed by peer reviewers?

*Interpretation*—For purposes of the program only, the required documentation of the understanding in the engagement letter should be treated as though it was a *report* (as reports are discussed and referred to in the standards). This documentation would not be considered a *report* for bylaw purposes.

**6-3 Question**—A firm is not required to enroll in the AICPA peer review program if its only level of service is performing compilations when the financial statements are not expected to be used by a third party (management use only)

and when no report is issued. However, if the firm elects to enroll in the peer review program, is the firm required to have a peer review?

*Interpretation*—Yes. If a firm elects to enroll in the peer review program, and its only level of service is performing management use only compilation engagements, it is required to have a peer review. The peer review is required to be performed under these standards.

**6-4 Question**—Specifically, what should the peer reviewer be reviewing on such an engagement in a System or Engagement Review?

*Interpretation*—AR section 80 requires the accountant to document the understanding of the engagement with the entity through the use of an engagement letter. The reviewer is to inquire about the engagement letter to determine that it documents that understanding. The reviewer should also review the financial statements to determine that the required restriction of their use is on each page. Except for the restriction of use, the reviewer should not be reviewing the financial statements, disclosures, or supplementary information for accuracy, appropriateness, or conformity with professional standards.

**6-5 Question**—Must a peer reviewer select such an engagement in a System or Engagement Review?

*Interpretation*—No. This engagement is not considered a different level of service. It is a compilation that either contains all disclosures required by generally accepted accounting principles (GAAP) or a special purpose framework,<sup>3</sup> or the disclosures are omitted. The standards already discuss the engagement selection process for such engagements in an Engagement Review. In addition, a System Review requires the peer reviewer to use a risk-based approach when selecting engagements. Management use only financial statements do not change the existing engagement selection process.

**6-6 Question**—Should the standard language in the peer review report be tailored on a System or Engagement Review, if such engagement(s) are selected for review, to reflect the fact that these are compilations with documentation requirements and issued without a compilation report?

*Interpretation*—No.

## Engagements Performed or Reported Under International Standards

**6-7 Question**—Paragraph .06 of the standards provides the definition of an accounting and auditing practice for the purposes of these standards as all engagements covered by SASs, SSARS, SSAEs, *Government Auditing Standards*, and engagements performed under PCAOB standards. Engagements subject to the program are those included in the firm's accounting and auditing practice that are not subject to PCAOB permanent inspection. What about International Standards on Auditing, Assurance Engagements and Related Services (ISAs), any other standards issued by the International Auditing and Assurance Standards Board (IAASB) or any other audit or assurance standards outside of the U.S. ("international standards")?

*Interpretation*—The "Council Resolution Designating Bodies to Promulgate Technical Standards" (ET appendix A) identifies the bodies recognized by AICPA Governing Council to set standards. The IASB (International Accounting Standards Board) which issues International Financial Reporting

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<sup>3</sup> The cash, tax, regulatory, and other bases of accounting that utilize a definite set of logical, reasonable criteria that are applied to all material items appearing in financial statements are commonly referred to as other comprehensive bases of accounting.

Standards (IFRS) is included (as is FASB, FASAB, and GASB). Although peer review standards do not refer to the accounting standard setters, this means that IFRS is within the scope of our peer review process.

However, the IAASB is not currently recognized by the AICPA (nor is the International Public Sector Accounting Standards Board), therefore compliance with ISAs issued by the IAASB, and any other audit or assurance standards outside of the U.S., is not included in the scope of peer review. Firms performing such engagements are required to follow certain U.S. professional standards—see Interpretation No. 6-8.

**6-8 Question**—Is an *engagement* performed under the ISAs, any other standards issued by the IAASB or any other audit or assurance standards outside of the U.S. ("international standards") included in the scope of the peer review?

*Interpretation*—Yes, an engagement performed under international standards would be included in the scope of the peer review. Under U.S. professional standards, the engagement would comply with elements of both the international standards and U.S. professional standards. However, the peer reviewer should only test compliance with the U.S. professional standards described in paragraph .06 of the peer review standards (that is, engagements performed under SASs, SSARS, SSAEs, *Government Auditing Standards*, and PCAOB standards not subject to PCAOB permanent inspection). Testing of compliance with any international standards is not included in the scope of the review.

The peer reviewer should inquire of the firm during planning about whether any engagements were performed under international standards. If yes, the peer reviewer should inquire if the firm understands professional guidance for reporting on statements for international use, specifically addressing the following issues:

- *For audit engagements.* AU-C section 910, *Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country*, indicates that if a U.S. auditor reports on U.S. entity financial statements that are used only outside of the United States, he or she should comply with generally accepted accounting standards (GAAS), except for requirements related to the form and content of the report. He or she should determine whether the application of GAAS requires special consideration in the circumstances of the engagement. However, when the audited financial statements of the entity are intended for use in the United States, then all GAAS standards must be followed, including the reporting standards.
- *For review and compilation engagements.* Interpretation Nos. 13–15 of AR section 80, *Compilation of Financial Statements* (AR sec. 9080 par. .49), and Interpretation Nos. 8–10 of AR section 90, *Review of Financial Statements* (AR sec. 9090 par. .29), conformed for SSARS No. 19, *Framework for Performing and Reporting on Compilation Engagements*, provide paralleling guidance to AU-C section 910. Any distribution in the United States would lead to the requirement to follow SSARS No. 19 reporting standards.
- *For any other types of engagements.* If not directly addressed in the applicable professional standards, reference should be made to the SAS or SSARS guidance.

In all cases, the peer reviewer should conclude whether the firm's classification for an engagement's report of "distribution in the U.S.," "distribution only outside of the U.S.," or "limited distribution in the U.S." was appropriate and reasonable. Then, the peer reviewer should determine that the appropriate

general, fieldwork, and reporting (if applicable) aspects of U.S. professional standards were followed. A misunderstanding of U.S. professional guidance for reporting on statements for international use increases the risk of an engagement not performed and reported on in accordance with professional standards (for instance, financial statements made available on the Internet may not reasonably be considered limited distribution in the U.S.).

The peer reviewer should consult with AICPA program staff for further guidance, if necessary.

## Engagements Subject to PCAOB Inspection

**6-9 Question**—Paragraph .06 of the standards cover engagements that are not subject to PCAOB permanent inspection. What does this mean?

*Interpretation*—PCAOB inspections generally cover audits of SEC issuers. Regulatory changes may provide the PCAOB with the authority to inspect additional engagements. In such scenarios, the PCAOB may undertake an interim inspection program to determine the scope of engagements that will be included in a permanent inspection. During an interim inspection period, such engagements are not deemed to be inspected by the PCAOB for purposes of peer review. Therefore, the engagements would still be included in the scope of peer review until such time that a permanent inspection is adopted by the PCAOB. Additionally, the SEC may set forth rules that require engagements to be performed under other professional standards, but do not require PCAOB permanent inspection. If the SEC rules indicate that the engagements are subject to professional standards, such as those included in paragraph .06 of the standards, but are not subject to PCAOB permanent inspection, those engagements are included in the scope of peer review.

## Engagements Under Peer Review

**7-1 Question**—Paragraph .07 of the standards indicates that the *Standards* are not intended for and exclude the review of the firm's accounting and auditing practice applicable to engagements subject to PCAOB permanent inspection. Firms that perform audits of employee benefit plans that are required to file a Form 11-K, must also comply with Generally Accepted Auditing Standards (GAAS) for ERISA or DOL reporting purposes by preparing a separate set of GAAS based financial statements. Because the firm must be registered with the PCAOB and perform the employee benefit plan audit in accordance with PCAOB standards, and the engagement is subject to PCAOB permanent inspection, should the scope of the peer review include the review of the GAAS based financials for 11-K filers?

*Interpretation*—Because the engagement is already included under the scope of the PCAOB permanent inspection process, and the PCAOB's requirements are more restrictive than GAAS requirements, it is not subject to peer review.

**7-2 Question**—Paragraph .07 of the standards indicates that firms that perform engagements that are not subject to PCAOB permanent inspection under the SASs or *Government Auditing Standards*, examinations under the SSAEs, or engagements under PCAOB standards have peer reviews called *System Reviews*. Firms that only perform services under SSARS or services under the SSAEs not included in System Reviews have peer reviews called *Engagement Reviews*. Is the System Review or Engagement Review determination based on the types of engagements a firm performs as its highest level of service?

*Interpretation*—Yes. The type of peer review determination is based on the engagements performed as its highest level of service.

<b>If a Firm Performs These Types of Engagements as Its Highest Level of Service, the Firm Would be Required to Have:</b>		<b>System Review</b>	<b>Engagement Review</b>
<b>Statements on Auditing Standards (SASs)</b>			
	Engagements	X	
<b>Government Auditing Standards (GAS)</b>			
	Financial Audits	X	
	Attestation Engagements (Examination, Review, or Agreed-Upon Procedures Under GAS)	X	
	Performance Audits	X	
<b>Statements on Standards for Attestation Engagements (SSAEs)</b>			
	Examinations performed under AT section 101, <i>Attest Engagements</i>	X	
	Reviews performed under AT section 101		X
	Agreed-upon procedures performed under AT section 201, <i>Agreed-Upon Procedures</i>		X
	Examinations of prospective financial statements performed under AT section 301, <i>Financial Forecasts and Projections</i>	X	
	Compilations of prospective financial statements and application of agreed-upon procedures to prospective financial statements performed under AT section 301		X
	Examinations performed under AT section 401, <i>Reporting on Pro Forma Financial Information</i>	X	
	Reviews performed under AT section 401		X
	Examinations performed under AT section 501, <i>An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements</i>	X	
	Examinations performed under AT section 601, <i>Compliance Attestation</i>	X	
	Agreed-upon procedures performed under AT section 601		X
	Examinations performed under AT section 701, <i>Management's Discussion and Analysis</i>	X	
	Reviews performed under AT section 701		X
	Examinations performed under AT section 801, <i>Reporting on Controls at a Service Organization</i>	X	
<b>Public Company Accounting Oversight Board (PCAOB) Standards</b>			
	Audits of non-SEC issuers	X	
	Attestation of non-SEC issuers	X	
<b>Statements on Standards for Accounting and Review Services (SSARs)</b>			
	Reviews of financial statements		X
	Compilations of financial statements with disclosures		X
	Compilations of financial statements without disclosures		X
	Compilations performed when the compiled financial statements are not expected to be used by a third party (management use only), when no compilation report is issued <sup>4</sup>		X
	Preparation engagements of financial statements with disclosures		X
	Preparation engagements of financial statements without disclosures		X

<sup>4</sup> Refer to Interpretation Nos. 6-1 to 6-6.

If a firm is required to have a System Review, all the engagements listed in the preceding table would be subject to selection for review, ordinarily based on periods ending during the year under review, except for financial forecasts, projections and agreed upon procedures. Financial forecasts, projections and agreed upon procedures with report dates during the year under review would be subject to selection.

If a firm performs or reports on engagements under International Standards, refer to Interpretation Nos. 6-7 and 6-8.

## Preparation of Financial Statements Engagement

**7-3 Question**—A firm is not required to enroll in the AICPA peer review program if its only level of service is performing preparation engagements (with or without disclaimer reports) under SSARs. However, if the firm elects to enroll in the peer review program, is the firm required to have a peer review?

*Interpretation*—Yes. If a firm is required to enroll in the peer review program due to licensing or other requirements or otherwise elects to enroll in the peer review program, and its only level of service is performing preparation engagements (with or without disclaimer reports) under SSARs, it is required to have a peer review. The peer review is required to be performed under these standards.

**7-4 Question**—Would preparation engagements (with and without disclaimer reports) be subject to peer review when the firm is already enrolled in the program because, for example, it performs services and issues reports on other engagements that are within the scope of the standards?

*Interpretation*—Yes. For firms enrolled in the program, preparation engagements (with and without disclaimer reports) fall within the scope of peer review. The standards define an accounting and auditing practice as all engagements covered by SSARs except when SSARs provide an exemption from those standards.

## Performing System Reviews at a Location Other Than the Reviewed Firm's Office

**8-1 Question**—Paragraph .08 of the standards states that the majority of the procedures in a System Review should be performed at the reviewed firm's office. What criteria have been established by the board for procedures to be performed at a location other than the reviewed firm's office?

*Interpretation*—If the review can reasonably be performed at the reviewed firm's office, it should be. Although certain planning procedures may be performed at the peer reviewer's office, it is expected that a majority of the peer review procedures, including the review of engagements, testing of functional areas, interviews, and concluding procedures should be performed at the reviewed firm's office.

However, it is recognized that there are some situations that make an on-site peer review cost prohibitive or extremely difficult to arrange, or both. In these situations, if the firm and reviewer mutually agree on the appropriateness and efficiency of an approach to the peer review such that it can be performed at a location other than the reviewed firm's office, then the reviewer can request the administering entity's approval to perform the review at a location other than the reviewed firm's office. This request should be made prior to the commencement of fieldwork, and the firm and reviewer should be prepared to respond to the administering entity's inquiries about various factors that could affect

their determination. These factors, which are not mutually exclusive and will be considered judgmentally, include but are not limited to

- the availability of peer reviewers qualified to review the firm, including whether they have the experience in the industries and related levels of service for which the firm practices, whether they are independent of the firm and not, for instance, competitors within the same close geographic area, and whether the firm is reasonably accessible to those reviewers.
- whether the review conducted at the reviewer's office or another agreed-upon location can still achieve the objectives of a System Review.
- whether the results are expected to be the same as they would be if the peer review was performed at the reviewed firm's office.
- the size of the reviewed firm, including the number of personnel and where they perform their work (for instance, whether they work solely at clients' offices and the firm does not have its own office).
- the number of engagements covered by the Statements on Auditing Standards (SASs), *Government Auditing Standards*, examinations under the Statements on Standards for Attestation Engagements (SSAEs), or audits of non-SEC issuers performed pursuant to the standards of the PCAOB.
- the ability of the reviewed firm and the peer reviewer to hold one or more effective meetings by telephone to discuss the firm's responses to the quality control policies and procedures questionnaire and other practice aid questionnaires (including various interviews), Engagement Review results, the reviewer's conclusions on the peer review, and any recommended corrective actions.
- the prior peer review results of the firm, including whether the firm received a report with a peer review rating of *pass with deficiencies* or *fail* on its last System or Engagement Review, or if it is the firm's first System Review.
- whether the firm is able to effectively comply with the reviewer's requests for materials to be sent to the reviewer prior to the review (except as noted in the following list). Those requests should include, in addition to materials outlined in section 4100, *Instructions to Firms Having a System Review*, the following materials:
  - a. All documentation related to the resolution of independence questions (1) identified during the year under review with respect to any audit or accounting client or (2) related to any of the audit or accounting clients selected for review, no matter when the question was identified if the matter still exists during the review period
  - b. The most recent independence confirmations received from other firms of CPAs engaged to perform segments of engagements on which the firm acted as principal auditor or accountant
  - c. The most recent representations received from the sole practitioner concerning his or her conformity with applicable independence requirements

- d. A written representation, dated the same as the peer review report, as described in paragraph .05(f) and appendix B of the standards
- e. Documentation, if any, of consultations with outside parties during the year under review in connection with audit or accounting services provided to any client
- f. A list of relevant technical publications used as research materials, as referred to in the quality control policies and procedures questionnaire
- g. A list of audit and accounting materials, if any, identified in response to the questions in the "Engagement Performance" section of the quality control policies and procedures questionnaire
- h. Continuing professional education (CPE) records sufficient to demonstrate compliance with state, AICPA, and other regulatory CPE requirements
- i. The relevant accounting and auditing documentation and reports on the engagements selected for review
- j. Documentation of the firm's monitoring results for each year since the last peer review or enrollment in the program
- k. Any other evidential matter requested by the reviewer

The reviewed firm should understand that in the event that matters are noted during the review of selected engagements, the scope of the review may have to be expanded before the review can be concluded.

## Peer Reviews To Be Administered by the National Peer Review Committee

**11-1 Question**—Paragraphs .11, .128, and .161 of the standards note that peer reviews intended to meet the requirements of the program should be carried out in conformity with the standards under the supervision of a state CPA society, group of state CPA societies, the National PRC, or other entity (hereinafter, administering entity) approved by the board to administer peer reviews. Under what circumstances are peer reviews administered by the National PRC?

**Interpretation**—Firms are required to have their review administered by the National PRC if they meet any of the following criteria:

- a. The firm is required to be registered with and subject to permanent inspection by the PCAOB.
- b. The firm performs engagements under PCAOB standards.
- c. The firm is a provider of quality control materials (QCM) (or affiliated with a provider of QCM) that are used by firms that it peer reviews.

Firms that meet any or all of the preceding criteria during the peer review year, but not as of their peer review year end (for example, because they resigned or were terminated from their SEC issuer clients, whether or not they deregistered with the PCAOB) are still ordinarily required to have their review administered by the National PRC. The firm's peer reviewer is still required to comply with guidance specific to firms administered by the National PRC, including, but not limited to, guidance at Interpretation Nos. 40-1 and 40-2 regarding other planning considerations and reporting of PCAOB inspection

results. One exception is if a firm was required to be registered with and inspected by the PCAOB during the peer review year, but then did not perform the engagement during that period (because they resigned or were terminated and thus were no longer the "auditor or accountant of record"), is not required to have its review administered by the National PRC if they deregister with the PCAOB prior to scheduling their review.

Firms that are not required to have their review administered by the National PRC may choose to do so. However, such firms are subject to the National PRC's administrative fee structure and should familiarize themselves with that structure prior to making such a decision. This would also require that at least one owner of the firm be a member of the AICPA.

## Timing of Peer Reviews

**13-1 Question**—Paragraph .13 of the standards notes that a firm's due date for its initial peer review is ordinarily 18 months from the date it enrolled in the program or should have enrolled, whichever date is earlier. What is meant by "should have enrolled?" In addition, what is the due date for a firm that was previously enrolled in CPCAF PRP?

*Interpretation*—When an individual becomes an AICPA member, and the services provided by his or her firm (or individual) fall within the scope of the AICPA's practice-monitoring standards, and the firm (or individual) issues reports purporting to be in accordance with AICPA *Professional Standards*, the firm (or individual) should enroll in the program and submit an enrollment form by the report date of the initial engagement. If the firm (or individual) does not initially provide services falling within the scope of the standards, the firm (or individual) should enroll in the program and submit an enrollment form by the report date of their initial engagement. The administering entity will consider the firm's (or individual's) practice, the year-ends of their engagements, the report dates of their engagements, and the number and type of engagements to be encompassed in the review, in determining an appropriate due date. A firm's subsequent peer review ordinarily will be due three years and six months from this peer review year-end.

If a firm's most recent peer review was under the auspices of the CPCAF PRP, its subsequent peer review ordinarily will be due three years and six months from the year-end of that peer review.

**14-1 Question**—Paragraph .14 of the standards states that when a firm performs its first engagement requiring it to have a System Review, the firm's next due date will be 18 months from the year-end of the engagement. What does this mean?

*Interpretation*—When a firm, subsequent to the year-end of its Engagement Review, performs an engagement under the SASs, *Government Auditing Standards*, examinations under the SSAEs, or an engagement performed under PCAOB standards that would have required the firm to have a System Review, the firm should (a) immediately notify the administering entity and (b) undergo a System Review. The System Review ordinarily will be due 18 months from the year-end of the engagement (for financial forecasts, projections and agreed upon procedures: 18 months from the date of report) requiring a System Review or by the firm's next scheduled due date, whichever is earlier. However, the administering entity will consider the firm's practice, the year-ends of engagements and when the procedures were performed, and the number of engagements to be encompassed in the review, as well as use its judgment, to determine the appropriate year-end and due date. Firms that fail to immediately inform the administering entity of the performance of an engagement previously described

will be required to participate in a System Review with a peer review year-end that covers the engagement. A firm's subsequent peer review ordinarily will be due 3 years and 6 months from this peer review year-end.

**14-2 Question**—When a firm has been performing engagements that allowed it to have an Engagement Review and, as a result of a change in paragraph .07 of the standards is now required to have a System Review, is the firm's next due date 18 months from the year-end of the engagement (report date for financial forecasts and projects) triggering a System Review?

*Interpretation*—No. If the firm continues to only perform the types of engagements that previously allowed it to have an Engagement Review, the firm would not be required to have its next peer review due 18 months from the year-end of the engagement (or report date for financial forecasts, projections and agreed upon procedures) triggering a System Review. The firm will stay on its current peer review cycle and the type of review for its next peer review will be determined based on the date it is scheduled. A firm's review is defined as scheduled when the review team is approved by the administering entity.

- If a review is scheduled prior to the effective date of the change to paragraph .07 of the standards and commences within one year of being scheduled, the firm may still have an Engagement Review or elect to have a System Review.
- If a review is scheduled prior to the effective date of the change to paragraph .07 of the standards, but does not commence within one year, the firm will have a System Review.
- If a review (regardless of commencement date) is scheduled on or after the effective date of the change to paragraph .07 of the standards, the firm will have a System Review.

For each scenario, the firm's subsequent peer review will be a System Review, ordinarily due 3 years and 6 months from the year-end of this peer review.

**18-1 Question**—Paragraph .18 of the standards requires that a firm maintain the same year-end on subsequent peer reviews (which is 3 years from the previous year-end) and the same review due date (which is 3 years from the previous due date). What options does a firm have to change its year-end or extend the due date?

*Interpretation*—A firm is expected to maintain the same year-end on subsequent peer reviews. Nevertheless, circumstances may arise that may influence a firm to want to change its year-end. For instance, the nature of the firm's practice may change or they may reevaluate their current year-end and determine as a result that a different year-end is more practical. In such situations, a firm may change its year-end only with prior, written approval of the administering entity.

Administering entities will consider many factors including the nature of the firm's practice (for instance, when audits are being performed and issued so they will be available for the peer review, tax season, and so on). However, a change in year-end will usually not be approved when there is a public interest concern. This may occur when the firm is requesting the change in an attempt to have an Engagement Review rather than a System Review, or when a change in year-end would cause the firm's only engagement meeting the criteria described in Interpretation No. 63-1, (engagements conducted in accordance with *Government Auditing Standards* [GAS, also known as the Yellow Book]; audits conducted pursuant to the Employee Retirement Income Security Act of 1974 (ERISA); audits of an insured depository institution subject to the FDIC Improvement Act of 1991; audits of carrying broker-dealers or examinations of

service organizations (SOC 1 and SOC 2 engagements) to fall out of the peer review selection process.

Ordinarily, the firm's due date for the subsequent peer review will be three years and six months from the year-end of the current peer review.

A firm is expected to maintain the same review due date. Nevertheless, circumstances may arise that require the firm to extend its review due date. In such situations, a firm may do so only with prior, written approval of the administering entity, and the extended review due date only applies to the current review. Extensions for subsequent review's due dates must be reapplied for.

Extensions of a review due date by more than three months should be rare. However, in some situations, due to the size of the firm, the complexity of the peer review, and whether or not the review team is integrating peer review procedures with the firm's internal inspection procedures, it is not unusual for a peer review to occur over a number of months. In such situations, a firm whose peer review has oversight performed by the administering entity may extend its review due date by up to six months with prior, written approval of the administering entity.

In any of the situations previously described, it is the responsibility of the firm to ensure that any change in the review due date (or year-end) approved by the administering entity is recognized by any other organizations requiring it to have a peer review. This includes but is not limited to state boards of accountancy, the Government Accountability Office, and other regulators.

**18-2 Question**—Situations may arise when circumstances out of a firm's control, such as a natural disaster or other catastrophic event, affect a firm's ability to comply with some or all of the peer review requirements, including timing of the peer review. What should a firm do in those specific circumstances?

*Interpretation*—The administering entity should be consulted, when possible, about how the firm believes the situation has affected or will affect its peer review or its ability to perform scheduled peer reviews (if applicable).

If the situation affected both the firm's operations and its ability to comply with peer review requirements, the firm should discuss the following with the administering entity:

- The firm's current peer review year-end and due date
- The extent of damage to the firm's office(s) and the working papers subject to peer review, if applicable (this would include off-site storage or data retention facilities that house working papers subject to peer review)
- The availability, or lack thereof, of personnel that performed engagements subject to peer review
- The firm's ability to continue operating and performing engagements subject to peer review
- If known, whether the firm's scheduled peer reviewer was also impacted
- The amount of time the firm deems necessary before it would be ready to undergo a peer review

The administering entity will assist in determining whether there could be a possible scope limitation due to the exclusion of any affected engagements or offices, the need for a change in year-end or an extension of due date, and the effect on the firm's continuing peer review cycle. These situations will be considered on a case-by-case basis.

If the firm's peer review already commenced and the continued performance of the peer review is impacted, the firm should notify its administering entity as soon as reasonably possible. The administering entity will assist in determining the best course of action.

If the situation did not directly affect the firm's operations but has impacted the firm's ability to comply with peer review requirements (that is, the firm's scheduled peer reviewer was directly affected and may no longer be able to perform the peer review), the firm should consult with its administering entity. The administering entity will assist the firm in determining whether it is appropriate to extend the peer review due date or if the firm should engage another firm to perform its peer review. In making this determination, the administering entity will consider the following:

- The firm's peer review year-end and the timing of when engagements falling within the peer review year are performed
- The length of time between the timing that the situation arose and the firm's due date
- The amount of time that the currently scheduled peer reviewer or review team would need before being able to perform the peer review
- Whether the firm has very specialized industries or types of engagements

If the firm performs peer reviews and a review is scheduled that the firm will be unable to perform by the reviewed firm's due date (or at all), the reviewing firm should communicate this information to the reviewed firm and the administering entity as soon as reasonably possible. Contacting the reviewed firm and the administering entity is especially important when the peer review has commenced but the reviewing firm has doubts about its ability to complete the review.

**19-1 Question**—Paragraph .19 of the standards states that when a firm resigns from the program and subsequently reenrolls in the program, the firm's due date is the later of the due date originally assigned or 90 days after reenrolling. How does this apply when a firm resigns from the program at the end of its peer review because it does not plan to perform engagements that require a peer review going forward, but subsequently performs such work?

*Interpretation*—If a firm performs an engagement that would require a peer review (see paragraph 7-1) subsequent to resigning from the program, the firm should immediately notify the administering entity in order to reenroll in the program and schedule its peer review. The appropriate due date for the peer review is determined as follows:

- If the firm resigned from the program and subsequently performs an engagement that requires a peer review within 3 years and 6 months of its prior peer review year-end, the current peer review due date is the later of the due date originally assigned or 90 days after reenrolling.
- If the firm resigned from the program and subsequently performs an engagement that requires a peer review after its next due date has passed (that is, the prior peer review is longer than 3 years and 6 months in the past), the current peer review due date is ordinarily 18 months from the year-end of the engagement (for financial forecasts, projections and agreed upon procedures, 18 months from the date of report) requiring a peer review.

In either case, the administering entity will consider the firm's practice, the year-ends of engagements and when the procedures were performed, and the number of engagements to be encompassed in the review, as well as use its judgment, to determine the appropriate year-end and due date. A firm's subsequent peer review ordinarily will be due 3 years and 6 months from this peer review year-end.

## Independence, Integrity, and Objectivity

**21-1 Question**—Paragraph .21 of the standards states that independence in fact and in appearance should be maintained with respect to the reviewed firm by a reviewing firm, by review team members, and by any other individuals who participate in or are associated with the review and that the review team should perform all peer review responsibilities with integrity and maintain objectivity in discharging those responsibilities. What criteria have been established by the board?

*Interpretation*—The following criteria have been established:

*a. Reciprocal Peer Reviews*

Reciprocal peer reviews are not permitted. This means that a firm may not perform a review of the firm that performed its most recent review. It also means that a reviewer may not serve on a review team carrying out a review of a firm whose personnel participated in the most recent review of that reviewer's firm.

*b. Relationships With Clients of the Reviewed Firm*

Review team members and, in the case of a review performed by a firm, the reviewing firm and its personnel are not precluded from owning securities in or having family or other relationships with clients of the reviewed firm. However, a review team member who owns securities of a reviewed firm's client shall not review the engagement of that client because that individual's independence would be considered to be impaired. In addition, the effect on independence of family and other relationships and the possible resulting loss of the appearance of independence must be considered when assigning team members to engagements.

*c. Relationships With the Reviewed Firm*

Reviewing firms should consider any family or other relationships, affiliate relationships, alternative practice structures, and common ownership of entities that provide products or services between the management at organizational and functional levels of the reviewing firm and the firm to be reviewed, and should assess the possibility of an impairment of independence. For peer review purposes (including QCM reviews), entities that are affiliated to, are part of an alternative practice structure with, or share common ownership with a reviewing firm are considered to be a part of the reviewing firm when assessing the independence of the reviewing firm.

If the fees for any services provided between firms (whether paid by the referring firm or by the client) are material to the reviewed firm, the reviewing firm, or the firm of any member of the review team, independence for the purposes of this program is impaired.

If arrangements exist between the reviewed firm and the reviewing firm (and any of its affiliates or related entities) or the firm of any member of the review team whereby expenses, office facilities, or personnel are shared, independence for the purposes of this program is impaired. Similarly, independence would be considered to be impaired by sharing arrangements involving, for example,

extensive consultation, or pre-issuance reviews of financial statements and reports. In such circumstances, the firms involved are sharing services that are an integral part of their systems of quality control.

If the reviewing firm has provided or sold QCM to the reviewed firm (such as manuals, guides, checklists, practice aids, and so on) independence for the purposes of this program is impaired. However, the impairment would be removed if an independent peer review of the QCM was performed and submitted to the National PRC before the commencement of the reviewed firm's peer review (see paragraphs .159-.160 and Interpretation No. 200-1). In addition, regardless of whether an independent review of the QCM was performed, the review team members cannot be directly involved in the development or maintenance of the provider firm's materials, report to those who were directly responsible for the development or maintenance of the materials, or receive more than a *de minimus* amount of revenues or other monies generated by the sale of the materials.

**21-2 Question**—Can an individual from Firm A be engaged by Firm B to conduct monitoring of Firm B's accounting and auditing practice or a consulting review and then be engaged to perform Firm B's subsequent peer review? What about another individual from Firm A?

*Interpretation*—In both cases, yes, except if the monitoring of Firm B's accounting and auditing practice or consulting review is performed for the year immediately preceding or during the peer review year.

**21-3 Question**—Firm A is engaged by Firm B to perform a quality control document review, a preliminary quality control procedures review, or both. Could Firm A then be engaged to perform a peer review of Firm B?

*Interpretation*—Yes, except if the quality control document review, preliminary quality control procedures review, or both are performed for the year immediately preceding or during the peer review year.

**21-4 Question**—Firm A is engaged to perform the peer review of Firm B. However, Firm A performed a pre-issuance review on one of Firm B's reports and accompanying financial statements for an accounting or auditing engagement during the period since the last peer review year-end. Can Firm A perform the peer review of Firm B?

*Interpretation*—Yes, unless the pre-issuance review(s) was performed on an engagement within the year immediately preceding or during the peer review year.

**21-5 Question**—Firm A audits the financial statements of Firm B's pension plan. Could either firm perform a peer review of the other?

*Interpretation*—Yes, provided that the fees incurred for the audit are not material to either of the firms. An audit of financial statements is a customary service of an accounting firm. However, reciprocal peer reviews are not permitted.

**21-6 Question**—A partner in Firm A serves as an expert witness for Firm B or for a party opposing Firm B. Are Firms A and B independent of each other?

*Interpretation*—Yes, provided that the fee is not material to either firm and provided that the outcome of the matter, if adverse to Firm B, would not have a material effect on its financial condition or its ability to serve clients.

**21-7 Question**—Firm A is engaged to perform the peer review of Firm B. Firm B's staff attends CPE programs developed by Firm A. Can Firm A perform a peer review of Firm B?

*Interpretation*—Yes, as long as Firm A has not effectively become part of Firm B's system of quality control. If Firm A, or any affiliates of or entities related

to Firm A, develop and customize CPE specifically to Firm B's needs, both firms would need to assess the extent and degree of customization to determine whether Firm A has become a part of Firm B's system of quality control or had a significant enough impact on that system such that Firm A's independence would be impaired. Factors to consider include the degree of customization, the significance of the programs to Firm B's system of quality control, whether Firm A was involved in determining the type of CPE programs that Firm B needs, and so on. Based on the factors considered, if the nature of Firm A's relationship with Firm B effectively makes Firm A part of Firm B's system of quality control, Firm A's independence is impaired for the first peer review immediately subsequent to the training provided.

For example, if Firm A developed and presented CPE programs and training for Firm B that were customized to Firm B's practice, including using some of Firm B's engagements as examples and learning tools, Firm A's independence is impaired for the first peer review immediately subsequent to the training provided. However, Firm A would be permitted to perform any successive peer reviews.

This assessment should be made by both firms prior to the commencement of the peer review. Firm B should consult with the administering entity if needed.

**21-8 Question**—Firm A occasionally consults with Firm B with respect to specific accounting, auditing, or financial reporting matters. Are Firms A and B independent of each other?

*Interpretation*—Yes, unless the frequency and extent of the consultation is such that Firm B is an integral part of Firm A's consultation process.

**21-9 Question**—Firm B uses Firm A's internally-developed accounting and auditing manual as its primary reference source. Can Firm A perform a peer review of Firm B, or can Firm B perform a peer review of Firm A?

*Interpretation*—No, unless Firm A has had a QCM review performed that covers its accounting and auditing manual and any other of its reference material used by Firm B as a primary reference source (see "Performing and Reporting on Reviews of Quality Control Materials (QCM)" in the standards). This is also applicable if the manual is developed by an affiliate of Firm A, or any other entity related to Firm A. If this is Firm A's initial QCM review, then Firm A is not independent to perform the peer review of Firm B until the QCM review is accepted. For all subsequent QCM reviews, Firm A will remain independent with respect to Firm B, as long as the QCM review is submitted by the due date. If Firm A elects not to have a QCM review performed before Firm B's peer review commences, Firm A would not be considered independent for purposes of conducting the peer review. In all circumstances, the review team members cannot be directly involved in the development or maintenance of Firm A's accounting and auditing manual, report to those who were directly responsible for the development or maintenance of the manual, or receive more than a *de minimus* amount of fees or other monies from the total revenues generated by the sale of the manual.

**21-10 Question**—Firm A performs a peer review of Firm B. Subsequently, Firm C performs a peer review of Firm B, and Firm D of Firm A. Would the restriction against reciprocity be violated if Firm B were now to review Firm A?

*Interpretation*—No. Although the standards state that reciprocal peer reviews are not permitted, that provision is intended only to prohibit back-to-back peer reviews when each firm has not had an intervening peer review by another firm or team. However, this may be a situation where the administering entity elects to perform oversight.

**21-11 Question**—A manager from Firm A served as a team member on the most recent peer review of Firm B. Can a reviewer from Firm B serve on the peer review team of Firm A?

*Interpretation*—No, because that would be considered a reciprocal review.

**21-12 Question**—Can an individual from Firm A be engaged by Firm B to perform a peer review of Firm B and subsequently be engaged the following year(s) to conduct an inspection of Firm B's accounting and auditing practice or a consulting review? What about another individual from Firm A?

*Interpretation*—In both cases, yes; however, individual(s) from Firm A would not be eligible to perform Firm B's subsequent peer review except as noted in Interpretation No. 21-2.

**21-13 Question**—Firm A included the qualifications of Firm B in a proposal for one or more specific engagements. Could either firm perform a peer review of the other following a successful proposal?

*Interpretation*—No, unless any fees paid to Firm B are not material to either of the firms; the firms do not share directly or indirectly, or participate in, the profits of the other; the firms do not share fees, office facilities, or personnel; the firms do not have joint ownership of a for-profit entity; and the firms do not exercise any direct or indirect management control over the professional or administrative functions of the other.

**21-14 Question**—A group of firms places an advertisement in a trade journal indicating that its members are "specialists" and provide the "best advice." Although the firms are not specifically identified in the advertisement, a toll-free telephone number or Internet site is provided for contact. Can one firm in the group perform the peer review of another member firm in the same group?

*Interpretation*—No, because the group is marketing or selling services to potential clients on behalf of the firms, where the representations about the firms and the quality of their services are not objective or quantifiable.

**21-15 Question**—A group of firms places an advertisement in a trade journal. The advertisement indicates the number and geographical location of the member firms and states that its members provide professional accounting and auditing services to over 2,500 industry clients nationwide and that each of the member firms passed its most recent peer review. A toll-free telephone number or Internet site is provided for contact. Can one firm in the group perform the peer review of another member firm in the same group?

*Interpretation*—Yes, provided that the group is not a network as defined by Interpretation No. 26-2, the group has submitted the Association Information Form (AIF) to the board; and the group has received notification that the AIF was accepted because the representations in the advertisement are objective or quantifiable.

**21-16 Question**—What would be *objective and quantifiable* with respect to representations made in advertisements by an association of CPA firms, such as in brochures, pamphlets, websites, and the like?

*Interpretation*—Representations made in advertisements by an association of CPA firms would be considered *objective and quantifiable* provided that the association of CPA firms maintains documentation to support the representations and such documentation is available for review by the board. For example, if an association of CPA firms advertises that its members provide professional accounting and auditing services to a designated number of industry clients in a certain geographic area, some form of client listing should be maintained in support of the representation. If an association of CPA firms advertises that each of its member firms have passed peer review, letters from the entities accepting

the peer review documents of those firms should be maintained. Representations should not be made by an association of CPA firms in their advertisements that designate themselves as "the best," "the finest," "uniquely qualified," "prestigious," "elite," or other similar language. These superlative descriptions are generic words and terms that are too subjective. Also, such representations in advertisements by an association of CPA firms cannot be readily supported by any form of documentation that can be reviewed.

**21-17 Question**—Certain members of an association (that is, parent association) may form a partnership or subassociation, which is a grouping of association member firms for the purpose of cooperating to enhance the firms' capabilities to provide professional services. Can members of the sub-association perform peer reviews on firms of the parent association that are not involved in the activities of the sub-association?

*Interpretation*—Although a member of a sub-association cannot peer review another member of the same sub-association, the existence of a sub-association by itself should not disqualify members of the sub-association from performing peer reviews of nonaffiliated member firms of the parent association. However, members of a sub-association should not perform peer reviews on firms of the parent association that are not involved in the activities of the sub-association if the parent association and sub-association belong to the same network as defined by Interpretation No. 26-2.

**21-18 Question**—Is independence impaired when the reviewers' firm and the firm subject to peer review have arrangements with the same non-CPA owned entity (including all entities owned or controlled by a common parent company) where the partners of both firms are also employees of that non-CPA owned entity and remit revenues or profits, or both, to the non-CPA owned entity for payment of the lease of employees, office facilities, equipment, or other services provided by the non-CPA owned entity?

*Interpretation*—Yes, independence is impaired, and the firms involved with the non-CPA owned entity are precluded from participating in the peer review of one another or of other firms related to the non-CPA owned entity.

**21-19 Question**—A state CPA society places an advertisement promoting the CPA profession without identifying any specific firms. May firms whose personnel belong to that state CPA society provide peer review for each other?

*Interpretation*—Yes.

**21-20 Question**—Firm A and Firm B have shared office facilities for the last several years. Due to the growth of both firms, Firm B moved into new offices on January 1, 2007. In March 2009, Firm A engaged Firm B to perform the peer review of Firm A. Firm A's peer review year-end is December 31, 2008. Can Firm A perform the peer review of Firm B?

*Interpretation*—Yes, because the firms did not share office facilities within the current peer review year and any subsequent periods thereafter.

**21-21 Question**—Firm A purchases an accounting and auditing manual developed by an association that it belongs to as its primary reference source. Personnel from Firm B who are also peer reviewers aided the association with the development of the manual by authoring significant sections of the manual. The association receives annual approval to form review teams for its member firms. Can the association include reviewers from Firm B on the review team to peer review Firm A?

*Interpretation*—Yes, as long as the following personnel from Firm B are not included on the review team: personnel directly involved in the development or maintenance of the association's accounting and auditing manual (such as

those who authored sections of the manual), personnel who report to those who were directly responsible for the development or maintenance of the manual, or personnel who receive more than a *de minimus* amount of fees or other monies from the total revenues generated by the sale of the manual.

**21-22 Question**—ABC, Inc. (an affiliate of Firm A) is a provider of audit manuals and guides for various industries. Firm B purchases an industry-specific audit manual from ABC, Inc., to assist with performing audit engagements for a niche industry. The niche industry represents an insignificant portion of Firm B's overall audit and attest practice. Firm B does not purchase any other practice aids or manuals from ABC, Inc. Can Firm A perform the peer review of Firm B?

*Interpretation*—Yes, unless either the niche industry grows to become a more significant part of the firm's overall practice and the same audit manual is used, or the niche industry is a must-select industry. If either occurs, then the industry manual would be assessed as being integral to Firm B's system of quality control, and Firm A's independence would be impaired (see Interpretation Nos. 21-1c and 159-1 for additional information on affiliate relationships). If ABC, Inc. had the relevant audit manual undergo an independent QCM review in compliance with the standards, Firm A's independence would not be impaired. However, any reviewers from Firm A who participated in the development or maintenance of ABC, Inc.'s materials, report to those who were directly responsible for the development or maintenance of the materials, or receive more than a *de minimus* amount of the revenues generated from the sale of the materials would not be independent of Firm B and would not be approved as a part of the review team under any circumstances. This is applicable regardless of the nature of the materials purchased by Firm B, and includes audit programs, practice aids, and so on.

If the nature of the audit manual or guide purchased and adopted is not integral to Firm B's system of quality control, independence would not be impaired. Factors that should be considered in assessing whether the manual is an integral part of the system of quality control include the size of the impacted portion of the firm's practice (by industry, level of service, engagement hours, and so on); the risk associated with that portion of the firm's practice (for example, must-select industries); the degree of reliance placed on the manual; the significance of the guidance provided by the manual to the related engagements; and so on.

**21-23 Question**—Reviewers from Firm A provide technical consultation to a third-party provider of QCM. The extent of the consultation entails reviewing portions of various guides for technical accuracy and providing feedback (if any) to the provider. The reviewers have no control over whether their feedback is addressed or how it impacts the end products ultimately marketed as the guides. Firm B uses guides developed by the provider as an integral part of its system of quality control. Can Firm A perform the peer review of Firm B?

*Interpretation*—Yes, Firm A would be independent for purposes of conducting the peer review of Firm B. However, when reviewers provide consulting or other services to third-party providers, they should assess whether their individual contributions were sufficiently significant to make them a part of the provider's system. In this circumstance, the extent of the reviewers' contributions does not make them a part of the provider's system of quality control. Similarly, if the reviewers from Firm A authored or edited portions of a third-party provider's guides or other materials, they should also assess the degree and impact of their contributions.

If the reviewers' contributions went beyond simple consultation and entailed more formal technical review and approval procedures as a part of the development and maintenance process, or if the reviewers exercised control within

the development and maintenance process such that feedback and comments had to be addressed or incorporated into the materials, then the independence of Firm A is impaired. Firm A's independence would also be impaired if the reviewers authored or edited substantial portions of the guides. In both of these scenarios, the reviewers' contributions are significant to the provider's development and maintenance process such that the reviewers has effectively become a part of the provider's system of quality control.

If the provider elected to have an independent QCM review, and the scope of the review included the materials technically reviewed, authored, and so on by the reviewers, then Firm A's independence would no longer be impaired. However, the specific reviewers from Firm A who participated in the development or maintenance of the materials, report to those that were directly responsible for the development or maintenance of the materials, or receive more than a *de minimus* amount of the revenues generated from the sale of the materials would not be independent of Firm B.

## Illegal Acts

**23-1 Question**—Paragraph .23 of the standards discusses the obligation for all those involved in carrying out the review to fulfill assigned responsibilities in a professional manner. What responsibilities do reviewers have to detect illegal acts during a peer review?

*Interpretation*—Reviewers have no responsibility to detect illegal acts that have either a direct or indirect effect on the firm's ability to practice public accounting. If a reviewer comes across an illegal act during a review, he or she should consider consulting with his or her attorney, and consult with appropriate AICPA staff.

## Peer Review Documentation and Retention Policy

**24-1 Question**—Paragraph .24 of the standards notes peer review documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. How should the peer review be documented to comply with this requirement?

*Interpretation*—Among other things, peer review documentation includes records of the planning and performance of the work, the procedures performed, and conclusions reached by the peer reviewer. This includes documenting the risk assessment, the understanding of the firm's system of quality control, and tests of compliance (including checklists for the review of engagements and staff interviews when there are professional staff). The board has authorized the issuance of materials and checklists, including checklists for the review of engagements, to guide team captains, review captains, and other members of the review team in carrying out their responsibilities under these standards.

Ordinarily, materials and checklists developed and issued by the board are to be used by reviewers in carrying out their responsibilities under these standards. Based on its understanding of the reviewed firm's system of quality control and its assessment of peer review risk, the review team should determine if materials and checklists issued by the board are not sufficiently comprehensive to use on the review. In this event, other materials and checklists may be used; however, they must include the same elements as, and must be more comprehensive than those versions issued by the board. Reviews conducted utilizing alternate materials and checklists will require advance notice to the administering entity and the review must be subject to on-site oversight. The electronic Matter for Further Consideration (MFC) and Disposition of Matter for Further

Consideration forms provided by the board must be used for all peer reviews and alternative forms will not be accepted. It is the responsibility of the team captain or review captain to ensure that the materials and checklists used meet these standards. Failure to complete all relevant materials and checklists may create the presumption that the review has not been performed in conformity with these standards, and thus the administering entity should be consulted in advance of use of any equivalents to assist in reaching these conclusions.

**25-1 Question**—Paragraph .25 of the standards notes that all peer review documentation should not be retained for an extended period of time after the peer review's completion, with the exception of certain documents that are maintained until the subsequent peer review's acceptance and completion. What period of time should peer review documentation be retained and what documentation should be maintained until the subsequent peer review's acceptance and completion?

*Interpretation*—Peer review documentation prepared during system and engagement reviews, with the exception of those documents described in the following paragraphs, should be retained by the reviewing firm, the administering entity, and the association in an association formed review team (if applicable) until 120 days after the peer review is completed (see Interpretation No. 25-2) or 42 months if firm is unenrolled or does not perform engagements requiring a peer review.

If the administering entity refers the firm to a hearing of the board due to non-cooperation, peer review documentation prepared during system and engagement reviews should be retained by the administering entity until the appeals period has ended. The appeals period ends 30 days from the date that the hearings process is completed (that is, the date of the decision notice letter, upon receipt of a plea of guilty by the firm, or the date of the administering entity's request to stop the hearings process). Peer review documentation should be retained by the administering entity for an additional 120 days after the end of the appeals period. If the reason the firm is referred for non-cooperation is due to failing to submit documentation or requested revisions to the review team or the administering entity, the reviewing firm and the association in an association formed review team (if applicable) should also adhere to these retention guidelines.

If the firm appeals the hearings decision, the administering entity, reviewing firm (if applicable), and the association in an association formed review team (if applicable) should retain peer review documentation until 120 days after the Joint Trial Board decision.

The reviewing firm and administering entities should retain the following documents until the firm's subsequent peer review has been completed:

- a. Peer review report and the firm's response, if applicable
- b. Letter notifying the firm that its peer review has been accepted
- c. Letter indicating that the peer review documents have been accepted with the understanding that the firm agrees to take certain actions, if applicable. The administering entity should retain the version signed by the firm
- d. Letter notifying the firm that certain required actions have been completed, if applicable
- e. Finding for Further Consideration (FFC) forms, if applicable
- f. Letter requesting the reviewed firm's completion of an implementation plan, if applicable (the administering entity should retain the version signed by the firm)

- g. Letter notifying the firm that the implementation plan has been completed, if applicable
- h. Letter(s) relating to peer review document recall considerations
- i. Written representations from management of the reviewed firm
- j. Scheduling information

If the firm received two consecutive *pass with deficiency(ies)* or *fail* peer review reports, the administering entity should retain both the prior and current peer review reports until the subsequent peer review has been completed.

Administering entities may also retain the following administrative materials until the firm's subsequent peer review has been completed:

- a. Engagement letters
- b. Review team appointment acceptance letters
- c. Due date extension and year-end change requests and approvals
- d. Settlement agreements received by the administering entity from the AICPA Professional Ethics Division related to individual members' performance on accounting, auditing, or attestation engagements

The administering entity's peer review committee or the board may indicate that any or all documentation for specific peer reviews should be retained for a longer period of time than specified in the preceding paragraphs because, for example, the review has been selected for oversight. All peer review documentation is subject to oversight or review by the administering entity, the board, or other bodies the board may designate, including their staff. All peer review documentation prepared by the administering entities is subject to oversight.

If a firm has been enrolled in an institute-approved practice-monitoring program but has not undergone a peer review in the last three years and six months since its last peer review because the firm has not performed engagements and issued reports requiring it to have a peer review, the documents previously noted should still be retained. The administering entity may also choose to retain the administrative documents noted, as applicable. The documents for a firm that has not been enrolled in an Institute-approved practice-monitoring program for the last consecutive three years and six months are not required to be retained.

**25-2 Question**—The standards and interpretations refer to *acceptance* and *completion* of peer reviews in several contexts, such as in relation to the retention policy for peer review documentation (paragraph .25 of the standards), when a review can be publicized (paragraph .146) and the qualifications for service as a peer reviewer (paragraph .31[c]) and a report acceptance body member (Interpretation No. 132-1). Is there a difference between the acceptance and completion dates of a peer review?

*Interpretation*—There is no difference in those cases in which the report and letter of response thereto, if applicable (peer review documents), are presented to the administering entity's peer review committee, and the committee requires no additional corrective action(s) related to the deficiencies or significant deficiencies in a peer review report with a rating of *pass with deficiency(ies)* or *fail* by the reviewed firm, nor are there any revisions necessary to the peer review documents. In this circumstance, the date that the committee (or technical reviewer in most cases on an Engagement Review) makes this decision is defined as the acceptance date, and is also defined as the completion date of the peer review. The acceptance date is noted in a letter from the administering entity to the reviewed firm.

There is a difference between the acceptance and completion dates of a peer review when the peer review documents are presented to the committee and the committee does not require any revisions to the peer review documents but does require the reviewed firm to take corrective action(s) related to deficiencies or significant deficiencies in the report. In this circumstance, the acceptance date is defined as the date that the reviewed firm signs the letter from the administering entity agreeing to perform the required corrective action(s). The completion date is then defined as the date the committee decides that the reviewed firm has performed the agreed-to corrective action(s) to the committee's satisfaction and the committee requires no additional corrective action(s) by the reviewed firm. This date is noted in a final letter from the administering entity to the reviewed firm.

In either of the situations described in the preceding paragraphs, the committee may require revisions to any of the peer review documents or have other matters that require resolution. In those cases, a review may not be deemed as accepted nor completed until such date that the peer review document(s) is (are) revised or the matter is resolved to the satisfaction of the committee. When there are required revisions or other matters that require resolution and a follow up action has been requested by the committee, the date of acceptance is the later of the date the required revisions are made or the matters are resolved, OR the date the firm has agreed to the follow up action.

## Associations of CPA Firms and Association Formed Review Teams

**26-1 Question**—Paragraph .26 of the standards states that a review team may be formed by a firm engaged by the firm under review (a firm-on-firm review) or an association of CPA firms authorized by the board to assist its members in forming review teams (an association formed review team). What criteria have been established by the board for association formed review teams?

*Interpretation*—Associations of CPA firms include any group, affiliations, or alliances of accounting firms. The term also applies to two or more firms or a group of firms (whether a formal or informal group) that jointly market or sell services. Firms and other entities in the association cooperate with one another to enhance their capabilities to provide professional services.

A member firm of an association may conduct a peer review of another association-member firm enrolled in the program, provided that the association is not a network as defined by Interpretation No. 26-2 and the association receives annual approval from the board. The National PRC administers this process on behalf of the board. The association must submit an AIF to the National PRC that must be approved by the board prior to any aspect of the review being planned, scheduled, or performed.

The AIF contains questions regarding general information about the association, independence matters, and whether the association requests to be approved to assist its members in the formation of review teams, provide technical assistance to such review teams, or do both. All review teams must still be approved by the administering entity. The AIF is subject to oversight by the board.

The approval of the AIF specifically relates to AICPA members of an association having the ability to perform peer reviews of other AICPA members in the same association enrolled in the program. Furthermore,

- a. Annual approval of the AIF does allow, where the association is not a network and has answered the specific questions making

such a request, the association the ability to assist its members in the formation of review teams (association formed review teams) or to provide technical assistance to such review teams.

- b. The reviewed firm and administering entity, not the association, is ultimately responsible for ensuring that its peer review is scheduled, performed, and completed in a timely manner.
- c. Annual approval of the AIF does not grant the association the authority to administer the program; therefore, the association is not deemed an approved administering entity.
- d. Approval of the AIF is not an endorsement of, approval of, or has any applicability to a separate peer review program that an association may conduct or administer for non-AICPA members.
- e. If the association makes any representations (in brochures, directories, pamphlets, websites, or any marketing or selling materials regarding its member firms in obtaining engagements), in order for the AIF to be approved such representations must be objective and quantifiable.

For a member firm of an association to conduct peer reviews of another association-member firm enrolled in the program, in addition to the independence requirements related to network firms appearing in Interpretation No. 26-2 and other peer review independence requirements, the association and its member firms must meet the following independence criteria:

- a. The association, as distinct from its member firms, does not perform any professional services other than those it provides to its member firms or affiliates. For purposes of this requirement, *professional services* include accounting, tax, personal financial planning, litigation support, and professional services for which standards are promulgated by bodies designated by AICPA Council.
- b. The association does not make representations regarding the quality of professional services performed by its member firms to assist member firms in obtaining engagements unless the representations are objective or quantifiable. However, member firms may independently publicize their membership in the association. In addition, an association may respond to inquiries and prepare promotional materials that firms may use to obtain professional engagements on their own behalf.
- c. Referral or participating work among member firms is arranged directly by the firms involved.

An association may voluntarily elect to have an independent QCM review of its system of quality control to develop and maintain QCM used by its member firms (see paragraphs .154–.205 of the standards). An association may wish to have such a review to enable its member firms that use the materials it develops to have more efficient peer reviews. Associations that elect to have this type of review should consult with AICPA program staff.

An association formed review team,

- a. requires that a majority of the review team members, including the team captain in a System Review, and all members in an Engagement Review, be from association member firms.

- b. performs peer reviews in accordance with these standards, interpretations, and other guidance and the peer review report is issued on the letterhead of the team captain or review captain's firm and signed in the name of the team captain or review captain's firm (not the association).

Peer reviews performed by association-formed review teams are subject to oversight by the board and the administering entities and other bodies agreed upon by the board and the administering entity.

**26-2 Question**—How are the terms network and network firm defined for peer review purposes? Is it appropriate for a network firm to perform the peer review of a firm within the same network?

*Interpretation*—Consistent with the "Network and Network Firms" interpretation (ET sec. 1.220.010), for peer review purposes, a network is an association of entities that includes one or more firms that cooperate for the purpose of enhancing the firms' capabilities to provide professional services and share one or more of the following characteristics:

- a. The use of a common brand name (including common initials) as part of the firm name.
- b. Common control (as defined by generally accepted accounting principles in the United States of America) among the firms through ownership, management, or other means.
- c. Profits or costs, excluding costs of operating the association; costs of developing audit methodologies, manuals and training courses; and other costs that are immaterial to the firm.
- d. Common business strategy that involves ongoing collaboration amongst the firms whereby the firms are responsible for implementing the association's strategy and are held accountable for performance pursuant to that strategy.
- e. Significant part of professional resources.
- f. Common quality control policies and procedures that firms are required to implement and that are monitored by the association.

A network firm is a firm or other entity that belongs to a network. This includes any entity, including another firm that the network firm, by itself or through one or more of its owners, controls, as defined by generally accepted accounting principles in the United States of America is controlled by; or is under common control with. For a further description of the characteristics of a network and network firm, reference the "Network and Network Firms" interpretation (ET sec. 1.220.010).

It is not appropriate for a network firm to perform the peer review of a firm within the same network. A network firm is not considered to be independent with respect to other firms within the same network. The owners and employees of network firms are also not considered to be independent with respect to other firms within the same network. Whether an association is a network and whether an entity is a network firm should be applied consistently by all members of the association. Due consideration should be given to what a reasonable and informed third party would be likely to conclude after weighing all the specific facts and circumstances.

## Organizing the System or Engagement Review Team

**30-1 Question**—Paragraph .30 of the standards states that a System Review team, a review captain on an Engagement Review, and, in unusual

circumstances, any additional reviewers on an Engagement Review ordinarily should be approved by the administering entity prior to the planning and commencement of the review. How is this accomplished?

*Interpretation*—The firm and the reviewer should submit scheduling information as required by the administering entity, and the System Review team, a review captain on an Engagement Review, and, in unusual circumstances, any additional reviewers on an Engagement Review should be approved by the administering entity prior to the commencement of the review. The administering entity will consider various factors, including the industries of the engagements of the firm, its size, whether or not the review is administered by the National PRC, and other factors in relation to the knowledge and experience of the members of the review team to determine if the team has the appropriate qualifications and capability to perform the review.

## Qualifying for Service as a Peer Reviewer

**31b-1 Question**—Paragraph .31(b–c) of the standards state that an individual serving as a peer reviewer should be currently active in public practice at a supervisory level in the accounting or auditing function of a firm enrolled in the program and the firm (or all firms if associated with more than one firm) that the member is associated with should have received a report with a peer review rating of *pass* for its most recent System Review or Engagement Review that was accepted timely, ordinarily within the last 3 years and 6 months. Does this apply to all firms the individual is associated with? Is the individual still qualified to serve as a reviewer if the individual starts, or becomes associated with, a newly formed firm (or a firm that has not had a peer review)?

*Interpretation*—If the individual is associated as a partner with more than one firm, then each of the firms the individual is associated with should have received a report with a peer review rating of *pass* for its most recent System Review or Engagement Review that was accepted timely, ordinarily within the last three years and six months.

An individual who was previously a System Review team captain, a reviewer in a System Review or a review captain in an Engagement Review that starts or becomes associated with a newly formed firm (or a firm that has not had a peer review) may continue to serve in such capacity during a transition period. The transition period begins with the earlier of the dates of disassociation from the previous firm or when the individual starts or becomes associated with a new firm. The transition period ends with the earlier of 18 months from the beginning date or the peer review due date of the new firm. In no circumstances will the transition period exceed 18 months. The previous firm should have received a report with a peer review rating of *pass* on its most recently accepted peer review, and the individual should meet all of the other qualifications for service as a team captain or reviewer in a System Review or review captain in an Engagement Review. An individual who was previously a team captain or reviewer in a System Review qualified to perform peer reviews administered by the National PRC or CPCAF PRP that starts or becomes associated with a newly formed firm (or a firm that has not had a peer review), or a firm enrolled in the program that has undergone a peer review administered by another administering entity, may serve as a team captain or a reviewer on a review administered by the National PRC under the same conditions and requirements mentioned previously.

**31b-2 Question**—What if the individual was a sole practitioner that has given up his or her own accounting and auditing practice, but is now serving

in the capacity of an external quality control or concurring reviewer for other enrolled firms?

*Interpretation*—If the individual was a sole practitioner that has given up his or her own accounting and auditing practice, but is now serving in the capacity of an external quality control or concurring reviewer for other enrolled firms, he or she would meet many of the minimum requirements in paragraph .31(b) of the standards, except for being a professional employee of the firm the work is being performed for, and therefore he or she would not meet the qualification requirements to serve in the capacity of a peer reviewer.

**31b-3 Question**—If the individual is associated with a firm who received a report with a peer review rating of *pass with scope limitation* on its most recent System Review or Engagement Review, does this meet the qualification requirements to be a peer reviewer?

*Interpretation*—There are three different grades which can be considered "passing": *pass*, *pass with scope limitation*, and *pass with deficiencies*. Only the first two (*pass* and *pass with scope limitation*) are acceptable grades in order to qualify as a peer reviewer.

**31b-4 Question**—What further qualifications are necessary to perform a peer review of a firm whose review is required to be administered by the National PRC?

*Interpretation*—In order to be qualified to perform a peer review of a firm required to be administered by the National PRC, ordinarily a peer reviewer must currently be with a firm whose most recent review was administered by the National PRC or the CPCAF PRP. This is not a requirement for a peer reviewer on a review of a firm that elects (but is not required) to have their peer review administered by the National PRC.

**31c-1 Question**—Paragraph .31(c) of the standards indicates that a peer reviewer should be associated with a firm (or all firms if associated with more than one firm) that has received a report with a peer review rating of *pass* for its most recent System or Engagement Review that was accepted timely, ordinarily within the last three years and six months. What is meant by "accepted timely, ordinarily within three years and six months?"

*Interpretation*—Peer reviewers are expected to have their own firm's peer review performed timely. They are also expected to cooperate with the program in all matters related to the peer review that could impact the firm's enrollment in the program. The peer review working papers and report for reviewers' firms should be submitted on or before the extended due date, ordinarily within six months of the peer review year end. If a valid extension is approved by the administering entity, the review working papers and report should be submitted by the approved extended due date. The review should be accepted by the administering entity ordinarily within 120 days of receipt of the working papers and report from the reviewer. Indications of his or her firm's noncooperation with the program may disqualify the peer reviewer from being able to schedule and perform reviews until the firm's peer review has been accepted.

**31d-1 Question**—Paragraph .31(d) of the standards states that an individual serving as a peer reviewer should possess current knowledge of professional standards applicable to the kind of practice to be reviewed, including quality control and peer review standards. This includes recent experience in and knowledge about current rules and regulations appropriate to the level of service applicable to the industries of the engagements the individual will be reviewing. How may such knowledge be obtained, and is there a minimum amount of CPE required to be a peer reviewer?

*Interpretation*—Such knowledge may be obtained from on-the-job training, training courses, or a combination of both.

If the administering entity determines that the peer reviewer does not have such experience, the peer reviewer may be called upon to justify why he or she should be permitted to review engagements in that industry. The administering entity has the authority to decide whether a reviewer or review team's experience is sufficient and whether they have the capability to perform a particular review whether related to high-risk engagements or other factors.

The fundamental purpose of CPE is to maintain or increase, or both, professional competence. AICPA members are required to participate in 120 hours of CPE every 3 years. In order to maintain current knowledge of accounting, auditing, and quality control standards, peer reviewers should obtain at least 40 percent of the AICPA required CPE in subjects relating to accounting, auditing, and quality control. Peer reviewers should obtain at least 8 hours in any 1 year and 48 hours every 3 years. The terms *accounting*, *auditing*, and *quality control* should be interpreted as CPE that would maintain current knowledge of accounting, auditing, and quality control standards for engagements that fall within the scope of peer review as described in paragraphs .06–.07 of the standards.

Peer reviewers have the responsibility of documenting their compliance with the CPE requirement. They should maintain detailed records of CPE completed in the event they are requested to verify their compliance. The reporting period will be the same as that maintained for the AICPA.

**31f-1 Question**—Paragraph .31(f) of the standards states that an individual serving as a peer reviewer on a System or Engagement Review should have provided the administering entity with information that accurately reflects the qualifications of the reviewer, including recent industry experience, and is updated timely. How is this accomplished?

*Interpretation*—Ordinarily, an individual serving as a reviewer on a System or Engagement Review should have completed a peer reviewer resume in accordance with guidance issued by the board that is updated timely and accurately reflects the qualifications of the reviewer, including recent industry experience. This may also be accomplished by providing similar information to those performing an on-site oversight under the direction of a National PRC panel.

**31g-1 Question**—Paragraph .31(g) of the standards indicates that a peer reviewer should be associated with a provider firm or affiliated entity that has received a QCM report with a review rating of *pass* for its most recent QCM review that was submitted timely (if applicable). Under what circumstances would the provider's independence with respect to user firms be impaired due to receiving a QCM report with a rating other than *pass*?

*Interpretation*—If the provider receives a report with a rating of *pass with deficiencies*, then the provider's independence with respect to user firms will be impaired and the provider will not be permitted to perform or schedule future peer reviews of user firms starting on the date that the QCM review is submitted. After accepting the report, the National PRC will identify a corrective action that will be communicated to the provider. Although the corrective action falls outside the reporting and acceptance process for reviews of QCM, it affords the provider an opportunity to maintain his or her independence with respect to users by remediating the deficiency identified in the report. The National PRC will set a date by which evidence of completion of the corrective action should be received. If evidence of completion of the corrective action is submitted by the date set by the National PRC, upon acceptance of the corrective action by the National PRC the provider's independence with respect to

user firms will no longer be impaired. If evidence of completion of the corrective action is not submitted by the date set by the National PRC, the provider's independence with respect to user firms will be impaired until the completion of the provider's subsequent QCM review.

If the provider receives a report with a rating of *fail*, then the provider's independence with respect to user firms will be impaired and the provider will not be permitted to perform or schedule future peer reviews of user firms starting on the date that the QCM review is submitted. The provider's independence with respect to user firms will remain impaired until the completion of the provider's next QCM review.

**32-1 Question**—Paragraph .32 of the standards states that a team captain, or the review captain in limited circumstances, is required to ensure that all team members possess the necessary capabilities and competencies to perform assigned responsibilities and that team members are adequately supervised. The team captain or review captain has the ultimate responsibility for the review, including the work performed by team members. What do those responsibilities include?

*Interpretation*—Team members should be brought on to a team when the team captain, or the review captain in limited circumstances, does not possess the adequate qualifications necessary in order to perform the review of engagements within certain industries or type of engagement in the reviewed firm's practice. In addition, there may be reasons, for instance depending on the size of the firm and its practice, that team members may be brought onto a team to assist the team captain in performing the review in an efficient and effective manner. Whether the team member is brought onto the team to cover certain industries or types of engagement, or just to assist the team captain in performing the review, it is still the responsibility of the team captain or review captain to ensure the team member selected has the appropriate qualifications and to supervise and review the work of the team member. The team captain or review captain is essentially relying on the work of the team member and accepting it as his or her own. The team captain or review captain should ensure that all of the working papers (engagement questionnaires, MFCs, and so on) completed by the team member are reviewed by the team captain or another appropriately qualified team member, and follow up with the reviewed firm or team member as necessary. By signing off on the Summary Review Memorandum or Review Captain Summary, the team captain or review captain is approving the team member's working papers and accepting responsibility for the work of the team member.

Team members may review their engagements prior to the team captain or review captain beginning their field work. Reviews of engagements that are performed by team members at locations other than the reviewed firm's office are acceptable, but the quality of work must be at the same level as it would be had the review been performed at the reviewed firm's office. In these situations, a review is considered to have commenced when the team member begins the review of engagements (if this is prior to the team captain or review captain beginning their fieldwork). All engagement checklists, MFC and FFC forms should be signed off by the team member prior to the exit conference. The team captain or review captain should consider if the team member should participate in the exit conference.

**33-1 Question**—Paragraph .33 of the standards states that a team captain in a System Review or a review captain in an Engagement Review should "have completed peer review training that meets the requirements established by the board." Interpretation No. 132-1 states that each report acceptance body member should demonstrate proficiency in the standards, interpretations, and

guidance of the program. Interpretation No. 132-1 also states that a technical reviewer charged with the responsibility for performing technical reviews should meet the requirements of the team captain or review captain training requirements established by the board. What peer review training meets the requirements established by the board and what are the criteria for demonstrating proficiency?

*Interpretation*—The peer review training and the criteria for demonstrating proficiency in the standards, interpretations, and guidance of the program is established from time to time by the board. Those criteria are located on the Peer Review page of the AICPA website.

**34-1 Question**—Paragraph .34 of the standards discusses that a peer reviewer or reviewing firm may have received communications from regulatory, monitoring, or enforcement bodies relating to allegations or investigations of the peer reviewer or reviewing firm's accounting and auditing practice. A peer reviewer or reviewing firm may also have received notifications of limitations or restrictions on the peer reviewer's or reviewing firm's ability to practice. How do these allegations or investigations, limitations or restrictions, or both, affect the reviewer's or reviewing firm's ability and qualifications to perform the peer review?

*Interpretation*—The peer reviewer and reviewing firm should notify the relevant administering entity of any communications relating to allegations or investigations from regulatory, monitoring, or enforcement bodies in the conduct of accounting, audit, or attestation engagements performed by the reviewer. For these purposes, an allegation or investigation is defined as a formal declaration, statement, or other similar assertion, the validity of which has not been established, indicating that there may be deficiencies in the reviewer or reviewing firm's compliance with a regulatory, monitoring, or enforcement body's (regulatory body) rules (procedures, laws, professional standards, or practices).

The peer reviewer and reviewing firm should notify the AICPA technical staff, then their relevant administering entity, of any limitations or restrictions on the peer reviewer's or reviewing firm's ability to practice. For these purposes, a limitation or restriction is a corrective or disciplinary action or sanction imposed on a reviewer or reviewing firm by a regulatory body). Examples include constraint of scope or volume of accounting and auditing engagements, required periodic reporting to the regulatory body, pre-issuance reviews of engagements, or additional peer review or professional education requirements.

The notifications should occur prior to the peer reviewer or reviewing firm's being engaged to perform a peer review, or immediately (if after engaged). The objective of the reviewer or reviewing firm informing the relevant administering entity or AICPA technical staff (as applicable) of such allegations or investigations, limitations or restrictions, or both, is to enhance the program's oversight process, which includes ensuring that peer reviewers and reviewing firms are appropriately qualified to perform reviews.

The fact that a reviewer or reviewing firm has received communication(s) relating to allegations or investigations does not automatically mean that he, she, or it is ineligible to perform peer reviews. However, there could be situations where the nature, significance, or pervasiveness of the alleged deficiencies, or an already existing preponderance of evidence, would necessitate immediate action in order to address the public interest. The administering entity's peer review committee will consider and investigate, as deemed necessary, the specific circumstances, including whether any action, including performing oversight on the reviewer or reviewing firm, is appropriate. This decision can only initially be appealed to the administering entity's peer review committee. For actions previously appealed to the committee, if the reviewer or reviewing firm

disagrees with the action(s), he or she may appeal the decision by writing the board, explaining why he or she believes that the action(s) are unwarranted. The board will review and consider the request and respond to it as necessary and appropriate.

However, an individual may not serve as a peer reviewer if his or her ability to practice public accounting has been limited or restricted in any way (including any specific industry restrictions) by the regulatory body beginning on the date he or she is notified by the regulatory body of the limitation or restriction, until it has been removed. If the limitation or restriction has been placed on the reviewer's firm, or one or more of its offices, then the board will consider and investigate the specific circumstances, including how the limitation or restriction relates to the firm's accounting and auditing practice and personnel, to determine whether any of the individuals associated with the firm may serve as reviewers.

The reviewer, reviewing firm, the relevant administering entity, or the AICPA technical staff may receive notification or knowledge of a limitation or restriction on a reviewer or reviewing firm when a review is in different stages (scheduling, commencement, fieldwork, acceptance or completion, within working paper retention period or not). In these circumstances, the board will consider various factors in determining if the review should be rescheduled, oversighted or other additional procedures performed, or a new review performed.

**34-2 Question**—What if a reviewer or reviewing firm fails to notify the relevant administering entity or AICPA technical staff, as applicable, of any such allegations or investigations, limitations or restrictions, or both, relating to the conduct of his, her or its performance of accounting, audit, or attestation engagements within the specified time requirements?

*Interpretation*—If a reviewer or reviewing firm fails to notify the relevant administering entity or AICPA technical staff, as applicable, of such allegations or investigations, limitations or restrictions, or both, within the specified time requirements of "prior to being engaged to perform a peer review, or immediately, (if after engaged)" the reviewer or reviewing firm is not cooperating with the program. The board will consider and investigate, as deemed necessary, what actions should be taken in the specific circumstances. These actions may include, but are not limited to, on-site oversight at the reviewer's expense, permanent removal from the list of qualified peer reviewers and referral to the AICPA's Professional Ethics Division for violating the AICPA *Code of Professional Conduct*.

**34-3 Question**—What are some types of communications of allegations or investigations, or notifications of limitations or restrictions, that are appropriately related to meeting the objectives described in this interpretation?

*Interpretation*—There are many types of communications and notifications that are appropriately related to meeting the objectives described in this interpretation. See Interpretation No. 208-1b-1 for a list, which is not intended to be all-inclusive, that represents examples of the types of organizations where communications of allegations or investigations or notifications of limitations or restrictions would be relevant to meeting the objectives of the requirement.

## Qualifying for Service as a Specialist

**35-1 Question**—Paragraph .35 of the standards states that if required by the nature of the reviewed firm's practice, individuals with expertise in specialized areas may assist the review team in a consulting capacity. At what point is a specialist going beyond a consulting capacity on the peer review?

*Interpretation*—The specialist is going beyond a consulting capacity when he or she prepares any other peer review documentation beyond preparing and completing the engagement checklist and Matter for Further Consideration (MFC) forms. When MFC forms are prepared for the engagement the specialist is reviewing, the specialist should plan on being available during the exit conference.

**35-2 Question**—If a review team uses a specialist to prepare and complete the engagement checklist and MFC forms for a must select engagement as described in Interpretation No. 63-1, is another team member required to have experience with the must select industry?

*Interpretation*—Yes. An approved team member with the appropriate experience is required to review all must select engagements except service organization control (SOC 1 and SOC 2) engagements. A specialist meeting criteria established by the AICPA may be approved to assist the team in reviewing SOC 1 or SOC 2 experience. A list of preapproved specialists will be maintained by the AICPA.

When a specialist is used, the team captain, as always, is responsible for supervising and conducting the review, communicating the review team's findings to the reviewed firm and administering entity, preparing the report on the review, and ensuring that peer review documentation is complete and submitted to the administering entity on a timely basis. The team captain should supervise and review the work performed by the specialist. The team captain will furnish instructions to the specialist regarding the manner in which materials and other notes relating to the review are to be accumulated to facilitate summarization of the review team's findings and conclusions. The specialist may be required to be available or participate in the exit conference.

## Other Planning Considerations

**40-1 Question**—Paragraph .40 of the standards notes that the peer reviewer should consider whether the areas to be addressed in the written representation require additional emphasis in the course of the review. To what extent should the team captain consider the results of regulatory or governmental oversights in the planning and performance of the peer review?

*Interpretation*—If the firm has undergone oversights or inspections by regulatory or governmental entities (for instance, the Department of Labor, the Department of Health and Human Services, or other local, state, or federal entities), the team captain should consider the results of those oversight reviews during planning and when determining the nature and extent of peer review procedures. The results from regulatory or governmental oversights are sources of information that should be considered within the context of peer review, as they can provide valuable information that may assist the review team in planning its procedures. However, the team captain should keep in mind that the goals of regulatory or governmental oversight may differ from the purpose of a system review, and it would be inappropriate to place reliance on regulatory or governmental oversight results. The team captain should consider and document the following factors regarding the procedures and results of regulatory or governmental oversights and communications from regulatory or governmental bodies:

- *The impact of regulatory or governmental oversight on the scope of the peer review.* When the types of engagements subject to regulatory or governmental oversight are also within the scope of engagements that can be selected for peer review, the review team should consider how the nature, cause, pattern, or pervasiveness

of the oversight results impact the peer review in terms of inherent risk (for example, the firm's demonstrated expertise in performing those types of engagements) and control risk (for example, how the system of quality control is designed to prevent issues in those types of engagements and the effectiveness of those controls based on the regulatory or governmental results), and document those considerations in the risk assessment.

If the oversight results indicate a lack of comments or only minor issues, the team captain should document the nature of the oversight results as a consideration in the risk assessment. Although a lack of comments is not necessarily indicative that the firm's system of quality control is operating effectively for the relevant industry practice, it is a factor in assessing inherent and control risk. When the oversight results include more substantive comments, the review team should evaluate the significance of the comments relative to the applicable industry and other industries and practice areas, and consider what impact, if any, they have on the peer review scope.

If the oversight results include deficiencies or indications of engagements that were not performed or reported on in conformity with applicable professional standards in all material respects in the view of the oversight body, the team captain should understand the underlying cause(s) identified by the firm and evaluate how the firm responded to the oversight results in order to properly consider the impact on the peer review risk assessment and engagement selection. If similar matters are identified as a result of the review team's review of engagements during the peer review, the team captain should consider whether the underlying causes identified by the firm (if any) are similar to the underlying causes identified by the review team.

- *The timing of the regulatory or governmental oversight results.* The team captain should consider the time period covered by the regulatory oversight results in determining their usefulness for assessing peer review risk and determining the impact (if any) on the extent of peer review procedures. When possible, the team captain should obtain the oversight results from the most recently available oversight reviews. The team captain should inquire about any open or ongoing oversight reviews, the status of those oversight reviews, and the firm's preliminary remediation plans (if applicable).
- *The firm's responsiveness to regulatory or governmental oversight results.* The team captain should consider the degree of the firm's responsiveness to oversight findings and other communications, as evidenced by the remediation planned or taken. Remediation efforts by the firm may impact industries that are subject to peer review and can be useful in assisting the team captain with considering the design of the firm's system of quality control or compliance with it. The team captain should document this consideration in the risk assessment during the planning of the review.
- *The size of the firm relative to its specialized industry practice(s).* The team captain should consider the relative significance of the specialized industry practice(s) subject to regulatory oversight to the firm's total practice in determining the relevance of the regulatory oversight results to the peer review. The team captain should

document this consideration in the Summary Review Memorandum (when applicable).

**40-2 Question**—What additional considerations related to the results of PCAOB inspections should the team captain address in the planning and performance of the peer review?

*Interpretation*—Although the PCAOB inspection reports only cover the portion of a firm's practice that is subject to permanent inspection, most firms typically have only one system of quality control. As a result, the PCAOB inspection report may contain information that could assist the reviewer in assessing risk, planning, and performing peer review procedures. The team captain should read the public portions of the most recently released PCAOB inspection reports and discuss both the public and nonpublic portions of the reports with appropriate firm personnel. If the report on the firm's most recent PCAOB inspection report has not been released, the team captain should discuss any findings that may have been communicated orally or in draft form with appropriate firm personnel. The firm is required to discuss relevant PCAOB matters with the team captain.

In considering the impact of the PCAOB report on the nature, planning, and extent of peer review procedures, the review team should consider the nature, cause, pattern, or pervasiveness of the findings contained in the PCAOB inspection report. The review team should also consider the relative importance of the finding(s) to the firm as a whole. When applicable, the review team should

- consider the information contained in public portions of the PCAOB inspection reports.
- consider the information in the nonpublic portions of the PCAOB inspection reports (based upon discussion with the firm).
- perform further inquiry of the firm in determining the offices, partners, and so on related to findings detailed in the PCAOB report.
- determine which PCAOB findings (if any) may be applicable to the portion of the firm's practice that was not subject to PCAOB inspection.
- understand the underlying cause(s) of the findings (as determined by the firm).
- understand how the firm remediated the findings for the most current inspection (or the firm's remediation plan).
- consider the firm's remediation history with respect to PCAOB inspection findings (if any).

The team captain should document in the risk assessment how this information impacts the planned peer review procedures. Discussion of PCAOB inspection findings should not be interpreted as permitting the peer reviewer to request the nonpublic portions of the PCAOB inspection report.

## Understanding the Firm's System of Quality Control

**42-1 Question**—Paragraph .42 of the standards requires the review team to obtain a sufficient understanding of the reviewed firm's system of quality control. How should the review team address elements of the system that reside outside of the firm?

*Interpretation*—The review team should inquire of the firm regarding elements of the system of quality control residing outside of the firm, for instance, membership in associations, joint ventures, non-CPA owned entities, alternative

practice structures, arrangements with outside consultants, third party QCM, or CPE (including whether they are peer reviewed) and other. The inquiries should include how they influence the firm's system of quality control, for instance by providing consultation opportunities, CPE, and monitoring services. These elements should be considered and documented within the risk assessment.

**42-2 Question**—How should the review team evaluate the firm's quality control policies and procedures for the adequacy of the QCM used by the reviewed firm?

*Interpretation*—To plan the review, the review team should obtain a sufficient understanding of the reviewed firm's system of quality control, including how the firm uses QCM to promote consistency in the quality of engagement performance.

### ***Firm's Policies and Procedures***

As a part of obtaining the understanding of the system of quality control, the review team should understand the firm's policies and procedures for adopting, developing, updating, modifying, and maintaining QCM that are purchased from a third party or developed internally and determine if those policies and procedures are appropriately designed and implemented.

### ***Reliability***

The review team should understand the firm's policies and procedures for determining the reliability of the QCM utilized by the reviewed firm and determine if those policies and procedures are appropriately designed and implemented. The review team should also determine that the firm's QCM are reliable. If the QCM, whether developed by a third party or internally developed, underwent a separate QCM review, then the results of that review should be considered as per Interpretation No. 42-3. Provider's QCM review results may be obtained from the AICPA's website, the provider, or the reviewed firm (which could also be the provider).

If the QCM did not undergo a separate QCM review, then the team captain should consult paragraphs .167–.176 for the procedures typically performed in assessing QCM for a QCM review performed for a provider. This step applies whether the QCM were obtained from a third party or were internally developed.

The objectives of those procedures are to determine whether the provider's system for the development and maintenance of the QCM was suitably designed and was being complied with during the year under review to provide firms with reasonable assurance that the materials are reliable aids to assist firms in conforming with all those components which are integral to the professional standards the materials purport to encompass. The procedures from paragraphs .167–.176 need to be adapted to the review team's use during a peer review of a reviewed firm. The team captain should use professional judgment in determining the extent of the procedures that need to be performed to evaluate the reliability of the QCM. Further, if the QCM were obtained from third parties, the team captain may be limited in his or her ability to assess the provider's system for the development and maintenance of the QCM and its compliance with that system. Therefore, there is a greater focus on whether the QCM is reliable.

### ***Suitability***

The review team should understand the firm's policies and procedures for determining the suitability of the QCM utilized by the reviewed firm, and determine

if they are appropriately designed, implemented, and suitable for the firm. Examples of factors to be considered include whether the QCM

- cover the practice areas and industries of the firm.
- are used for the intended type of client and users.
- are used by the firm as intended by the QCM's instructions and guidance (see Interpretation No. 176-1 for further guidance).
- contain an appropriate level of explanatory guidance for the users.
- are updated with current professional standards.

Any weaknesses noted in the system of quality control as a result of the preceding procedures should be considered when the team captain assesses other aspects of the firm's system of quality control. This includes the firm's compliance with quality control standards established by the AICPA and how the firm's policies and procedures identify and mitigate the risk of material non-compliance with applicable professional standards. The weaknesses should also be considered when the team captain prepares his risk assessment, determines scope, performs his functional testing, concludes on the peer review, and considers the systemic causes for matters, findings, deficiencies and significant deficiencies.

**42-3 Question**—Many firms rely on third party QCM as integral portions of the firm's system of quality control. Some third party providers elect to undergo QCM reviews. How should the review team evaluate the results of a QCM review in its consideration of the design of a reviewed firm's system of quality control?

*Interpretation*—An independent QCM review entails an assessment of the provider's system of quality control to develop and maintain the QCM, and an assessment of the resultant materials.

The QCM review report includes opinions on the

- provider's system to develop and maintain reliable aids (see paragraph .175).
- reliability of the specific QCM covered by the review.

The review team's evaluation of the design of the reviewed firm's system of quality as it relates to the QCM materials should assess the

- reliability of the QCM and
- the firm's policies and procedures for adopting, updating, and modifying the provider's QCM.

The review team should obtain the QCM review results (that is, the report or letter of response, if applicable) to consider the impact on the reviewed firm's system of quality control. The provider's QCM review results may be obtained from the AICPA's website, the provider, or the reviewed firm.

The review team should carefully compare the specific QCM utilized by the firm with those materials and elements opined on within the QCM report. The provider determines which QCM are included within the scope and may not include all material published by the provider in the scope of a QCM review. The specific QCM opined on in the QCM review report will be listed in the first paragraph of the QCM review report or in an addendum to the report.

Other scoping factors to consider include the following:

- The QCM review report is applicable to the substance and content of the specified QCM regardless of the different formats or media

through which it could be available or marketed (for example, print or electronic), unless specified in the QCM review report.

- QCM will often have different elements, such as written guidance, practice aids, letter templates, sample completed aids or templates, and continuing professional education modules. The QCM report will identify specific exclusions or inclusions if only a particular element or portion of a guide (for example, practice aids) is opined on in the QCM review report.

The review team should also consider the QCM review's report rating as it relates to the QCM used by the firm.

If the provider received a *pass* report, then the review team can place reliance on the provider's QCM review results with respect to that portion of the reviewed firm's design of its system. This should be reflected in the review team's discussion of control risk in the overall peer review risk assessment. Ordinarily, a *pass* QCM report on materials that are integral to the firm will help lower control risk.

If the provider received a *pass with deficiencies* report, the review team should first determine whether the deficiency(ies) impacted the reliability of one or more of the QCM listed in the report. Next, the review team should consider the reasons for the deficiencies identified in the report and assess their relevance to the reviewed firm. Once this assessment is made, the review team can determine the degree of reliance it can place on the provider's results.

If a deficiency is impacting the reliability of one or more QCM used by the reviewed firm, the review team should determine whether the reviewed firm has mitigated the risk that its reliance on the QCM may lead to the firm not addressing one or more integral components of professional standards in its performance of audit or attest engagements.

If a deficiency is on the provider's system of quality control but does not directly affect the separate opinion on the QCM, or is specific to QCM that are not used by the reviewed firm (for example, a deficiency related to an employee benefit plan manual, but the firm only uses a construction manual from that provider), then once this assessment is made, the review team can determine the degree of reliance it can place on the provider's results.

The impact (or lack thereof) of a *pass with deficiencies* QCM report should be fully explained in the discussion of control risk in the overall peer review risk assessment.

If the provider received a *fail* report, no reliance can be placed on the results and the review team should evaluate and document the impact on the reviewed firm's system of quality control in the peer review risk assessment. The review team will also need to consider the impact on the peer review scope if the firm fully relied on QCM that are not reliable aids.

If applicable, the review team should review the definitions of deficiencies and significant deficiencies in QCM reviews provided in paragraph .178 to further understand the impact to the reviewed firm.

If the provider obtained a QCM review, but the specific QCM used by the reviewed firm were not opined on in the QCM report, the review team will need to perform the appropriate procedures to evaluate whether the QCM were suitably designed. See Interpretation No. 42-2 for additional information.

The review team should always obtain the most recently accepted QCM report, and consider (a) the version date of the materials relative to the period covered by the report and (b) the amount of time that has passed since the period covered

by the report in determining the degree of reliance that can be placed on the QCM review results.

Factors to consider include the following:

- The issuance of new standards
- Changes in regulatory requirements
- Changes in economic conditions that affect the provider
- Limitations or restrictions on authors of the materials
- Any substantial changes or updates to the materials

Regardless of the degree of reliance placed on the provider's QCM review results, the review team is still responsible for determining which forms, checklists, or programs are used by the reviewed firm as a part of its system of quality control, how often the materials are updated, the degree of reliance that the reviewed firm placed on the materials, and assessing compliance with their use. The results of the provider's QCM review should weigh in the assessment of control risk and be documented in the risk assessment.

For additional information on QCM reviews, please see paragraphs .154–.204, and appendix A of the standards.

## Considering the Firm's Monitoring Procedures

**45-1 Question**—Paragraph .45 of the standards notes that the review team should obtain a sufficient understanding of the reviewed firm's monitoring policies and procedures since its last peer review, and their potential effectiveness, to plan the current peer review. In doing so, the review team may determine that the current year's internal monitoring procedures could enable the review team to reduce, in a cost-beneficial manner, the number of offices and engagements selected for review or the extent of the functional area review. What are some factors to consider in obtaining an understanding of the firm's monitoring procedures? If the review team plans to consider the current year's internal inspection procedures to reduce the scope of the peer review, what procedures are necessary?

**Interpretation**—Factors to consider in obtaining the understanding of the firm's monitoring procedures include

- a. the qualifications of personnel performing the monitoring procedures.
- b. the scope of the monitoring procedures (coverage of functional areas and engagements and the criteria for selecting offices and engagements for review).
- c. the appropriateness of the materials used for monitoring procedures (for example, questionnaires or checklists and instructions).
- d. the depth of the review of individual engagements, particularly with respect to the review of working papers and coverage of significant areas.
- e. the findings of the monitoring procedures, including internal inspections.
- f. the nature and extent of reporting and communicating the results of the monitoring procedures.
- g. the follow-up of findings resulting from the monitoring procedures.

In making a judgment about the effects that the firm's current year's internal inspection procedures will have on the selection of offices and engagements to be reviewed, the review team should consider the size of the firm and the potential effectiveness of the internal inspection procedures.

If internal inspection procedures were not, or will not be, performed to cover the review year, the review team may not consider the prior year's internal inspection procedures to reduce the scope of the peer review.

If the review team does not plan to consider the reviewed firm's current year's internal inspection procedures to reduce the scope of the peer review, the review team need not necessarily perform the review of any of the engagements on which internal inspection procedures were performed by the reviewed firm. However, the review team may still wish to re-perform the review of a few such engagements to assist the review team in obtaining a better understanding of the effectiveness of the internal inspection procedures performed by the reviewed firm.

If the review team plans to consider the current year's internal inspection procedures to reduce the scope of the peer review, the review team should test the firm's internal inspection procedures at selected offices and on selected engagements. These tests should be sufficient to provide the review team with a basis for determining whether (a) the reviewed firm's internal inspection procedures were applied properly in the reviews of individual practice offices and engagements, (b) the practice office and Engagement Reviews were carried out conscientiously by competent persons with appropriate expertise and objectivity, and (c) the findings from the reviewed firm's internal inspection procedures are indicative of the work performed in the particular office and therefore can be considered by the review team to reach an overall conclusion regarding the reviewed firm's compliance with its quality control policies and procedures. The testing of internal inspection procedures can be performed (a) contemporaneously with the reviewed firm's internal inspection procedures (commonly called *piggyback reviews*) or (b) after the internal inspection procedures are completed. Because of the insight gained from observing the performance of internal inspection procedures, a review team testing the effectiveness of internal inspection procedures contemporaneously is generally in a better position to assess the effectiveness of the procedures.

When the review team tests the effectiveness of the internal inspection procedures contemporaneously with the performance by the internal inspection team performing the procedures, the review team should visit selected practice offices during the performance of the internal inspection procedures to (a) re-perform the review of a sample of engagements subjected to internal inspection procedures and (b) re-perform the review of a sample of the quality control policies and procedures (functional elements) subjected to internal inspection procedures in the office. During the visits, the review team should compare its findings to the internal inspection team's findings and resolve any differences. In addition, if applicable, the review team should attend discussions of engagement findings and the overall office findings.

When the review team tests the effectiveness of the internal inspection procedures after the procedures have been completed, the review team should re-perform the review of a sample of engagements and the quality control policies and procedures (functional elements) subjected to internal inspection procedures in the office(s). The review team should compare its findings to the internal inspection team's findings and resolve any differences.

**45-2 Question**—Is there more guidance regarding the extent that scope may be reduced, and what factors must be considered and steps performed in

order to conclude on the effectiveness? In addition, may a review team apply this same guidance to the involvement of and results from regulatory oversight?

*Interpretation*—Peer reviewers should refer to guidance on reducing scope included in section 3100 *Supplemental Guidance*. If, after considering that guidance, the peer reviewer plans on significantly reducing the scope of the procedures he or she will be performing, he or she is required to inform AICPA technical staff during peer review planning.

## Understanding, Assessing, and Documenting Peer Review Risk Factors and Risk Assessment

**52-1 Question**—Paragraphs .46–.52 discuss peer review risk factors and risk assessment. What other guidance should be considered?

*Interpretation*—Reviewers must assess peer review risk and use a risk-based approach in the selection of engagements and offices for review. Reviewers should formalize the risk assessment before arriving on-site in the reviewed firm's office and before selecting one or more engagements for review, otherwise they should expect ineffectiveness and, at the very least, inefficiency.

### ***Inherent Risk Factors***

In assessing inherent risk factors, the reviewer should consider

- circumstances arising within the firm (for example, the firm or individual partners have engagements in several specialized industries);
- circumstances outside the firm that impact the firm's clients (for example, new professional standards or those being applied initially for one or more clients, changes in regulatory requirements, adverse economic developments in an industry in which one or more of the firm's clients operate, or significant developments in the client's organization); and
- variances that may occur from year to year, engagement to engagement or, perhaps, from partner to partner, within the firm (for example, inherent risk will always be higher for an audit of a company or organization operating in a high-risk industry than for a compilation of financial statements without disclosure for a company operating in a noncomplex industry; and there are many situations between these two extremes).

### ***Control Risk Factors***

Assessing control risk requires reviewers to evaluate the effectiveness of the reviewed firm's quality control policies and procedures in preventing the performance of engagements that do not comply with professional standards. When assessing control risk, the review team should evaluate the reviewed firm's quality control policies and procedures and discuss with the firm if it considered the guidance in AICPA Accounting and Auditing Practice Aid *Establishing and Maintaining A System of Quality Control for a CPA Firm's Accounting and Auditing Practice*. The reviewer should evaluate whether the reviewed firm has adopted appropriately comprehensive and suitably designed policies and procedures for each of the elements of quality control in the context of the firm's overall control environment and the inherent risk embodied in its accounting and auditing practice.

The assessed levels of risk are the key considerations in deciding the number and types of engagements to review and, where necessary, offices to visit. Through the assessment of risk, the reviewer determines the coverage of the firm's accounting and auditing practice that will result in an acceptably low peer review risk. Engagements selected should provide a reasonable cross-section of the firm's accounting and auditing practice, with a greater emphasis on those engagements in the practice with higher assessed levels of peer review risk.

Reviewers must document, as part of the Summary Review Memorandum (SRM), the risk assessment of the firm's accounting and auditing practice and its system of quality control, the number of offices and engagements selected for review, and the basis for that selection in relation to the risk assessment. To effectively assess risk of the firm's accounting and auditing practice and its quality control policies, risk assessment documentation should not only address the engagements selected and the reasoning behind that selection, but also the environment of the firm and its system of quality controls. Some factors that should be considered in assessing risk include the following:

- The relationship of the firm's audit hours to total accounting and auditing hours
- Size of the firm's major engagement(s), relative to the firm's practice as a whole
- Initial engagements and their impact on the firm's practice
- The industries in which the firm's clients operate, especially the firm's industry concentrations
- The results of the prior peer review
- The results of any regulatory or governmental oversight or inspection procedures
- Owners' CPE policies and the firm's philosophy toward continuing education (Accumulate the necessary hours or maintain the needed skills and improve delivery of professional services.)
- Firm's policies and procedures to determine and monitor compliance with legal and regulatory requirements in accordance with SQCS No. 8, including but not limited to the following:
  - Firm and individual licenses to practice, in the state the practice unit is domiciled (main office is located) and in the state in which the individual primarily practices public accounting
  - Additional policies and procedures to comply with applicable out-of state firm and individual licensing requirements
- The firm's monitoring policies
- Adequacy of the firm's professional library
- Risk level of the engagements performed (For example, does the firm perform audits of employee benefit plans, entities subject to Circular A-133, and others under *Government Auditing Standards*, HUD-regulated entities, and others with high-risk features or complex accounting or auditing applications?)
- Have there been any major changes in the firm's structure or personnel since the prior peer review?

### ***Detection Risk***

Inherent risk and control risk directly relate to the firm's accounting and auditing practice and its system of quality control, respectively, and should be assessed in planning the review. Based on the combined assessment, the reviewer selects engagements for review and determines the scope of other procedures to reduce the peer review risk to an acceptable level. The lower the combined inherent and control risk, the higher the detection risk that can be tolerated. Conversely, a high combined inherent and control risk assessment results in a low detection risk and the resulting increase in the scope of review procedures.

See section 3100, *Supplemental Guidance*, for an example of an appropriately documented risk assessment in the SRM.

## **Review of CPE Records During a Peer Review**

**53-1 Question**—Paragraph .53 discusses testing the functional areas of a firm. What are some factors to consider regarding continuing professional education (CPE) records?

*Interpretation*—In accordance with SQCS No. 8, a firm should establish policies and procedures designed to provide it with reasonable assurance that its personnel have the appropriate competence, capabilities, and commitment to ethical principles. Such policies and procedures should address, among other items, professional development (including training or CPE). The fundamental purpose of CPE is to maintain or increase professional competence. Team captains on System Reviews should carefully consider a firm's CPE policies and the firm's philosophy toward continuing education when assessing risk during planning. In addition, team captains should carefully test a firm's CPE records to the extent deemed necessary during their testing of the functional areas of a firm. They should ascertain that the appropriate amounts and types (accounting, auditing and quality control) of CPE are being taken by the appropriate firm personnel, including that personnel are in compliance with CPE requirements for boards of accountancy in states in which the firm's personnel are licensed. The team captain should also consider if the firm is taking appropriate action to correct situations where personnel are not in compliance with CPE requirements. The lack of appropriateness or quality of a firm's compliance with CPE requirements can be the systemic cause of a matter, finding or deficiency and thus affect the firm's peer review results. A team captain's diligence in considering and testing CPE can impact the quality of the peer review and hence the program's goal of improving audit quality. A team captain's steps in considering and testing CPE during a peer review are subject to review and oversight by the administering entity.

## **Planning and Performing Compliance Tests of Requirements of Voluntary Membership Organizations**

**54d-1 Question**—Paragraph .54(d) discusses the peer reviewer's requirement in a System Review to review other evidential material as appropriate, including selected administrative or personnel files. Should the reviewer test the firm's compliance with requirements of voluntary membership organizations?

*Interpretation*—Voluntary membership requirements that are not directly imbedded into the firm's written system of quality control for its accounting and auditing practice are not tested as a part of the peer review. In addition, voluntary membership requirements, even those included in the firm's written

system of quality control, that do not directly contribute to the firm's compliance with the requirements of the SQCSs are not tested, addressed, or reported on in the peer review process. Those membership requirements that are specifically imbedded into the firm's written system of quality control and directly contribute to the firm's compliance with the SQCSs are within the scope of peer review, but not because they are a membership requirement, but rather because they are an integral part of the firm's system of quality control for the firm to comply with the SQCSs. In this instance, any matters, findings, or deficiencies noted in these areas would only be addressed as they relate to the firm's system of quality control and they would not be described as related to the voluntary membership requirements.

## Inclusion of Engagements and Aspects of Functional Areas in the Scope of the Peer Review

**55-1 Question**—Paragraph .55 of the standards notes that there is a presumption that all engagements and all aspects of functional areas otherwise subject to the peer review will be included in the scope of the review. Could a firm have a legitimate reason for an exclusion and what is the effect on the performance of the review?

*Interpretation*—In rare situations a reviewed firm may have legitimate reasons for excluding certain engagements or certain aspects of functional areas, for example when an Engagement or an employee's personnel records are subject to pending litigation. In those instances a reviewer should carefully consider the implication of such exclusions. Those considerations should include assessing the reasonableness of the reasons for the exclusions and assessing the effect on peer review risk assessments and scope, including whether alternate procedures can be performed. To reduce the potential for disagreement about such matters among the reviewed firm, the reviewer, and the administering entity, ordinarily, when the reviewed firm contemplates excluding engagement(s) or aspect(s) of functional area(s), it should notify the team captain in a timely manner and submit a written statement to the administering entity, ordinarily prior to the commencement of the review, indicating (a) it plans to exclude an engagement(s) or aspect(s) of functional area(s) from the peer review selection process, (b) the reasons for the exclusion, and (c) it is requesting a waiver for the exclusion. The administering entity should satisfy itself concerning the reasonableness of the explanation before agreeing to the exclusion.

For peer reviews overseen by a panel pre-assigned by the administering entity for on-site oversight purposes, the reviewed firm should notify the team captain in advance that it is probable that engagement(s) or aspect(s) of functional area(s) will be excluded from the review, the general reasons for such exclusion, and a detailed description of the procedures used to identify and assess those situations. The panel as previously described should determine that those procedures are appropriate in light of the circumstances. They should consider the level of oversight to which the review may be subject and the level of involvement that members of the board have in that oversight. In addition, they should consider the practicality of selecting a replacement and the availability of other engagement(s) or aspect(s) of functional area(s) as appropriate replacements. Ordinarily, the greater the population to select from, the more there is an opportunity to find an appropriate replacement, and the less there is a risk that there is a scope limitation.

The administering entity (or panel as previously described) should approve the request to exclude engagement(s) or aspect(s) of functional area(s) as the situation arises only when it is satisfied that, based on the reasonableness of

the procedures used to identify and assess the situations and the other factors described in the preceding, there will be no limitations on the scope of the review.

Regardless of the approach used to notify the administering entity of exclusions, the reasons for the exclusions and the risk assessment implications should be fully documented in the peer review working papers, and the peer review committee should consider those factors as part of its evaluation and acceptance process.

An administering entity may conclude that scope has been limited due to circumstances beyond the firm's control and the review team cannot accomplish the objectives of those procedures through alternate procedures, thus precluding the application of one or more peer review procedure(s) considered necessary in the circumstances. For example, ordinarily, the team would be unable to apply alternate procedures if the firm's only engagement in an industry that must be selected is unavailable for review and there isn't an earlier issued engagement that may be able to replace it, or when a significant portion of the firm's accounting and auditing practice during the year reviewed had been divested before the review began. In these circumstances, the team captain or review captain should consider issuing a report with a peer review rating of *pass (with a scope limitation)*, *pass with deficiency (with a scope limitation)*, or *fail (with a scope limitation)*, as applicable. The existence of a scope limitation in and of itself does not result in a report with a peer review rating of *pass with deficiencies* or *fail*; it is in addition to the grade that was determined to be issued (which is why it is possible to have a report with a grade of *pass (with a scope limitation)* to which there would be no letter of response).

If the administering entity (or panel as previously described) concludes that there is not a legitimate reason for the requested exclusion and the firm continues to insist on the exclusion, it should be evaluated whether this is a matter of noncooperation (see Interpretation No. 5h-1).

## Office and Engagement Selection in System Reviews

**56-1 Question**—Paragraph .56 of the standards provides factors to consider when assessing peer review risk at the office level. What are some other examples of factors to consider?

**Interpretation**—Other examples of factors to consider when assessing peer review risk at the office level follow. This list is for illustrative purposes only, and does not include all possible inherent and control risk factors, nor is the peer reviewer required to consider every item on the list when assessing inherent and control risk:

- Offices with one or a few engagements comprising a significant portion of the office's accounting and auditing practice
- Offices with concentrations of high risk engagement
- Offices with a pattern of litigation or regulatory actions
- Offices identified in the preceding peer review or through monitoring procedures as operating at a level significantly below the firm's quality standards
- Offices with an unreasonably large number of accounting and auditing hours per engagement partner
- Offices with only one or a few engagements in a specialized industry

- Offices not subjected to monitoring procedures or not scheduled to be subject to monitoring procedures since the last peer review
- Offices where individual partners practice in many industries
- Offices in geographic areas that are experiencing economic hardships
- Offices with numerous clients in industries experiencing economic hardships

**58-1 Question**—Paragraph .58 of the standards provides guidance on steps to follow if a current year's engagement has not been completed and issued. What is the impact, if any, for audit engagements subject to professional standards, statutes, regulations, or the firm's quality control policies, which may allow a specified time for an assembly process after issuance?

*Interpretation*—Professional guidance indicates that auditors should not date the audit report until they have obtained sufficient appropriate audit evidence to support the opinion. At that point audit documentation should have been reviewed, financial statements should have been prepared, and management should have asserted its responsibility for them. Document completion dates specify a date certain by which assembly of the audit file must be completed. During the period leading up to that date, changes can be made to the audit documentation to complete the documentation and assembly of audit evidence, perform routine file-assembling procedures, sign off on file completion checklists and add information received after the date of the auditor's report; for example, an original confirmation that was previously faxed. However, the sufficient appropriate audit evidence would have already been required to be in place when the report was dated and thus would be in place when it was issued. Thus, there is no impact on the process of selecting engagements for review.

**58-2 Question**—What if the incomplete engagement is an initial engagement and there is no comparable engagement?

*Interpretation*—If there is an incomplete engagement (which is an initial engagement) and there is no comparable engagement, the firm should request an extension from the administering entity. The administering entity will consider the circumstances and evaluate whether there is actually a matter of noncooperation (see Interpretation No. 5h-1). Although the administering entity will otherwise likely grant the extension, the firm needs to consider if it will be meeting the requirements of its state board of accountancy or other regulatory bodies. If an extension is not possible, the peer review should be performed and the report should include a scope limitation.

If the situation arose due to a permanent change in the nature of the firm's business, the firm should consider requesting a change in its peer review year-end date. If there is any uncertainty concerning how the situation should be handled, the administering entity should be contacted. See section 3100 *Supplemental Guidance* for an example when there is an initial engagement performed under *Government Auditing Standards* (GAS, also known as the Yellow Book) meeting the preceding criteria.

**58-3 Question**—Paragraph .58 of the standards indicates that if the subsequent year's engagement has been completed and issued, the review team should consider, based on its assessment of peer review risk, whether the more recently completed and issued engagement should be reviewed instead. What are some factors to be considered and implications on the peer review?

*Interpretation*—Other than consideration of the firm's risk assessment and the factors that contributed to it, the reviewer may consider if the subsequent

engagement was performed during or after the peer review year. In addition, the reviewer should consider the number of subsequent engagements available and selected for review, as well as the differences in issues encountered in the engagements whether the year-end was within the peer review year or subsequent to it. The greater the number of subsequent year engagements selected, the greater the risk that the results of the review are not appropriate or matched in relation to the peer review year covered by the report and the related peer review results. In some situations, the team captain should consider whether it is more appropriate to issue the peer review report on the subsequent year. However, this should be a rare situation, would require advance approval from the administering entity, and that entity may request that the next review be accelerated to put the firm back on cycle. If many of the subsequent engagements have been issued, the reviewer should discuss the timing of the peer review with the firm so that future reviews may benefit from the results of the peer review before the subsequent engagements are issued.

**59-1 Question**—Paragraph .59 of the standards requires that engagements selected for review should provide a reasonable cross section of the reviewed firm's accounting and auditing practice, with greater emphasis on those engagements in the practice with higher assessed levels of peer review risk, and the guidance provides examples of factors to consider when assessing peer review risk at the engagement level. What are some other considerations?

*Interpretation*—A reasonable cross section of a firm's accounting and auditing practice, not only includes consideration of the specific industries that are required to be selected, but other industries that have a significant public interest. Industries that have a significant public interest are those that benefit the general welfare of the public, such as those that have recent regulatory and legislative developments (for example broker-dealers). Public interest industries will vary across firms and reviewers should consider the composition of a firm's accounting and auditing practice when determining if their risk assessment should address a public interest industry. The reviewer also needs to carefully consider the industries that the firm has identified in the category of "other audits" when determining whether to select such an engagement(s). A selection consisting solely of public interest industries would not necessarily represent a reasonable cross section. Other factors to consider in selecting a reasonable cross section may include the number of partners, the number of practice offices, and materiality thresholds of accounting and auditing hours.

The reviewer should explain and document in the *Summary Review Memorandum* key decisions that he or she made when he or she chose not to select any one or more of the following: a level of service, industries in which a significant public interest exists, and industries in which the firm performs a significant number of engagements. This does not give authority to the reviewer to avoid selecting an engagement(s) by simply documenting the reason(s) why he or she did not select certain engagement(s). Therefore the reviewer should document important considerations regarding the engagement selection process.

A reasonable cross section does not always require that at least one engagement from every level of service provided by the firm be selected for review; however, it often may be appropriate in the circumstances. There is no percentage of coverage that necessarily ensures a reasonable cross section. Therefore, there is a relationship between a risk-based approach and a reasonable cross section when selecting engagements, and in that regard each peer review needs to be considered on a case-by-case basis.

The following are examples of risk considerations when addressing obtaining a reasonable cross section of the engagements, including engagements that must

be selected and non-carrying broker-dealers. It is expected that the various types of engagements within an industry are specifically addressed in the risk assessment. Similar considerations should be made for industries that have a significant public interest.

- a. *Governmental—Government Auditing Standards*—Inclusion of a must select engagement should not supersede the reviewer's consideration of engagements and industries that have a significant public interest such as state and local governments, school districts and HUD engagements. For example, if for-profit HUD multifamily housing project audit engagements constitute a significant percentage of a firm's practice, one would expect the reviewer to select at least one such engagement for review. However, if the firm also performed an audit of an engagement subject to Circular A-133, such as a local government or not-for-profit organization, one such engagement must also be selected to perform an evaluation of the firm's compliance with Circular A-133. Peer reviewers should also consider audit firm experience such as how many governmental audits the firm performs, the length of experience in performing these engagements, the number of team members with experience, whether the team members have undergone CPE or specialized training, and reasonableness of hours spent on GAS engagements. Further consideration should be given to communications from regulatory agencies.
- b. *Employee benefit plans*—For employee benefit plans under ERISA, the peer reviewer should consider whether the engagement selection process has adequately addressed the risks involved in limited versus full scope audits and in different types of benefit plans such as defined benefit, defined contribution, and voluntary health and welfare plans. If a firm has more than one of the preceding types of plans, the reviewer must consider the unique risks associated with that type of plan and document how these risks were addressed in the risk assessment. Peer reviewers should also consider audit firm experience such as how many ERISA audits the firm performs, the length of experience in performing these engagements, the number of team members with experience, whether the team members have undergone CPE or specialized training, and reasonableness of hours spent on ERISA engagements. Further consideration should be given to communications from regulatory agencies.
- c. *Depository Institutions*—For FDICIA engagements, peer reviewers should take into consideration the amount of total assets held by the federally insured depository institution (less than \$500 million, more than \$500 million, more than \$1 billion). Peer reviewers should also consider audit firm experience such as how many FDICIA audits the firm performs, the length of experience in performing these engagements, the number of team members with experience, whether the team members have undergone CPE or specialized training, and reasonableness of hours spent on FDICIA engagements. Further consideration should be given to the risks of the audited company such as the level of reporting the institution complies with (the holding company level or the bank subsidiary level and the regulatory issues associated with each), the balance of the lending portfolio (the industries and concentration percentage of the portfolio), any regulatory correspondence

and examination results, capital ratios, financial institution management experience, economic environment and geographic location of the institution, number of branches, and experience and longevity of the board of directors and audit committee.

- d. *Broker-dealers*—The peer reviewer should consider whether the engagement selection process has adequately addressed the risks involved in carrying and non-carrying broker-dealers. Consideration of carrying broker-dealers should include carrying, clearing, and custodial broker-dealers. Consideration of non-carrying broker-dealers should include introducing broker-dealers. The peer reviewer should also consider other types of broker-dealers that fit the description of carrying and non-carrying broker-dealers in Interpretation No. 63-2. If a firm has more than one of the preceding types of audits, the reviewer must consider the unique risks associated with that type of audit and document how these risks were addressed in the risk assessment. For all broker-dealer engagements, the peer reviewer should consider audit firm experience such as how many broker-dealer audits the firm performs, the length of experience in performing these engagements, the number of team members with experience, whether the team members have undergone CPE or specialized training, and reasonableness of hours spent on broker-dealer engagements. Further consideration should be given to communications from regulatory agencies. For non-carrying broker-dealers, the peer reviewer's risk assessment is expected to address the risks associated with those broker-dealers (for example, if the broker-dealer has some form of custody and control that may create risk and require additional internal controls).
- e. *Service Organizations*—The peer reviewer should consider whether the engagement selection process has adequately addressed the risks involved in different types of Service Organization Control (SOC) engagements (SOC 1 and SOC 2 engagements). If a firm performs more than one of the preceding types of SOC engagements, the reviewer must consider the unique risks associated with that type of engagement and document how these risks were addressed in the risk assessment. Peer reviewers should also consider audit firm experience such as how many SPC engagements the firm performs, the length of experience in performing these engagements, the number of team members with experience, whether the team members have undergone CPE or specialized training, whether the firm utilizes a group that specializes in internal controls for completing its SOC engagements, and reasonableness of hours spent on SOC engagements. Additional considerations should be given to whether the firm performs SOC engagements with significant sub-service organizations identified in the auditor's opinion (inclusive method is higher risk than carve out). Further consideration should be given to communications from regulatory agencies. Although SOC 1 and SOC 2 engagements are different, noncompliance for one type may be indicative of noncompliance in the other. SOC 3 engagements are not must select engagements but when considering the pervasiveness of a systemic cause and the portion of the firm's practice that may be impacted by matters identified with other SOC engagements, the reviewer should also consider SOC 3 engagements.

**59-2 Question**—Paragraph .59 of the standards provides factors to consider when assessing peer review risk at the engagement level. What are some other examples of factors to consider?

*Interpretation*—Other examples of factors to consider when assessing peer review risk at the engagement level follow. This list is for illustrative purposes only, and does not include all possible inherent and control risk factors, nor is the peer reviewer required to consider every item on the list when assessing inherent and control risk:

- Engagement size, in terms of the hours required to plan and perform it
- Engagements involving experienced personnel hired from other firms, and partners who also have office, regional or firm-wide management, administrative, or functional responsibilities
- Engagements where work on segments has been referred to other firms, foreign offices, domestic or foreign affiliates, or correspondents
- Engagements where one or more affiliated entities (for example, parent companies and subsidiaries or brother and sister companies) constitute a large portion of the firm's overall clientele
- Engagements identified in the firm's quality control System or guidance material as having a high degree of risk
- Engagements where departures from professional standards and failure to comply with the firm's quality control policies and procedures were noted in the preceding year's monitoring procedures
- Engagements in industries where the firm has experienced high instances of litigation, proceedings, or investigations
- Engagements affected by recently implemented revisions of the firm's quality control policies and procedures
- Engagements affected by newly effective professional standards
- Clients in industries in poor financial condition
- Clients in industries with complex or sophisticated transactions
- Engagements from merged-in practices
- Engagements subject to *Government Auditing Standards*
- Engagements subject to the Employee Retirement Income Security Act of 1974 (ERISA)
- Engagements subject to the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)
- Audits of securities and commodities broker-dealers
- Examinations of controls relevant to both a service organization and its user entities

**59-3 Question**—What factors should be considered if a firm has an office in a foreign country or other territory?

*Interpretation*—The standards are intended for firms of AICPA members who are engaged in the practice of public accounting in the United States or its territories. Some firms also have offices in foreign countries or their territories ("foreign jurisdictions"), including the Cayman Islands and Bermuda. One important factor to consider in determining whether reports issued for clients

in those foreign jurisdictions are to be included in the scope of the peer review is the letterhead of the report issued. For instance, ordinarily if a U.S. firm issues a report on letterhead from its office in that foreign jurisdiction, the engagement would not be included in the scope of the peer review. Another factor is whether the reports issued for clients in the foreign jurisdictions are addressed by guidance from the state board of accountancy(s) that issues the firm's license(s). Team or review captains should consult with AICPA technical staff if there is any question of whether an engagement is subject to peer review under these circumstances. In addition, reviewed firms need to consider whether there are peer review or practice monitoring requirements issued by the licensing authority of the foreign jurisdiction which are applicable to the reviewed firm.

**61-1 Question**—Paragraph .61 of the standards requires that at least one engagement from the initial selection to be reviewed should be provided to the firm once the review commences and not provided to the firm in advance (the surprise engagement). What steps should be followed when making the selection of the surprise engagement?

*Interpretation*—The following steps should be followed:

1. Complete the risk assessment as described in paragraphs .46–.52 of the standards.
2. Plan the compliance tests as described in paragraphs .53–.63 of the standards and determine which engagements should be selected for the review, independent of any surprise selections.
3. Based on those engagements selected for review, determine which engagement should be the surprise engagement. If the risk assessment warrants, more than one surprise engagement may be selected.

Although the standards indicate that the engagement should be the firm's highest level of service (which ordinarily means an audit), in situations where the audit cannot be the surprise selection (for instance, if there is only one audit required to be selected or the only audit is a must select engagement), an engagement from the next highest level of service should be selected. It is not always possible for the reviewer to know whether a reviewed firm expects a certain engagement to be selected. Reviewers are asked to use their professional judgment in these situations. The selection should be based on the risk assessment performed in step 1 and the engagement should be from the list of engagements determined in step 2. The team captain should not increase the original scope of the selection whether another audit or another level of service is selected as the surprise engagement.

See section 3100, *Supplemental Guidance*, for several examples for selecting surprise engagements.

**61-2 Question**—How does the requirement to select a surprise engagement apply for a System Review performed at a location other than the reviewed firm's offices (Interpretation No. 8-1)?

*Interpretation*—For System Reviews approved by the administering entity to be performed at a location other than a reviewed firm's offices, engagements selected to be reviewed are submitted to the reviewer by the firm. As a result, the requirement to select a surprise engagement on a System Review performed at a location other than the reviewed firm's offices is not applicable.

**62-1 Question**—Paragraph .62 of the standards requires that the team captain consult with the administering entity about the selection of engagements

for review if the team captain finds that meeting all of the criteria in the related guidance results in the selection of an inappropriate scope of the firm's accounting and auditing practice. What items should the team captain consider to determine if the selection is appropriate?

*Interpretation*—The team captain should carefully consider whether

- a. significant risk areas have appropriate coverage (see paragraph .65 of the standards).
- b. appropriate weight has been given to reviewing work performed by all or most supervisory personnel.
- c. adequate consideration has been given to engagement selection based on peer review risk on a firm-wide basis. For example, if two offices are selected for review and each has a large client in the same specialized industry, peer review risk should be considered in determining whether more than one of these engagements should be selected for review.

If an engagement(s) within the team captain's selection is not available for review, a comparable engagement within the peer review year-end is also not available, nor is there a prior year's engagement that may be reviewed; the team captain should consult with the administering entity to determine the effects on the timing or year-end of the peer review, if any, and whether a report with a peer review rating with a scope limitation should be issued.

**63-1 Question**—Paragraph .63 of the standards requires that specific types or number of engagements must be selected in a System Review as well as specific audit areas. In a System Review, what specific types and number of engagements, if any, should be included in the sample of engagements selected for review or assessed at a higher level of peer review risk?

*Interpretation*—At least one of each of the following types of engagements is required to be selected for review in a System Review:

- a. *Governmental*—*Government Auditing Standards*, issued by the U.S. Government Accountability Office, requires auditors conducting engagements in accordance with those standards to have a peer review that includes the review of at least one engagement conducted in accordance with those standards. If a firm performs an engagement of an entity subject to GAS and the peer review is intended to meet the requirements of those standards, at least one engagement conducted pursuant to those standards should be selected for review. Additionally, if the engagement selected is of an entity subject to GAS but not subject to the Single Audit Act/OMB Circular A-133 and the firm performs engagements of entities subject to OMB Circular A-133, at least one such engagement should also be selected for review. The review of this additional engagement must evaluate the compliance audit requirements and may exclude those audit procedures strictly related to the audit of the financial statements.
- b. *Employee Benefit Plans*—Regulatory and legislative developments have made it clear that there is a significant public interest in, and a higher risk associated with, audits conducted pursuant to ERISA. Therefore, if a firm performs the audit of one or more entities subject to ERISA, at least one such audit engagement conducted pursuant to ERISA should be selected for review. Refer to Interpretation No. 59-1.
- c. *Depository Institutions*—The 1993 FDIC guidelines implementing the FDICIA require auditors of federally insured depository

institutions having total assets of \$500 million or greater at the beginning of its fiscal year to have a peer review that includes the review of at least one audit of an insured depository institution subject to the FDICIA. If a firm performs an audit of a federally insured depository institution subject to the FDICIA and the peer review is intended to meet the requirements of the FDICIA, at least one engagement conducted pursuant to the FDICIA should be selected for review. The review of that engagement should also include a review of the reports on internal control if applicable because those reports are required to be issued under the FDICIA when total assets exceed \$1 billion.

- d. *Broker-Dealers*—Regulatory and legislative developments have made it clear that there is a significant public interest in, and a higher risk associated with, audits of broker-dealers. The type of broker-dealer with the highest risk is a carrying broker-dealer. Therefore, if a firm performs the audit of one or more carrying broker-dealers, at least one such audit engagement should be selected for review. It is also expected that if a firm's audits of broker-dealers include only non-carrying broker-dealers, the team captain should be aware of and give special consideration to the risks associated with such broker-dealer audits in making engagement selections.
- e. *Service Organizations*—Due to the reliance on Service Organization Control (SOC) reports, particularly SOC 1 and SOC 2 reports, there is a significant public interest in examinations of service organizations relevant to user entities. Therefore, if a firm performs an examination of one or more service organizations and issues a SOC 1 or SOC 2 report, at least one such engagement should be selected for review. If a firm performs both SOC 1 and SOC 2 engagements and a proper risk assessment determined that only one SOC engagement should be selected, ordinarily a SOC 1 engagement should be selected over a SOC 2 engagement due to the reliance upon the report by other auditors. Because SOC 2 engagements are a new type of service, peer reviewers may deem it necessary to select both SOC 1 and SOC 2 engagements. However, there may also be situations in which it would be appropriate to pick on SOC 2 engagement and not select a SOC 1 engagement. An example may be that the SOC 2 engagements have not been previously selected and the SOC 1 engagements have been selected; the SOC 2 practice is growing and the SOC 1 practice is stable; and so on.

In complying with the requirements in the previous list, peer reviewers should also ensure that the engagements selected include a reasonable cross section of the firm's accounting and auditing engagements, appropriately weighted considering risk. Thus, the peer reviewer may need to select greater than the minimum of one engagement from these industries in order to attain this risk weighted cross section. Refer to Interpretation No. 59-1.

The team captain's consideration of this coverage should be discussed in his or her risk assessment documentation. This discussion should include any factors considered when the reviewed firm has a significant number of engagements in one of these high risk areas and it is not otherwise evident why only one engagement from the industry has been included in the scope of the review.

**63-2 Question**—For purposes of the AICPA Peer Review Program, what is the difference between a carrying and non-carrying broker-dealer?

*Interpretation*—Carrying broker-dealers include all broker-dealers that clear customer transactions, carry customer accounts or hold custody of customer cash or securities. Examples of carrying broker-dealers include (a) clearing broker-dealers who receive and execute customer instructions, prepare trade confirmations, settle the money related to customer trades and arrange for the book entry (or physical movement) of the securities and (b) carrying broker-dealers that hold customer accounts or clear customer trades for introducing broker-dealers. Non-carrying broker-dealers are those broker-dealers that do not clear customer transactions, carry customer accounts, or hold custody of customer cash or securities. Examples of non-carrying broker-dealers are (a) introducing broker-dealers that introduce transactions and accounts of customers or other broker-dealers to another registered broker-dealer that carries such accounts on a fully disclosed basis and does not receive or hold customer or other broker-dealers securities and (b) a broker-dealer whose business does not involve customer accounts, such as proprietary trading firms, investment banking firms, and firms that sell interest in mutual funds or insurance products.

**63-3 Question**—Paragraph .63 of the standards requires that specific types or number of engagements must be selected in a System Review as well as specific audit areas. What is the difference between a must select and a must cover engagement?

*Interpretation*—Must select engagements must be included in the sample of engagements selected for review. A must cover industry does not have to be selected for review, however, either the team captain or a team member must have at least recent experience in the industry to aid in the risk assessment process and determination of whether an engagement from the must cover industry should be selected for review.

The Board periodically assesses engagements to determine which may have the most significant public interest of the moment. These engagements are deemed to be must cover engagements. Currently, the list includes HUD, school districts, and state and local government. These engagements, in addition to the must select engagements (as described in Interpretation No. 63-1), are must cover engagements for all firms. A firm may have additional must cover industries based on the concentration of its practice that subjects it to a System Review (as described in paragraph .07 of the standards). Industries in which a firm's practice that subjects it to a System Review has a 10 percent or more concentration or the firm's three largest industry concentrations (if none represent more than 10 percent) are also considered must cover engagements.

A team member must have recent experience in and knowledge about rules and regulations appropriate to the level of service applicable to the industries of the engagements the individual will be reviewing, regardless of whether the engagement is a must select or must cover.

## Concluding on the Review of an Engagement

**66-1 Question**—Paragraphs .66–.67, and .109 of the standards requires the review team to conclude on the review of an engagement by determining whether the engagement was performed or reported on in conformity with applicable professional standards in all material respects. How should this conclusion be made?

*Interpretation*—The review team should use practice aids that document, for each engagement reviewed, whether anything came to the review team's attention that caused it to believe the following, as applicable:

- a. The financial statements were not in conformity with GAAP in all material respects or, if applicable, with a special purpose framework<sup>5</sup> and the auditor or accountant's report was not appropriately modified.
- b. The firm did not perform or report on the engagement in all material respects in accordance with generally accepted auditing standards and other applicable standards; for example, *Governmental Auditing Standards*.
- c. The firm did not perform or report on the engagement in all material respects in accordance with SSARS.
- d. The firm did not perform or report on the engagement in all material respects in accordance with SSAEs or any other applicable standards not encompassed in the preceding.

In Engagement Reviews, these results should be considered by the review captain in determining the type of report to issue.

**67-1 Question**—Paragraphs .67 and .109 of the standards notes that the team captain or review captain should promptly inform the firm when an engagement is not performed or reported on in conformity with applicable professional standards in all material respects and remind the firm of its responsibilities under professional standards to take appropriate actions. How is this communication made and what other responsibilities does the team captain or review captain have in regard to the affected engagements?

*Interpretation*—If the reviewer concludes that an engagement is not performed or reported on in conformity with applicable professional standards in all material respects, the team captain or review captain should promptly inform an appropriate member of the reviewed firm on a MFC form. The team captain or review captain should remind the reviewed firm of its responsibilities under professional standards to take appropriate actions as addressed in AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*, or SSARS No. 19, *Framework for Performing and Reporting on Compilation and Review Engagements*, as applicable, or, if the firm's work does not support the report issued, as addressed in AU-C section 585, *Consideration of Omitted Procedures After the Report Date*. The reviewed firm should investigate the issue questioned by the review team and determine what timely action, if any, should be taken, including actions planned or taken to prevent unwarranted continued reliance on its previously issued reports. The reviewed firm should then advise the team captain or review captain of the results of its investigation, including parties consulted, and document on the MFC form the actions planned or taken or its reasons for concluding that no action is required.

Reviewers or administering entities should not instruct reviewed firms to perform omitted procedures, reissue accounting or auditing reports, or have previously issued financial statements revised and reissued because those are decisions for the reviewed firm and its client to make. However, the administering entity can require the reviewed firms to make and document appropriate considerations regarding such engagements as a condition of acceptance of the peer review. The firm's response may affect other monitoring actions the administering entity's peer review committee may impose, including actions to verify that the reviewed firm adheres to the intentions indicated in its response.

If the reviewed firm has taken action, ordinarily the review team should review documentation of such actions (for example, omitted procedures performed, reissued report and financial statements, or notification to users to discontinue

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<sup>5</sup> See footnote 3.

use of previously issued reports) and consider whether the action is appropriate. If the firm has not taken action, the review team should consider whether the planned actions are appropriate (genuine, comprehensive, and feasible).

## Determining the Cause for a Finding in a System Review

**83-1 Question**—Paragraph .83 of the standards notes that when a review team is faced with an indication that a matter(s) could be a finding or that the firm failed to perform or report in conformity with applicable professional standards in all material respects, the review team's first task in such circumstances is to determine the cause of the finding or failure. Why?

*Interpretation*—The evaluation of a firm's system of quality control is the primary objective of a System Review and the basis for the peer review report.

As such, when a reviewer in a System Review discovers a matter, including an engagement that was not performed or reported in conformity with applicable professional standards in all material respects, he or she should avoid considering the type of report to issue until the underlying cause of the matter (to determine if it rises to the level of a finding, deficiency or significant deficiency) is identified, where it is reasonably possible to do so.

Reviewers in a System Review must think of matters as symptoms of weaknesses in the firm's system of quality control. Further, reviewers must make a good faith effort to try to identify the underlying systemic cause for those matters to determine if they rise to the level of a finding. A finding has a systemic definition; a finding is one or more related matters that result from a *condition* in the reviewed firm's system of quality control or compliance with it such that there is more than a remote possibility that the reviewed firm would not perform or report in conformity with applicable professional standards. With a finding, the reviewer is considering more than just the "matter;" they are considering the condition (that is, systemic cause) that resulted in the matter(s) occurring. Otherwise said, the reviewer must determine why the matters occurred. Upon further evaluation, a finding may rise to a systemically oriented deficiency or significant deficiency.

Causes for one or more matters are only documented when one or more matters rise to the level of a finding or a deficiency or significant deficiency (and then are documented on a FFC form or in the report, respectively). Furthermore, because the cause may not ultimately be documented for all matters, the only way to determine if one or more matters rise to the level of a finding or higher, is to try to identify the underlying systemic cause.

One reliable method for identifying a matter's systemic cause is to require complete answers on all MFC forms, instead of merely a check mark for the "yes we agree" response. The reviewer may also survey firm personnel for causes of matters. Reviewers should consider that separate matters that are exactly the same may result from completely different quality control weaknesses in the firm.

Without identifying and understanding the underlying cause(s), a reviewer cannot make meaningful recommendations that help reduce the likelihood of the repeat finding(s), deficiency(ies) or significant deficiency(ies) recurring (or findings that develop into deficiencies or significant deficiencies in the future).

Reviewers should not assume that the recommendation of the use of standard forms and checklists will improve a firm's system of quality control. Although forms and checklists are helpful in many circumstances, their use may not

change behavior, improve performance or cure findings, deficiencies and significant deficiencies. For example, checklists will not help firms that lack overall knowledge of accounting and auditing matters or knowledge in the specific area in which the deficiency arose. Nor will standard checklists help firms in which policies and procedures for the review of engagements are routinely overridden.

Additional guidance on the systemic approach of a System Review is included in chapter 4 of PRP 3300 *AICPA Peer Review Program Report Acceptance Body Handbook*.

**83-2 Question**—For System Reviews and Engagement Reviews, what is considered a repeat finding on a finding for further consideration (FFC) form?

*Interpretation*—On System Reviews, a repeat finding is one or more related matters that result from a condition in the reviewed firm's system of quality control or compliance with it that is noted during the current review and also on a FFC form in the prior peer review. The review team should read the prior review documentation, including the report, letter of response and FFC forms, if applicable, and evaluate whether the firm's planned actions noted on those forms were implemented. If the firm's planned actions to remediate the prior review findings were implemented, and the same finding is occurring, the review team should determine the condition in, or compliance with, the firm's system of quality control that caused the current finding. If it is determined to be the same systemic cause, the FFC form should indicate that similar findings were noted in the prior review. If the prior remedial actions (corrective actions, implementation plans, or as discussed in the firm's response on the FFC form) appear to be effective, the finding may be caused by some other condition in, or compliance with, the firm's system of quality control. If the underlying cause of the finding is different from that noted in the prior review, it would not be a repeat.

See section 3100, *Supplemental Guidance*, for an example of identifying repeat findings, deficiencies and significant deficiencies in a System Review.

On Engagement Reviews, a repeat is one in which the identified finding is substantially the same (that is, the same kind or very similar) as noted on a FFC form in the prior peer review as it relates to reporting, presentation, disclosure or documentation. For example, if a reviewer notes an engagement that had a disclosure or financial statement presentation finding on a FFC form in the prior peer review, the disclosure or financial statement presentation finding noted in the current review would need to be substantially the same disclosure or financial statement presentation finding to qualify as a repeat.

A firm that repeatedly receives peer reviews with consistent findings that are not corrected may be required to complete an implementation plan.

**83-3 Question**—Paragraph .83 of the standards notes the importance of determining the cause of the identified findings or failures to determine whether they are systemic in nature. How do the results of regulatory or governmental oversight or inspection factor into this determination?

*Interpretation*—If similar issues were raised in both the regulatory or governmental oversight(s) and in the peer review, the review team should further understand the causes identified by the reviewed firm and consider whether there may be a systemic issue related to the design of the system of quality control or compliance with it. It may also be helpful when considering appropriate recommendations to understand remediation taken by the firm. See Interpretation Nos. 40-1 and 40-2 for additional considerations.

## Isolated Matters in a System Review

**84-1 Question**—Paragraph .84 refers to isolated matters in a System Review. What is an isolated matter and what further guidance is there to address isolated matters?

*Interpretation*—An isolated matter occurs when there is an incident (or limited incidents) of noncompliance with professional standards or the firm's quality control policies and procedures on one or more engagements (or aspect of a functional area) and the identical standards or policies and procedures were complied with on the remaining engagements or aspect of a functional area.

Reviewers should follow the guidance in paragraph .68, "Expansion of Scope," and paragraphs .84–.85, "Determining the Cause for a Finding," of the standards. The reviewer needs to evaluate the pervasiveness of the issue, including expanding scope if necessary. In some instances the team captain should expand scope to other engagements or aspects of functional areas, and determine that such matters did not occur elsewhere, thus evidencing that the noncompliance with the firm's system of quality control was truly isolated. In these situations, team captains should focus on the underlying cause of the matter when analyzing if it is isolated and may consider a key area approach when expanding scope to other engagements or aspects of functional areas to determine if the matter is isolated. The reviewer's ability to conclude a matter is isolated may be dependent on his or her ability to expand scope to engagements or aspects of functional areas that are classified by common characteristics such as, but not limited to, the industry, level of service, the practitioners in charge, or engagements that must be selected in a peer review.

The reviewer should consider that a single disclosure matter and a single documentation matter may be isolated when taken individually but they may have resulted from the same underlying systemic cause. They should further consider that an isolated matter may be materially significant in amount or nature or both.

Reviewers should document their consideration of an isolated matter and the conclusions reached in the MFC form. Team captains should document the same in the Summary Review Memorandum. The documentation should include the details of the matter noted, how the reviewer expanded scope, if applicable, and why the reviewer concluded the matter was isolated. The documentation should provide enough information for the administering entity's peer review committee to determine if the team captain's conclusion is appropriate.

## Communicating Conclusions at the Exit Conference

**91-1 Question**—Paragraph .91 of the standards instructs a team captain on communicating conclusions at the exit conference in a System Review. What other guidelines should be followed?

*Interpretation*—The team captain should consider the need to have the team member(s) participate (in person or via teleconference) in the exit conference or be available for consultation during the exit conference, especially when, in unusual circumstances, the team captain does not have the experience to review the industry of an engagement that was reviewed by the team member. Furthermore, the exit conference is not the appropriate place or time to surprise the firm with the intention of issuing a *pass with deficiency* or *fail* Report or to discuss any unresolved accounting and auditing issues. It is expected that the team captain will have an open means of communication with various levels of personnel leading up to the exit conference, having at a minimum and as applicable, promptly informed them when an engagement is not

performed or reported on in conformity with applicable professional standards, having discussed MFC and FFC forms including the systemic causes and related recommendations for any matters, findings, deficiencies, and significant deficiencies in advance, and having followed up on open questions and issues.

## Notification and Submission of Peer Review Documentation to the Administering Entities by the Team Captain or Review Captain

**94-1 Question**—Paragraphs .94, .120, and .190 of the standards instruct a reviewer to see the interpretations for guidance on notification requirements and submission of peer review documentation to the administering entity. What materials should be submitted by the team captain or review captain, and when should they be submitted by?

*Interpretation*—The team captain or review captain should notify the administering entity that the review has been performed and should submit to that administering entity within 30 days of the exit conference date in a System Review (or the review captain's discussions with the reviewed firm regarding the results of the review in an Engagement Review) or by the firm's peer review due date, whichever date is earlier, a copy of the report, and the following documentation required by the administering entities at a minimum (consider sending by an insured carrier or retaining or sending copies, or both):

*For System and Engagement Reviews:*

- Report, and letter of response, if applicable (reminder: The reviewer is not expected to delay submission of peer review documents to the administering entity for receipt or review of the letter of response from the firm)
- Summary Review Memorandum, or Review Captain Summary, as applicable
- Engagement Summary Form (For Engagement Reviews)
- FFC forms, as applicable
- MFC forms, submitted electronically or hard copy, as applicable
- DMFC form, submitted electronically or hard copy, as applicable
- Firm's representation letter
- 22,100-Part A, Supplemental Checklist(s) for Review of Single Audit Act/A-133 Engagement(s) and engagement profile(s) for A-133 engagements reviewed (if applicable) (for System Reviews)

Note that other working papers on these peer reviews are subject to oversight procedures and may be requested at a later date.

*For:*

- *Committee-appointed review team Engagement Reviews*
- *All System Reviews, Engagement Reviews, and quality control materials reviews administered by the National PRC*

In addition to the preceding, include all other working papers incorporated by reference, as applicable, including engagement questionnaires or checklists; quality control documents and related practice aids; staff interview, focus group, and other interview sessions; planning documents; and any other relevant documents.

## Reporting on System and Engagement Reviews When a Report With a Peer Review Rating of *Pass With Deficiency or Fail* Is Issued

**96m-1 Question**—Paragraphs .96(m) and .122(m) of the standards instruct a team captain in a System Review (or review captain on an Engagement Review) to include, for reports with a peer review rating of *pass with deficiency(ies)* or *fail*, descriptions (systemically written, in a System Review) of the deficiencies or significant deficiencies and the reviewing firm's recommendations. What is the treatment of FFCs, if any, when these reports are issued, and how are deficiencies treated for reports with a peer review rating of *fail*?

*Interpretation*—Any findings that are only raised to the level of a FFC remain in a FFC and are not included in a report with a peer review rating of *pass with deficiency or fail*.

A *significant deficiency* in a System Review is one or more *deficiencies* that the peer reviewer has concluded results from a condition in the reviewed firm's system of quality control or compliance with it such that the reviewed firm's system of quality control taken as a whole does not provide the reviewed firm with reasonable assurance of performing or reporting in conformity with applicable professional standards in all material respects. Such *deficiencies* are communicated in a report with a peer rating of *fail*. Therefore, this is a systemic approach to determining whether the *deficiencies* identified meet this *significant deficiency* threshold. If they do, then a report with a peer review rating of *fail* is issued and *all* of the *deficiencies* are considered *significant deficiencies* and are identified as such. Such a report would not have a section with "Significant Deficiencies" and another section for "Deficiencies," as they would all be categorized as *Significant Deficiencies*.

A *significant deficiency* on an Engagement Review exists when the review captain concludes that *deficiencies* are evident on all of the engagements submitted for review. Such *deficiencies* are communicated in a report with a peer review rating of *fail*. Therefore, on an Engagement Review, all of the engagements reviewed are considered concerning whether *deficiencies* were noted when determining if the *significant deficiency* threshold is met. If they do, then a report with a peer review rating with *fail* is issued and *all* of the *deficiencies* are considered *significant deficiencies* and are identified as such. Such a report would not have a section with "Significant Deficiencies" and another section for "Deficiencies," as they would all be categorized as *Significant Deficiencies*.

**96n-1 Question**—Paragraphs .96(n) and .122(n) of the standards instruct a team captain in a System Review (or review captain on an Engagement Review) to identify, for any deficiencies or significant deficiencies included in the report with a peer review rating of *pass with deficiencies* or *fail*, any that were also made in the report issued on the firm's previous peer review. What further guidance is available in regards to this requirement?

*Interpretation*—On System Reviews, a repeat is a deficiency or significant deficiency noted during the current review that was caused by the same system of quality control weakness noted in the prior review's report. The review team should read the prior report and letter of response and evaluate whether corrective actions discussed have been implemented to determine whether the systemic cause is the same. The deficiency or significant deficiency should note that "This deficiency [or significant deficiency, as applicable] was noted in the firm's previous peer review."

If the corrective actions have been implemented and the same deficiency or significant deficiency is occurring, the review team should determine the weakness in the firm's system of quality control that is causing the deficiency or significant deficiency to occur. In this case, if the prior corrective actions appear to be effective, the deficiency or significant deficiency may be caused by some other weakness in the firm's system of quality control. If the underlying cause of the deficiency or significant deficiency is different from that reported in the prior review, it would not be a repeat.

The preceding also applies when the deficiency or significant deficiency noted during the current review was caused by the same system of quality control weakness noted on a FFC form in the prior review. The team captain should consider if the firm's planned actions to remediate the prior review findings were implemented, including implementation plans or those discussed in the firm's response on the FFC form. If the prior remedial actions appear to be effective, the current deficiency may be caused by some other weakness in or compliance with the firm's system of quality control. If the underlying cause of the deficiency is different from that noted in the prior review, it would not be a repeat. If the underlying cause is determined to be the same, under these circumstances, it would still be appropriate to use the same wording as previously described "This deficiency [or significant deficiency, as applicable] was noted in the firm's previous peer review."

See section 3100, *Supplemental Guidance*, for an example of identifying repeat findings, deficiencies and significant deficiencies in a System Review.

On Engagement Reviews, a repeat is one in which the identified engagement deficiency or significant deficiency is substantially the same (that is, the same kind or very similar) as noted in the prior review's report as it relates to reporting, presentation, disclosure or documentation. For example, if a reviewer notes an engagement that had a disclosure or a financial statement presentation deficiency in a prior review's report, the disclosure or financial statement presentation deficiency noted in the current review would need to be substantially the same disclosure or financial statement presentation deficiency to qualify as a repeat.

The preceding also applies when the deficiency or significant deficiency noted during the current review was substantially the same as was noted on a FFC form in the prior review. Under these circumstances, it would still be appropriate to use the same wording as previously described: "This deficiency [or significant deficiency, as applicable] was noted in the firm's previous peer review."

For System Reviews and Engagement Reviews in which there are repeat deficiencies or significant deficiencies that have occurred on two or more prior reviews the reviewer should state in the current report that, "this deficiency [or significant deficiency, as applicable] was noted on previous reviews."

A firm that repeatedly receives peer reviews with consistent deficiencies or significant deficiencies that are not corrected may be deemed as a firm refusing to cooperate. For such firms that fail to cooperate, the AICPA Peer Review Board may decide, pursuant to fair procedures that it has established, to appoint a hearing panel to consider whether the firm's enrollment in the AICPA peer review program should be terminated or some other action taken. Therefore, it is critical that peer reviewers appropriately identify the underlying causes of deficiencies and significant deficiencies on System Reviews and that reporting on System and Engagement Reviews is appropriate.

## Firm Responses in a System or Engagement Review

**97-1 Question**—Paragraphs .97 and .123 of the standards discuss the team captain or review captain's responsibility to review, evaluate, and comment on the reviewed firm's letter of response prior to its submission to the administering entity. What should be considered during that review?

*Interpretation*—The purpose of the letter of response is for a firm to stipulate, in writing, the specific action(s) that will be taken to correct deficiencies noted by the reviewer and, on a System Review, to enhance the current system of quality control. The description of the action(s) the firm has taken or will take should ensure prevention of recurrence of the deficiency or significant deficiency discussed in the report. The action(s) should be feasible, genuine, and comprehensive. The letter of response should not be vague or repetitive of the deficiency or significant deficiency in the report, because then it is difficult to determine if the planned action will be appropriately implemented to ensure prevention; or if the action is inappropriate for correcting the deficiency or significant deficiency. The letter of response should not be used as a place to indicate justification for the firm's actions that related to the deficiency or significant deficiency.

## Submission of FFC Forms to the Administering Entities by the Team Captain or Review Captain

**99-1 Question**—Paragraphs .99 and .125 of the standards instruct a team captain or review captain to review and evaluate the firm's responses to all findings and recommendations not rising to the level of a deficiency or significant deficiency as reflected on the related FFC forms before they are submitted to the administering entity. When should the FFC forms be submitted to the administering entity and who should submit them?

*Interpretation*—Ordinarily, the FFC forms should be responded to by the reviewed firm during the peer review; for example, during or immediately following the exit conference (in a System Review) or before or immediately following the review captain's discussions with the reviewed firm regarding the results of the review (in an Engagement Review). This would allow the team captain or review captain to assist the firm in developing its responses and obtaining the necessary signatures on the FFC forms and allow the team captain or review captain to review the responses at that time, all of which will expedite the process.

The reviewed firm's response should describe how the firm intends to implement the reviewer's recommendation (or alternative plan if the firm does not agree with the recommendation); the person(s) responsible for implementation; the timing of the implementation; and, if applicable, additional procedures to ensure that the finding is not repeated in the future. The team captain or review captain can provide assistance in ensuring that the responses are appropriate and comprehensive. However, it is also recognized that the reviewed firm may prefer to provide its final responses after it has had the opportunity to discuss them further internally, develop a plan of action, and more formally respond. In either case, the completed FFC forms should be submitted to the team captain or review captain no later than two weeks after the exit conference (in a System Review) or the review captain's discussions with the reviewed firm regarding the results of the review (in an Engagement Review), or by the peer review's due date, whichever is earlier. FFC forms are then submitted by the team captain or review captain with the applicable working papers to the administering entity.

If the reviewed firm's response is not deemed to be comprehensive, genuine, and feasible, the technical reviewer or RAB will request a revised response.

## Election to Have a System Review

**103-1 Question**—Paragraph .103 of the standards notes that firms eligible to have an Engagement Review may elect to have a System Review. What tailoring is required to the peer review report under these circumstances?

*Interpretation*—Under these circumstances, any references in the peer review report to "the accounting and auditing practice" should be tailored to refer only to "the accounting practice." In addition, the following sentence should be added: "Firm XYZ & Co. has represented to us that the firm did not perform engagements that would require a system review."

## Selecting a Preparation Engagement in an Engagement Review

**104-1 Question**—Must a peer reviewer select a preparation engagement in an Engagement Review?

*Interpretation*—No. A reviewer is not necessarily required to select a preparation engagement in an Engagement Review. If a reviewer is able to meet the requirements of paragraph .104 of the standards without selecting a preparation engagement, then a preparation engagement is not selected. However, if selecting a preparation engagement is the only way a reviewer can meet any of the following requirements (as outlined in paragraph .104 of the standards), then a preparation engagement (either with or without a disclaimer report) should be selected. These requirements are as follows:

- Ordinarily, at least two engagements should be selected for review.
- One engagement should be selected from each partner (or individual of the firm) responsible for the issuance of reports or performance of engagements.
- An engagement with disclosures (performed under SSARs or SSAEs) should be selected.
- An engagement that omits substantially all disclosures (performed under SSARs) should be selected.

**104-2 Question**—What should the peer reviewer be reviewing on a preparation engagement in an Engagement Review?

*Interpretation*—The reviewer would review the engagement letter as well as the legend on each page of the financial statements to determine that they comply with SSARs. If the firm issues a disclaimer report, the reviewer would also assess whether it complied with SSARs. In addition, the reviewer should also perform procedures to determine whether the presentation of the financial statements is appropriate and that the disclosures are adequate based on the applicable financial reporting framework. If substantially all disclosures are omitted, the reviewer would need to determine whether the appropriate label is present for any disclosures that are made.

**104-3 Question**—Should the standard language in the peer review report be tailored on an Engagement Review, if preparation engagement(s) are selected for review?

*Interpretation*—No.

**104-4 Question**—What are some examples of when a preparation engagement should be selected during an Engagement Review?

*Interpretation*—

Example 1. If a sole practitioner performs compilation engagements with disclosures (or SSAEs, or reviews) and compilation engagements that omit substantially all disclosures, then one of each of these levels of service should be selected as part of the peer review. None of the firm's preparation engagements should be selected.

Example 2. If a sole practitioner only performs compilation engagements with disclosures and preparation engagements that omit substantially all disclosures (and no other engagements under SSAEs or SSARs), then one of each type of engagement should be selected as part of the peer review because an engagement that omits substantially all disclosures should be selected.

Example 3. If a sole practitioner only performs compilation engagements that omit substantially all disclosures and preparation engagements with disclosures (and no other engagements under the SSAEs or SSARs), then one of each type of engagement should be selected as part of the peer review because a full disclosure engagement should be selected.

Example 4. If a sole practitioner only performs compilation engagements with disclosures and preparation engagements with disclosures, then two compilation engagements should be selected as the selection of a preparation engagement is not required to be and should not be selected to meet any of the criteria outlined in paragraph .104 of the standards. However, if the firm only performs one compilation engagement with disclosures (as well as preparation engagements with disclosures and no other engagements under SSAEs or SSARs), the compilation engagement and a preparation engagement should be selected as part of the peer review. In this case, a preparation engagement is selected in order to meet the requirement of selecting a minimum of two engagements.

Example 5. Firm ABCDE is a five-partner firm and partner A performs agreed-upon procedure engagements, partner B performs review engagements, partner C performs full disclosure compilation engagements, partner D performs compilation engagements that omit substantially all disclosures and partner E performs preparation engagements. In this scenario one engagement is selected from each partner A, B, C and D which fulfills the requirement to select an engagement in each level of service outlined in paragraph .104a of the standards. However, because every person in the firm responsible for the issuance of financial statements must have an engagement selected, one of partner E's preparation engagements should be selected. Because the requirement to select an engagement with disclosures and an engagement that omits substantially all disclosures has been met (through the selection of engagements performed by the other partners) any preparation engagement performed by partner E may be selected.

Example 6. Using the same facts described in example 5, if partner E also performed a review engagement and a compilation engagement that omits substantially all disclosures, either the review engagement or the compilation engagement should be selected. The reviewer should not select any of partner E's preparation engagements unless one of the requirements listed in paragraph .104 of the standards cannot otherwise be met.

## Impact of SQCS No. 8 on Engagement Reviews

**109-1 Question**—Paragraph .109 of the standards notes that an Engagement Review does not include a review of other documentation prepared on the

engagements submitted for review (other than the documentation referred to in paragraphs .107–.108), tests of the firm's administrative or personnel files, interviews of selected firm personnel, or other procedures performed in a System Review. Should or may the review captain obtain or make inquiries regarding a firm's written quality control policies and procedures during an Engagement Review? Would a firm's failure to have its quality control policies and procedures documented result in an individual engagement being deemed not performed or reported on in conformity with applicable professional standards, even if there are no other matters, findings, or deficiencies noted on the engagement?

*Interpretation*—SQCS No. 8 states that firms should document their quality control policies and procedures and that 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.

However, the objective of an Engagement Review is to evaluate whether engagements submitted for review are *performed and reported on* in conformity with applicable professional standards in all material respects. An Engagement Review consists of reading the financial statements or information submitted by the reviewed firm and the accountant's report thereon, together with certain background information and representations the applicable documentation required by professional standards. An Engagement Review does not provide the review captain with a basis for expressing any form of assurance on the firm's system of quality control (which is what the documentation requirements are related to).

Further, AR section 100 paragraph .72 states, "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 SSARS." This is also consistent with the SSAEs (and SASs).

Therefore, if reading the firm's documented quality control policies and procedures or the inability for the review captain to do so has no impact on whether the actual engagements submitted for review are performed and reported on in conformity with SSARS and the SSAEs in all material respects, reading the documented quality control policies and procedures would only appear to give a review captain the insight concerning the *underlying cause* concerning why a matter, finding, or deficiency occurred. Although this may be useful information in preparing MFCs or FFCs, the systemic reasons for these items are beyond the scope of an Engagement Review.

Therefore, obtaining or reviewing a firm's documented quality control policies and procedures would not be applicable to Engagement Reviews.

Although the standards allow for "reading the applicable documentation required by professional standards," and the SQCSs are a part of professional standards, it might appear that the standards do not prohibit the reviewer from obtaining and reading the firm's documented quality control policies and procedures; however, it is deemed as beyond the scope of an Engagement Review.

SQCS No. 8 also states that 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 the "Independence" topic (ET sec. 1.200) which includes the "Independence Rule" (ET sec. 1.200.001) and its related interpretations and the rules of state boards of accountancy and applicable regulatory agencies. Written confirmation may be in paper or electronic form. Analogous to the preceding situation, obtaining or reviewing a firm's written independence confirmations would not

be applicable to Engagement Reviews because the requirement is imbedded in the SQCSs and not a procedure required by SSARs or the SSAEs.

## Qualifying for Service as a Peer Review Committee Member, Report Acceptance Body Member, or Technical Reviewer

**132-1 Question**—Paragraphs .132 and .136 of the standards note that minimum requirements must be met to be a peer review committee member, a report acceptance body member, or a technical reviewer. What are those requirements?

*Interpretation—*

### *Peer Review Committee Member*

A majority of the peer review committee members and the chairperson charged with the overall responsibility for administering the program at the administering entity should possess the qualifications required of a team captain in a System Review. A committee member who is suspended or restricted from scheduling or performing peer reviews no longer meets the qualifications until such suspension or restriction is removed. Reinstatement as a committee member would be at the discretion of the administering entity or committee.

### *Report Acceptance Body Member*

Each member of an administering entity's report acceptance body charged with the responsibility for acceptance of peer reviews should

- a. be currently active in public practice at a supervisory level in the accounting or auditing function of a firm enrolled in the program, as a partner of the firm, or as a manager or person with equivalent supervisory responsibilities. To be considered currently active in the accounting or auditing function, a reviewer should be presently involved in the accounting or auditing practice of a firm supervising one or more of the firm's accounting or auditing engagements or carrying out a quality control function on the firm's accounting or auditing engagements.
- b. be associated with a firm (or all firms if associated with more than one firm) that has received a report with a peer review rating of *pass* on its most recently accepted System or Engagement Review that was accepted timely, ordinarily within the last 3 years and 6 months (see Interpretation No. 31b-1).
- c. demonstrate proficiency in the standards, interpretations, and guidance of the program (see Interpretation No. 33-1).

A majority of the report acceptance body members and the chairperson charged with the responsibility for acceptance of System Reviews should possess the qualifications required of a System Review team captain.

A national list of consultants will be maintained by the AICPA, so that the administering entity has an available pool of consultants with GAS, ERISA, FDI-CIA, carrying broker-dealer, and service organization experience to call upon in the instance when it does not have an experienced RAB member to consider the review of a firm when circumstances warrant. The national RAB consultant would not necessarily have to participate physically in the RAB meeting (teleconference option). The national RAB consultant will not be eligible to vote on the acceptance of a review. Determination that a review requires a national RAB consultant should be made prior to assigning the review to a RAB. The

national RAB consultant would have to meet the following qualifications for RAB participation:

- a. Currently active in public practice at a supervisory level in the accounting or auditing function of a firm enrolled in the program, as a partner of the firm, or as a manager or person with equivalent supervisory responsibilities. To be considered currently active, a consultant should be presently involved in the supervision of one or more of his or her firm's accounting or auditing engagements or carrying out a quality control function on the firm's accounting or auditing engagements. To be considered a consultant on GAS, ERISA, FDICIA, carrying broker-dealer or service organization engagements, the current activity must include the respective industry asked to consult upon.
- b. Associated with a firm (or all firms, if associated with more than one firm) that has received a report with a peer review rating of *pass* on its most recently accepted System Review that was accepted timely, ordinarily within the last three years and six months.
- c. Not associated with an engagement that was deemed not performed in accordance with professional standards on the consultant's firm's most recently accepted System Review.

A report acceptance body member who is suspended or restricted from scheduling or performing peer reviews no longer meets the qualifications until such suspension or restriction is removed. Reinstatement as a report acceptance body member would be at the discretion of the administering entity or committee.

#### *Technical Reviewers*

Each technical reviewer charged with the responsibility for performing technical reviews should

- a. demonstrate proficiency in the standards, interpretations, and guidance of the program applicable to the type of peer reviews being evaluated and that meet the requirements of the team captain or review captain training requirements established by the board (see Interpretation No. 33-1).
- b. participate in at least one peer review each year, which may include participation in an on-site oversight of a System Review.
- c. have an appropriate level of accounting and auditing knowledge and experience suitable for the work performed. Such knowledge may be obtained from on-the-job training, training courses, or a combination of both. Technical reviewers are to obtain a minimum amount of CPE to maintain the appropriate level of accounting and auditing knowledge.

If a technical reviewer does not have such knowledge and experience, the technical reviewer may be called upon to justify why he or she should be permitted to perform technical reviews or oversights. The administering entity has the authority to decide whether a technical reviewer's knowledge and experience is sufficient and whether he or she has the capability to perform a particular technical review or oversight whether there are high-risk engagements involved or other factors.

The fundamental purpose of CPE is to maintain or increase, or both, professional competence. AICPA members are required to participate in 120 hours of CPE every 3 years. In order to maintain current knowledge of accounting,

auditing, and quality control standards, technical reviewers should obtain at least 40 percent of the AICPA-required CPE in subjects relating to accounting, auditing, and quality control. Technical reviewers should obtain at least 8 hours in any 1 year and 48 hours every 3 years in subjects relating to accounting, auditing, and quality control. The terms *accounting*, *auditing*, and *quality control* should be interpreted as CPE that would maintain current knowledge of accounting, auditing, and quality control standards for engagements that fall within the scope of peer review as described in paragraphs .06–.07 of the standards.

Technical reviewers have the responsibility of documenting their compliance with the CPE requirement. They should maintain detailed records of CPE completed in the event they are requested to verify their compliance. The reporting period will be the same as that maintained for the AICPA.

A technical reviewer who is also a peer reviewer and is suspended or restricted from scheduling or performing peer reviews no longer meets the qualifications until such suspension or restriction is removed. Reinstatement as a technical reviewer would be at the discretion of the administering entity or committee.

## Accepting Engagement Reviews by the Technical Reviewer

**137-1 Question**—The standards and interpretations indicate that the technical reviewer should be delegated the authority from the committee to accept Engagement Reviews in certain circumstances. What are those circumstances?

*Interpretation*—The technical reviewer should be delegated the authority from the committee to accept Engagement Reviews on the committee's behalf when the technical reviewer determines that any MFC forms prepared only relate to compilations under SSARs, that no MFC forms should have been prepared except as related to compilations under SSARs, and there are no other issues associated with the peer review warranting committee consideration or action that could potentially affect the results of the peer review.

The technical reviewer may identify reviewer feedback that should be considered and approved by the peer review committee prior to issuance. The technical reviewer should still be delegated the authority from the committee to accept Engagement Reviews on the committee's behalf when such feedback may be provided to the review captain unless the circumstances leading up to the feedback may have affected the results of the review. Accordingly, if the feedback being provided to the review captain involves issues which could potentially affect the results of the peer review, the technical reviewer should not accept the Engagement Review but present it to the committee for consideration.

## Cooperating in a Peer Review—Implementation Plans and Correction Action Plans

**143-1 Question**—Paragraph .143 of the standards notes that an implementation plan in addition to the plan described by the firm in its responses on the FFC forms may be requested by the administering entity's peer review committee. Can this plan only be requested when a report with a rating of *pass* has been issued?

*Interpretation*—No, an implementation plan may be requested whether a report with a rating of *pass*, *pass with deficiency*, or *fail* is issued for any findings that were only raised to the level of a FFC and did not get elevated further. Thus, it is possible to have a required corrective action as a condition of acceptance of the

peer review stemming from a report with a rating of *pass with deficiencies* or *fail* and a required implementation plan as a condition of cooperation (unrelated to the acceptance of the review) for the findings included in the FFCs.

## Publicizing Peer Review Information

**146-1 Question**—Paragraph .146 of the standards discusses that neither the administering entity nor the AICPA shall make the results of the review available to the public, except as authorized or permitted by the firm under certain circumstances. What are examples of those circumstances?

*Interpretation*—A firm may be a voluntary member of one of the AICPA's audit quality centers or sections that has a membership requirement such that certain peer review documents be open to public inspection. Other firms may elect not to opt out of the program's process for voluntary disclosure of peer review results to state boards of accountancy where the firm's main office is located. Also, firms may voluntarily instruct their administering entity to make the peer review results available to certain other state boards of accountancy. In these cases, the firm permits the AICPA or administering entities to make their peer review results available to the public or to state boards of accountancy, respectively.

Peer review results include, as applicable, the

- peer review report;
- letter of response;
- acceptance letter;
- letter(s) signed by the reviewed firm indicating that the peer review documents have been accepted with the understanding that the reviewed firm agrees to take certain actions; and
- letter notifying the reviewed firm that certain required actions have been completed.

**146-2 Question**—Paragraph .146 of the standards discusses that neither the administering entity nor the AICPA shall make the results of the review available to the public except as authorized or permitted by the firm, which is addressed in Interpretation No. 146-1. When a firm is enrolled in the program, what information, in addition to results, may be provided to the AICPA Professional Ethics Division with the firm's explicit permission?

*Interpretation*—When there is evidence of an open ethics investigation and the respondent makes a knowingly, intelligent, voluntary waiver of the right to confidentiality in writing, in those circumstances, AICPA Peer Review may provide information to the AICPA Professional Ethics Division. Information available for disclosure about the firm includes, but is not limited to, the following:

- Fieldwork commencement date
- Exit conference date
- Review acceptance date(s)
- Industries included on the firm's background form for prior or current peer reviews
- Level of service and industry of engagements included in prior or current peer reviews and those determined not to be in conformity with professional standards in all material respects

- Signed confirmations by a firm representative that the enrolled firm did not perform any services or issue reports which would require the firm to undergo a peer review
- Other similar information related to a prior or current peer review

## Peer Reviewers' Performance and Cooperation

**147-1 Question**—A team captain, review captain, or reviewer (hereinafter, reviewer) has a responsibility to perform a review in a timely, professional manner. What happens when a reviewer fails to perform the review in a timely and professional manner?

*Interpretation*—When a reviewer fails to perform the review in a timely and professional manner, the reviewer may be deemed as not cooperating. Such situations might include, but are not limited to, the following:

- Failure to submit the report; FFC forms, if applicable; and required peer review documents to the administering entity within the required specified time
- Failure to respond or resolve questions from the technical reviewer or committee or RAB within the specified time including requests for additional procedures such as the expansion of scope on the review
- Failure to revise the report and FFC forms, if applicable, as requested by the committee or RAB
- Failure to respond to requests for documents (in addition to those originally required to be submitted) or requests to complete documents
- Failure to submit peer review documents and other information for oversight
- Failure to update or verify reviewer resume on a periodic basis

Situations such as those previously indicated, arise when the reviewer fails to cooperate with the administering entity. This development warrants communication to the reviewer and may result in his or her potential suspension from scheduling peer reviews.

**148-1 Question**—The board or committee may consider the need to impose corrective actions on the service of the reviewer. What are examples of corrective actions?

*Interpretation*—The board or committee may require the reviewer to comply with certain prescribed actions in order for the reviewer to continue performing peer reviews, such as (but not limited to) the following:

- a. Oversight at the discretion of an administering entity until evidence of attendance at a future reviewer's training or accounting or auditing course(s) is received or performance improves.
- b. Having committee oversight on the next review(s) performed by the reviewer at the expense of the reviewer's firm (including out-of-pocket expenses, such as cost of travel).
- c. Completing all reviews to the satisfaction of the committee including submitting all reports and appropriate documentation on all outstanding peer reviews before scheduling or performing another review, thus limiting the number of reviews that the reviewer may schedule or have open at one time.

- d. Having pre-issuance review(s) of the report and peer review documentation on future peer reviews by an individual acceptable to the committee chair or designee who has experience in performing peer reviews.
- e. Consultations with the administering entity to discuss the planning and performance of the next review.
- f. Remove or revise rsum code until appropriate proof of experience and knowledge have been provided to the satisfaction of the committee.

**149-1 Question**—When one or more corrective actions are imposed on a reviewer, the administering entity will inform the board and may request that the board ratify the action(s) to be recognized by other administering entities. When can these actions be imposed by other administering entities without board ratification?

*Interpretation*—When the reviewer is notified of performance issues through deficiency letters, corrective actions or restrictions placed upon the reviewer. For reviewers who perform reviews in multiple administering entities, any corrective action or restriction included in a deficiency letter should be considered by other administering entities regarding whether they want to enforce the action or restriction on all or some reviews performed by the reviewer in their jurisdiction.

**151-1 Question**—When the board or committee require the reviewer to comply with such actions and the reviewer fails to correct the poor performance or refuses to cooperate, what procedures should be followed?

*Interpretation*—The committee or board must assess if the reviewer is making a reasonable effort to improve performance. After being provided reasonable time to improve performance, if the prescribed actions are not resulting in the necessary performance improvements, the committee or board may determine that the reviewer's action warrant board consideration. If a reviewer is referred to the board, the board will consider whether the reviewer should be prohibited from performing reviews or whether some other action should be taken.

## Independent QCM Reviews

**159-1 Question**—Paragraph .159 of the standards refers to an affiliate or related entity as considerations in determining whether the QCM review is required. What does affiliate mean in this context, and how can an affiliate relationship lead to a required QCM review?

*Interpretation*—For QCM review purposes, a CPA firm has an affiliate relationship with another entity if the firm controls or has the power to control the other entity (or vice versa), if there is mutual ownership of the firm and the other entity, or if a third party controls or has the power to control both the firm and other entity. If a CPA firm is affiliated with an entity that is a provider of QCM, and the CPA firm performs peer reviews of other firms, the CPA firm is considered a provider firm. The CPA firm's independence will be impaired to perform peer reviews of firms that use the QCM sold by the affiliate, unless an independent review on the QCM is completed.

**161-1 Question**—The standards note that in the event of substantial changes in a provider's system of quality control to develop and maintain materials, or substantial changes in the materials themselves, the provider should consult with the National PRC to determine whether an accelerated QCM review is warranted. What are factors that the National PRC will consider in making this determination?

*Interpretation*—The National PRC will consider the following (at a minimum) in determining whether the provider should have an accelerated review:

- The reasons for and types of changes in the system, the resultant materials, or both
- The period of time since the last QCM review
- The rating of the last QCM report

If the provider is a provider firm that performs peer reviews of user firms, and the provider firm's system of quality control or the resultant materials underwent substantial changes, it may be necessary for the provider firm to have an accelerated QCM review in order to maintain independence with respect to user firms.

**166-1 Question**—Paragraph .166 of the standards indicates that the National PRC will consider other factors (in addition to the qualifications set forth in the paragraphs under "Organizing the System or Engagement Review Team" and "Qualifying for Service as a Peer Reviewer") in determining whether a peer reviewer is appropriately qualified to perform a QCM peer review. What are the other considerations?

*Interpretation*—The National PRC, as the administering entity for QCM reviews, establishes the qualifications necessary to perform a QCM review. In addition to the peer reviewer qualifications set forth in paragraphs .26–.35 of the standards, reviewers of QCM must have relevant and current industry experience in their own firm. The National PRC will also consider the history and nature of reviewer feedback, AICPA or administering entity-imposed peer reviewer restrictions, and other pertinent factors.

Subsequent to the approval of a QCM reviewer, situations may arise that causes the QCM reviewer to no longer meet the qualifications for serving as a QCM reviewer. Such situations include, but are not limited to, the following:

- Suspension or termination of AICPA membership
- Change in the status of the reviewer's CPA license from active status
- Eligibility criteria in paragraph .31 of the standards to serve as a peer reviewer are no longer met
- Communications from regulatory, monitoring, or enforcement bodies relating to allegations or investigations of the peer reviewer's firm's accounting and auditing practice or notifications of limitations or restrictions on the peer reviewer's firm's right to practice

It is the responsibility of the provider to ensure that QCM review team members continue to meet the qualifications. Peer reviewers that have a conflict of interest with respect to the QCM under review will not be approved as a QCM review team member. Examples of individuals with conflicts of interest include someone who assisted in the materials' development or maintenance process, uses the materials as an integral part of his or her firm's system of quality control, or is an individual from a firm that is a member of the association whose materials are under review.

**167-1 Question**—Paragraph .167 of the standards requires the provider to identify the specific materials subject to the QCM review that will be opined upon in the report. What should be identified?

*Interpretation*—QCM are materials that are suitable for adoption by a firm as an integral part of that firm's system of quality control. Such materials provide guidance to assist firms in performing and reporting in conformity

with professional standards and may include, but are not limited to, such items as engagement aids, including accounting and auditing manuals, checklists, questionnaires, work programs, computer-aided accounting and auditing tools, and similar materials intended for use by accounting and auditing engagement teams.

The provider determines the specific QCM included in scope. The scope is applicable to the substance and content of the specified QCM regardless of the different formats or media through which it could be available (print or electronic), unless specified by the provider. Further, QCM (for instance, a guide) will often have different elements, such as written guidance, practice aids, letter templates, sample completed aids or templates, and continuing professional education modules. Some of these elements may be excluded from the scope of the review. Elements may be marketed by the provider separately as well. If not excluded from the scope of the review, then the separately marketed element QCM is also within the scope of the QCM review. However, if only the element (for example, practice aids) is opined on in the QCM review report, then the other elements of the QCM (written guidance, letter templates, and so on) are not included in the scope of the QCM review.

The provider and QCM reviewer should document during planning the specific QCM, elements, and formats or media (if not all) that will be included in the scope of the QCM review (for instance, within an engagement letter). Those specifics will later be incorporated into the QCM review report by the QCM reviewer. Carefully documenting the scope of a QCM review is an important step to ensure that the scope is clear to QCM report users.

**175-1 Question**—In a QCM review, the standards note that the QCM review team determines and documents the extent to which individual manuals, guides, checklists, practice aids, and so on are reviewed. What should the QCM reviewer consider when making this judgment?

*Interpretation*—Because the QCM review report opines on both the quality control system and the specific materials or aids listed in the report, all those materials or aids listed must be tested to some extent in order to support the opinion. However, the QCM reviewer can judgmentally determine the extent of testing or review procedures necessary on each aid. Considerations include areas within the materials or aids that address new guidance or changes in professional standards, areas that address procedures that rely heavily on judgment, or areas that contain methodology unique to the materials reviewed or unique interpretations of professional standards or other guidance. The assessment of the provider's system, including the review and editorial process, update and revision procedures, and so on should also factor into the QCM reviewer's judgment. The QCM reviewer's considerations for determining the extent of testing necessary for the materials or aids should be documented in the risk assessment. In addition, the QCM review working papers should document the actual testing or review procedures performed for each aid.

**176-1 Question**—Paragraph .176 of the standards discusses the QCM review team's assessment of whether the materials are reliable aids by assessing the level of instructions and explanatory guidance in the materials, and determining whether the methodology inherent in the materials is appropriate. What other information is available to further explain these considerations?

*Interpretation*—Many firms place a high degree of reliance on QCM, based on the nature and use of such materials. Because of this reliance, there are expectations that the materials are standalone aids, and use of the materials as designed by a professional with an appropriate level of experience and expertise, provides reasonable assurance to assist user firms in conforming with all of the

components which are integral to the applicable professional standards that the materials purport to encompass. Accordingly, the QCM review team should assess and document how the materials address each of these considerations in order to be reliable aids:

- a. Instructions should include, but are not limited to, the aids' applicability for different firms or clients (for example, based on size, industry, or engagement complexity; levels of experience or knowledge; and so on); a reminder for the need to tailor the materials as appropriate; and a reminder to use professional judgment in the application of the materials based on the facts and circumstances of each engagement. The instructions should also address the documentation requirements in professional standards, and specifically discuss whether completion of the aids will assist users with fulfilling those requirements.
- b. Guidance should be sufficient and technically accurate to assist users with conforming with the components that are integral to the professional standards that the materials purport to encompass, regardless of whether such standards are encompassed explicitly or implicitly. Explanatory guidance ranges from specific cross references to professional standards or directly quoting the standards, to explanations of the standards or integrating the verbiage of the standards into audit checklists or programs. QCM limited to audit program steps without explanatory guidance or specific reference to applicable professional standards would be considered insufficient and do not constitute reliable aids. In addition, materials that are industry specific should appropriately address the relevant professional standards and industry guidance from a completeness standpoint (for example, an aid that purports to assist users with performing risk assessment procedures for an ERISA engagement should include AU-C section 320, *Materiality in Planning and Performing an Audit* [AICPA, *Professional Standards*], considerations tailored to the industry; the reviewer should question if AU-C section 320 considerations are omitted).
- c. The methodology inherent in the materials (if applicable), including the provider's stance on the application of professional standards or alternative procedures, should be evaluated to determine if the methodology provides reasonable assurance to assist user firms in performing an engagement in conformity with the components that are integral to the applicable professional standards that the materials purport to encompass. This is especially important when the methodology addresses the treatment of unique transactions or accounts, contains unique interpretations of professional standards, incorporates elements of widely recognized and accepted industry practice when higher levels of guidance are not available, or suggests departures from professional standards in certain circumstances.

QCM reviewers should refer to section 3100 for additional illustrative guidance for reliable aids.

Aids either lacking or containing an insufficient level of instructions or guidance or that contain inappropriate methodology, should be further evaluated by the QCM review team to determine if the aids are reliable. The QCM review team should also evaluate the impact on the provider's system of quality control for

the development and maintenance of the aids. If an aid is deemed to not be a reliable aid, this should be reflected in a QCM review report with a rating of *pass with deficiencies* or *fail*, depending on the underlying cause of the issue.

Note that the intent of QCM is to assist in providing firms and practitioners with reasonable assurance of complying with professional standards as a part of their overall system of quality control. The independent review of such materials does not provide firms or practitioners with absolute assurance of compliance solely through reliance on the materials, nor is it intended to.

**199-1 Question**—Paragraph .199 of the standards discusses that providers that undertake to have a QCM review under these standards have a responsibility to cooperate with the QCM review team, the National PRC, and the board in all matters related to the QCM review. How does the guidance at Interpretation No. 5h-1, "Cooperating in a Peer Review," apply to QCM providers?

**Interpretation**—Providers (paragraph .159) have a responsibility to cooperate with the QCM review team, the National PRC, and the board in all matters related to the QCM review in order for the review to be presented and accepted by the National PRC.

A provider is deemed by the National PRC as failing to cooperate once the review has commenced by actions or omissions including, but not limited to, the following:

- Not responding to inquiries.
- Withholding information significant to the QCM review (for instance, failing to discuss communications received by the provider or any of its authors and their firms, if applicable, relating to allegations or investigations in the conduct of accounting, auditing, or attestation engagements from regulatory, monitoring, or enforcement bodies).
- Not providing documentation including, but not limited to, the representation letter, documentation of the system of quality control, the QCM under review, or all aspects of functional areas as applicable to QCM reviews.
- Not timely responding to MFCs or FFCs, or not timely providing a letter of response.
- Not providing a substantive response to MFCs, FFCs, deficiencies or significant deficiencies. The National PRC has the authority to determine if a provider's response is substantive. If the National PRC determines that a response is not substantive, and the provider does not revise its response or submits additional responses that are not substantive as determined by the National PRC, this would also be deemed as a provider's failure to cooperate.
- Limiting access to offices, personnel or other.
- Not facilitating the arrangement for the exit conference on a timely basis.
- Failing to cooperate during oversight.
- Failing to timely pay fees related to the administration of the program that have been authorized by the National PRC.
- Failing to receive a report with a rating of *pass* after (1) receiving at least two consecutive peer reviews prior to the third that had a report with a QCM review rating of *pass with deficiencies* or

*fail* (previously referred to as modified or adverse reports) and (2) receiving notification via certified mail after the second consecutive report with a QCM review rating of *pass with deficiencies* or *fail* (previously referred to as modified or adverse reports) that a third consecutive failure to receive a report with a QCM review rating of *pass* (previously referred to as an unmodified report) may be considered a failure to cooperate with the National PRC.

- Providing erroneous information or omitting information discovered after acceptance of the provider's review that results in a significant change in the planning, performance, evaluation of results, or QCM review report. The National PRC has the authority to determine if this has occurred. The provider's failure to provide substantive responses during the process of resolving such an issue may also be deemed as a provider's failure to cooperate.

If the National PRC believes there is noncooperation, it will conduct a hearing to determine if the provider should be deemed by the National PRC as failing to cooperate. If the provider is deemed as failing to cooperate, the National PRC at its sole discretion may refuse to continue to administer the QCM review, even though the review has commenced.

The National PRC may also, at its sole discretion, without a hearing, refuse to administer future QCM reviews for a provider that has outstanding fees related to the administration of the program that have been authorized by the National PRC, after reasonable collection efforts have been made.

For any situations where the National PRC has the sole discretion to take or refuse to take an action, there is no subsequent appeal to any other body. The decision of the National PRC is final. However, if a provider resolves the issue(s) that led to its previous noncooperation to the National PRC's satisfaction, or remits full payment of outstanding fees related to a previous QCM review, the provider may request that the National PRC continue or commence administration of the QCM review(s). The National PRC will consider all available information including the provider's input, but also has the sole discretion to approve or deny the request depending on whether the National PRC believes the issue(s) were resolved to the satisfaction of the National PRC.

A provider may decide to withdraw from the review process after the review's commencement; however, a provider firm that decides to withdraw from the review process after the review's commencement is no longer independent to perform peer reviews of user firms. If a provider withdraws from the process after the review commences, the National PRC has the sole discretion to refuse to administer future QCM reviews for that provider.

Corrective actions (relating to the deficiencies or significant deficiencies noted in the QCM report) or implementation plans (relating to findings on the FFC form[s]) do not apply to QCM providers. QCM providers are required to provide responses that are comprehensive, genuine, feasible, and substantive to MFCs, FFCs, and deficiencies and significant deficiencies and the level of responsiveness affects the QCM's reliability (and marketability).

**200-1 Question**—Paragraph .200 of the standards states that if a provider refuses to cooperate during the course of a QCM review, the provider's firm's independence with respect to user firms may be impaired. Under what circumstances would the provider's independence with respect to user firms be impaired due to noncooperation?

**Interpretation**—If the required QCM review documents are not submitted by the due date due to the provider's noncooperation, the provider's independence with respect to user firms will be impaired and the provider will not be permitted

to perform or schedule future peer reviews of user firms until the provider's QCM review is completed (see Interpretation No. 25-2).

Once all the required QCM review documents have been submitted timely but before the report has been accepted, the National PRC may make whatever inquiries or initiate whatever actions of the provider or QCM review team it considers necessary under the circumstances. The National PRC will set a date by which responses to inquiries and evidence of completion of required actions must be received. If, as a result of noncooperation by the provider, inquiries or required actions remain unresolved as of the due date established by the National PRC, the provider's independence with respect to user firms will be impaired and the provider will not be permitted to perform or schedule future peer reviews of user firms until the provider's QCM review is completed.

## Definition of Commencement

**206-1 Question**—There are a number of instances in which the standards and interpretations refer to the "commencement" date of a review to determine whether a situation applies. Some examples are cooperating in a peer review (Interpretation No. 5h-1), approval of the review team by the administering entity (Interpretation No. 30-1), provision of the surprise engagement to the firm (Interpretation No. 61-1) and when the standards are effective for a firm's peer review (paragraph .206 of the standards). What is meant by "commencement"?

*Interpretation*—Interpretation No. 5g-1 notes that "A peer review commences when the review team begins field work, ordinarily at the reviewed firm's office in a System Review, or begins the review of engagements in an Engagement Review." The easiest measure is "when fieldwork begins." However, there are times when this may not apply. Therefore, Interpretation No. 32-1 further notes that "team members may review their engagements prior to the team captain or review captain beginning their field work. In these situations, a review is considered to have commenced when the team member begins the review of engagements (if this is prior to the team captain or review captain beginning their fieldwork)." In certain circumstances, fieldwork may commence before the review of engagements, such as during planning.

The significance of this enhanced definition of "commencement" is emphasized by how it affects a firm's ability to resign from the program once a review commences. Once a team captain, review captain or team member learns information that affects the results of the review, the review is deemed to have commenced. Some examples are if the team captain identifies a design deficiency, or learns about the firm's noncompliance with state board of accountancy licensing requirements, during planning. Another example is the identification of a finding during a team member's review of a specialized industry at a location other than the reviewed firm's offices, prior to the team captain beginning fieldwork at the reviewed firm's offices.

As indicated in Interpretation No. 5g-1, a firm whose peer review has commenced may not resign from the program unless certain steps are followed which include the firm evidencing their noncooperation with the program and the AICPA publishing notice of the action so that the public interest is served.

## Firm Representations

**208-1-1 Question**—Paragraph .208(1) (appendix B) of the standards advises that the firm is not prohibited from making additional representations beyond the required representations, in its representation letter to the team

captain or review captain. What parameters should be used in expanding the representation letter?

*Interpretation*—The representation letter is not intended to be onerous for the reviewed firm. Allowing reviewers to add whatever they want to the representation letter would make it very difficult to maintain consistency in the program. In addition, this becomes a very important issue because a firm's failure to sign the representation letter may be considered noncooperation.

However, at a minimum the representation letter should comply with the spirit of the guidance, there is value to the reviewer of obtaining certain representations in writing. Thus, if during the review, something comes to the reviewer's attention whereby the reviewer believes the reviewed firm is providing contradicting or questionable information, the reviewer should investigate the matter further and may consider having the firm include the matter in the representation letter.

## Firm and Individual Licenses

**208-1a-1 Question**—Paragraph .208(1)(a) (appendix B) of the standards advises that firms include representations to the team captain or review captain concerning when management is aware that the firm or its personnel has not complied with the rules and regulations of state board(s) of accountancy or other regulatory bodies (including applicable firm and individual licensing requirements in each state in which it practices for the year under review). What further guidance should be followed in regards to firm and individual licenses?

*Interpretation*—SQCS No. 8 requires firms to comply with "applicable legal and regulatory requirements", which includes firm and individual licensing requirements. Firms are required to comply with the rules and regulations of state boards of accountancy and other regulatory bodies in the states where they practice.

For System Reviews, the team captain should also obtain an understanding of the firm's system of quality control with respect to firm and individual licensing.

As a part of a System or Engagement review, reviewers should make inquiries of the firm to determine if the firm and its personnel are appropriately licensed as required by the state boards of accountancy in the state(s) in which the firm and its personnel practice. In addition, firms should submit written representations from the firm's management indicating compliance with such required rules and regulations. If the reviewed firm is aware of any situation whereby it is not in compliance with the rules and regulations of the state boards of accountancy or other regulatory bodies, it should tailor the representation letter to provide information on the areas of noncompliance.

To support the firm's responses and representations, a reviewer is required to verify the following:

- The *practice unit* license (firm license) in the state in which the practice unit is domiciled (main office is located).
- Individual (personnel) licenses in the state in which the individual primarily practices public accounting
  - For System Reviews, for a sample of appropriate personnel
  - For Engagement Reviews, for appropriate personnel on engagements selected

The reviewer should verify the license by requiring the firm to provide documentation from the licensing authority that the license is appropriate and active

during the peer review year, and through the earlier of reviewed engagements' issuance dates or the date of peer review fieldwork. Acceptable documentation includes an original or copy of the license, print-out from an on-line license verification system, correspondence from the licensing authority, or other reasonable alternative documentation. The reviewer's judgment may be needed to determine what alternative documentation is reasonable.

A reviewer is not required to verify an out-of-state practice unit license or an out-of-state individual license, on an individual engagement basis when that engagement is selected for review and was performed by the reviewed firm in another state requiring a firm or individual license. However, in a System Review, the reviewer's understanding of the firm's quality control procedures related to licensing, and the related risk of noncompliance, are considerations in determining whether any further testing is appropriate. In an Engagement Review, the reviewer should consider the firm's responses to inquiries in determining whether any further procedures are appropriate.

It is the reviewed firm's responsibility to have understood and complied with its licensing requirements. Therefore it should be prepared to respond to the reviewer's inquiries and requests for documentation. This is also important for out-of-state firm and individual licenses when licensing requirements may be more difficult to identify and understand. When the reviewer deems it appropriate to test out-of-state licenses, the reviewer should expect the firm to provide documentation supporting its compliance with, or approach to, out-of-state licensing requirements. AICPA on-line CPA mobility provisions may be used to assist the reviewer in evaluating the firm's approach to firm and individual out-of-state licensing.

The reviewer should analyze the information obtained through inquiry and in the written representation letter to determine the impact on the peer review.

## Communication of Report Acceptances

**208-1a-2 Question**—In furtherance to Interpretation No. 208-1a-1, what additional guidance should be followed in regards to firm and individual licenses?

*Interpretation*—Firms are required to comply with the rules and regulations of state boards of accountancy and other regulatory bodies in the state where they practice. Therefore, a state board of accountancy may be sent a list of firms with *accepted* peer reviews ("accepted" as defined in the Interpretations to the standards) in a given period which would allow the state board of accountancy to verify that firms undergoing peer review are licensed in that state.

Entities administering the AICPA Peer Review Program are not prohibited outside of the peer review process from gathering information from firms and communicating to the state boards of accountancy on licensure compliance matters.

## Communications Received by the Reviewed Firm Relating to the Conduct of Engagements From Regulatory, Monitoring, or Enforcement Bodies

**208-1b-1 Question**—Paragraph .208 (paragraph 1(b) and (e) of appendix B) of the standards discusses the reviewed firm's requirement to inform the

reviewer of communications or summaries of communications from regulatory, monitoring, or enforcement bodies relating to allegations or investigations of deficiencies in the conduct of an accounting, auditing, or attestation engagement performed and reported on by the firm. What are the objectives of this requirement and what are some examples, although not an all-inclusive list, of such communications?

*Interpretation*—The objective of the firm informing its reviewer of such communications or summaries of communications is to enhance the risk-based approach to peer review by allowing the reviewer to better plan and perform the review, including engagement, industry, office, and owner selection that should be given greater emphasis in the review. It is expected that the reviewer and the firm will discuss these communications and that the firm will be able to submit the actual documentation to the reviewer in those circumstances that the reviewer deems appropriate. The reviewed firm is not required to submit confidential documents to the reviewer but should be able to discuss the relevant matters and answer the reviewer's questions.

It is also expected that the reviewer and firm will discuss notifications of limitations or restrictions on the reviewed firm's ability to practice public accounting by regulatory, monitoring or enforcement bodies.

There are many types of communications that are appropriately related to meeting the objectives described in this interpretation. The following list, which is not intended to be all inclusive, represents examples of the types of organizations where communications would be relevant to meeting the objectives of the requirement:

- a. AICPA or State CPA Society Ethics Committees
- b. AICPA Joint Trial Board
- c. State boards of accountancy
- d. SEC
- e. PCAOB
- f. State auditor
- g. Department of Labor
- h. Employee Benefits Security Administration
- i. Government Accountability Office
- j. Office of Management and Budget
- k. Department of Housing and Urban Development
- l. FDIC
- m. Office of Thrift and Supervision
- n. Federal or State Inspector General's Offices
- o. Rural Utility Service
- p. Other governmental agencies or other organizations that have the authority to regulate accountants (in connection with the firm's accounting, auditing, or attestation engagements)

**208-1b-2 Question**—What if a reviewed firm chooses not to discuss or make such communications or notifications available to the reviewer during the review?

*Interpretation*—If a firm fails to discuss such communications with the reviewer, the reviewer should immediately consult with the relevant administering entity because this constitutes a failure to cooperate, and the firm would be subject to fair procedures that could result in the firm's enrollment in the program being terminated (see interpretations).

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## TS Section

# TAX SERVICES

## STATEMENTS ON STANDARDS FOR TAX SERVICES

The Statements on Standards for Tax Services (SSTSs) and interpretations, promulgated by the Tax Executive Committee, reflect the AICPA's standards of tax practice and delineate members' responsibilities to taxpayers, the public, the government, and the profession. The statements are intended to be part of an ongoing process that may require changes to and interpretations of current SSTSs in recognition of the accelerating rate of change in tax laws and the continued importance of tax practice to members. *Interpretation No. 1-2* was approved by the Tax Executive Committee on August 21, 2003; its effective date is December 31, 2003.

The SSTSs have been written in as simple and objective a manner as possible. However, by their nature, ethical standards provide for an appropriate range of behavior that recognizes the need for interpretations to meet a broad range of personal and professional situations. The SSTSs recognize this need by, in some sections, providing relatively subjective rules and by leaving certain items undefined. These terms and concepts are generally rooted in tax concepts, and therefore should be readily understood by tax practitioners. It is, therefore, recognized that the enforcement of these rules, as part of the AICPA's Code of Professional Conduct Rule 201, *General Standards* (ET sec. 201 par. .01), and Rule 202, *Compliance With Standards* (ET sec. 202 par. .01), will be undertaken with flexibility in mind and handled on a case-by-case basis. Members are expected to comply with them.

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## Preface

Standards are the foundation of a profession. The AICPA aids its members in fulfilling their ethical responsibilities by instituting and maintaining standards against which their professional performance can be measured. Compliance with professional standards of tax practice also reaffirms the public's awareness of the professionalism that is associated with CPAs as well as the AICPA.

This publication sets forth enforceable tax practice standards for members of the AICPA, Statements on Standards for Tax Services (SSTSs or statements) (sections 100–700). These statements apply to all members providing tax services regardless of the jurisdictions in which they practice. Interpretations of these statements may be issued as guidance to assist in understanding and applying the statements. The SSTSs and their interpretations are intended to complement other standards of tax practice, such as Treasury Department Circular No. 230, *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, Enrolled Retirement Plan Agents, and Appraisers before the Internal Revenue Service*; penalty provisions of the Internal Revenue Code; and state boards of accountancy rules.

The SSTSs are written in as simple and objective a manner as possible. However, by their nature, practice standards provide for an appropriate range of behavior and need to be interpreted to address a broad range of personal and professional situations. The SSTSs recognize this need by, in some sections, providing relatively subjective rules and by leaving certain terms undefined. These terms are generally rooted in tax concepts and, therefore, should be readily understood by tax practitioners. Accordingly, enforcement of these rules, as part of the AICPA's Code of Professional Conduct Rule 201, *General Standards* (ET sec. 201 par. .01), and Rule 202, *Compliance With Standards* (ET sec. 202 par. .01), will be undertaken on a case-by-case basis. Members are expected to comply with them.

## History

The SSTSs have their origin in the Statements on Responsibilities in Tax Practice (SRTPs), which provided a body of advisory opinions on good tax practice. The guidelines as originally set forth in the SRTPs became more important than many members had anticipated when the guidelines were issued. The courts, the IRS, state accountancy boards, and other professional organizations recognized and relied on the SRTPs as the appropriate articulation of professional conduct in a CPA's tax practice. The SRTPs became *de facto* enforceable standards of professional practice, because state disciplinary organizations and courts regularly held CPAs accountable for failure to follow the guidelines set forth in the SRTPs.

The AICPA's Tax Executive Committee concluded it was appropriate to issue tax practice standards that would become a part of the AICPA's *Professional Standards*. At its July 1999 meeting, the AICPA Board of Directors approved support of the executive committee's initiative and placed the matter on the agenda of the October 1999 meeting of the AICPA's governing Council. On October 19, 1999, Council approved designating the Tax Executive Committee as a standard-setting body, thus authorizing that committee to promulgate standards of tax practice. As a result, the original SSTSs, largely mirroring the SRTPs, were issued in August 2000.

The SRTPs were originally issued between 1964 and 1977. The first nine SRTPs and the introduction were promulgated in 1976; the tenth SRTP was issued in 1977. The original SRTPs concerning the CPA's responsibility to sign

the tax return (SRTP No. 1, *Signature of Preparers*, and No. 2, *Signature of Reviewer: Assumption of Preparer's Responsibility*) were withdrawn in 1982 after Treasury Department regulations were issued adopting substantially the same standards for all tax return preparers. The sixth and seventh SRTPs, concerning the responsibility of a CPA who becomes aware of an error, were revised in 1991. The first interpretation of the SRTPs, Interpretation No. 1-1, "Realistic Possibility Standard," was approved in December 1990. The SSTSs and Interpretation No. 1-1, "Realistic Possibility Standard," of SSTS No. 1, *Tax Return Positions* (sec. 100), superseded and replaced the SRTPs and their Interpretation No. 1-1, effective October 31, 2000. Although the number and names of the SSTSs, and the substance of the rules contained in each of them, remained the same as in the SRTPs, the language was revised to both clarify and reflect the enforceable nature of the SSTSs. In addition, because the applicability of these standards is not limited to federal income tax practice (as was the case with the SRTPs), the language was changed to indicate the broader scope. In 2003, in connection with the tax shelter debate, SSTS Interpretation No. 1-2, "Tax Planning," of SSTS No. 1 (sec. 100) was issued to clarify a member's responsibilities in connection with tax planning; that interpretation became effective December 31, 2003.

When the original SSTSs were issued, an effort was made to keep to a minimum any changes in the language of the SSTSs from that of the predecessor SRTPs. This was done to alleviate concerns regarding the enforceability of standards that differed from the SRTPs under which members had been practicing. Since the issuance of the original SSTSs, members have asked for clarification on certain matters, such as the duplication of the language in SSTS No. 6, *Knowledge of Error: Return Preparation*, and No. 7, *Knowledge of Error: Administrative Proceedings*. Also, certain changes in federal and state tax laws have raised concerns regarding the need to revise SSTS No. 1 (sec. 100). As a result, in 2008, the original SSTS Nos. 1–8 (sections 100–800) were updated, effective January 1, 2010. The original SSTS Nos. 6–7 were combined into the revised SSTS No. 6, *Knowledge of Error: Return Preparation and Administrative Proceedings* (sec. 600). The original SSTS No. 8, *Form and Content of Advice to Taxpayers*, was renumbered SSTS No. 7 (sec. 700). In addition, various revisions were made to the language of the original SSTSs.

## Ongoing Process

The following SSTSs and any interpretations issued thereunder reflect the AICPA's standards of tax practice and delineate members' responsibilities to taxpayers, the public, the government, and the profession. The statements are intended to be part of an ongoing process of articulating standards of tax practice for members. These standards are subject to change as necessary or appropriate to address changes in the tax law or other developments in the tax practice environment.

Members are encouraged to assess the adequacy of their practices and procedures for providing tax services in conformity with these standards. This process will vary according to the size of the practice and the nature of tax services performed.

The Tax Executive Committee promulgates the SSTSs and their interpretations. Acknowledgment is also due to the many members who have devoted their time and efforts over the years to developing and revising the AICPA's standards.

## TS Section 100

### Tax Return Positions

Source: SSTS No. 1

Effective date, unless  
otherwise indicated:  
January 2010

#### Introduction

**.01** This statement sets forth the applicable standards for members when recommending tax return positions, or preparing or signing tax returns (including amended returns, claims for refund, and information returns) filed with any taxing authority. For purposes of these standards

- a. a *tax return position* is (i) a position reflected on a tax return on which a member has specifically advised a taxpayer or (ii) a position about which a member has knowledge of all material facts and, on the basis of those facts, has concluded whether the position is appropriate.
- b. a *taxpayer* is a client, a member's employer, or any other third-party recipient of tax services.

**.02** This statement also addresses a member's obligation to advise a taxpayer of relevant tax return disclosure responsibilities and potential penalties.

**.03** In addition to the AICPA, various taxing authorities, at the federal, state, and local levels, may impose specific reporting and disclosure standards with regard to recommending tax return positions or preparing or signing tax returns.<sup>1</sup> These standards can vary between taxing authorities and by type of tax.

#### Statement

**.04** A member should determine and comply with the standards, if any, that are imposed by the applicable taxing authority with respect to recommending a tax return position, or preparing or signing a tax return.

**.05** If the applicable taxing authority has no written standards with respect to recommending a tax return position or preparing or signing a tax return, or if its standards are lower than the standards set forth in this paragraph, the following standards will apply:

- a. A member should not recommend a tax return position or prepare or sign a tax return taking a position unless the member has a good-faith belief that the position has at least a realistic possibility of being sustained administratively or judicially on its merits if challenged.

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<sup>1</sup> A member should refer to the current version of Internal Revenue Code Section 6694, *Understatement of taxpayer's liability by tax return preparer*, and other relevant federal, state, and jurisdictional authorities to determine the reporting and disclosure standards that are applicable to preparers of tax returns.

- b. Notwithstanding paragraph .05(a), a member may *recommend a tax return position* if the member (i) concludes that there is a reasonable basis for the position and (ii) advises the taxpayer to appropriately disclose that position. Notwithstanding paragraph .05(a), a member may *prepare or sign a tax return* that reflects a position if (i) the member concludes there is a reasonable basis for the position and (ii) the position is appropriately disclosed.

**.06** When recommending a tax return position or when preparing or signing a tax return on which a position is taken, a member should, when relevant, advise the taxpayer regarding potential penalty consequences of such tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**.07** A member should not recommend a tax return position or prepare or sign a tax return reflecting a position that the member knows

- a. exploits the audit selection process of a taxing authority, or
- b. serves as a mere arguing position advanced solely to obtain leverage in a negotiation with a taxing authority.

**.08** When recommending a tax return position, a member has both the right and the responsibility to be an advocate for the taxpayer with respect to any position satisfying the aforementioned standards.

## Explanation

**.09** The AICPA and various taxing authorities impose specific reporting and disclosure standards with respect to tax return positions and preparing or signing tax returns. In a given situation, the standards, if any, imposed by the applicable taxing authority may be higher or lower than the standards set forth in paragraph .05. A member is to comply with the standards, if any, of the applicable taxing authority; if the applicable taxing authority has no standards or if its standards are lower than the standards set forth in paragraph .05, the standards set forth in paragraph .05 will apply.

**.10** Our self-assessment tax system can function effectively only if taxpayers file tax returns that are true, correct, and complete. A tax return is prepared based on a taxpayer's representation of facts, and the taxpayer has the final responsibility for positions taken on the return. The standards that apply to a taxpayer may differ from those that apply to a member.

**.11** In addition to a duty to the taxpayer, a member has a duty to the tax system. However, it is well established that the taxpayer has no obligation to pay more taxes than are legally owed, and a member has a duty to the taxpayer to assist in achieving that result. The standards contained in paragraphs .04–.08 recognize a member's responsibilities to both the taxpayer and the tax system.

**.12** In reaching a conclusion concerning whether a given standard in paragraph .04 has been satisfied, a member may consider a well-reasoned construction of the applicable statute, well-reasoned articles or treatises, or pronouncements issued by the applicable taxing authority, regardless of whether such sources would be treated as *authority* under Internal Revenue Code Section 6662, *Imposition of accuracy-related penalty on underpayments*, and the regulations thereunder. A position would not fail to meet these standards merely because it is later abandoned for practical or procedural considerations during an administrative hearing or in the litigation process.

**.13** If a member has a good-faith belief that more than one tax return position meets the standards set forth in paragraphs .04–.05, a member's advice concerning alternative acceptable positions may include a discussion of

the likelihood that each such position might or might not cause the taxpayer's tax return to be examined and whether the position would be challenged in an examination. In such circumstances, such advice is not a violation of paragraph .07.

**.14** A member's determination of whether information is appropriately disclosed by the taxpayer should be based on the facts and circumstances of the particular case and the disclosure requirements of the applicable taxing authority. If a member recommending a position, but not engaged to prepare or sign the related tax return, advises the taxpayer concerning appropriate disclosure of the position, then the member shall be deemed to meet the disclosure requirements of these standards.

**.15** If particular facts and circumstances lead a member to believe that a taxpayer penalty might be asserted, the member should so advise the taxpayer and should discuss with the taxpayer the opportunity, if any, to avoid such penalty by disclosing the position on the tax return. Although a member should advise the taxpayer with respect to disclosure, it is the taxpayer's responsibility to decide whether and how to disclose.

**.16** For purposes of this statement, preparation of a tax return includes giving advice on events that have occurred at the time the advice is given if the advice is directly relevant to determining the existence, character, or amount of a schedule, entry, or other portion of a tax return.

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## TS Section 9100

# ***Tax Return Positions: Tax Services Interpretations of Section 100***

### **Notice to Readers**

The Statements on Standards for Tax Services (SSTSs) and interpretations, promulgated by the AICPA Tax Executive Committee (TEC), reflect the AICPA's standards of tax practice and delineate members' responsibilities to taxpayers, the public, the government, and the profession. The SSTSs are intended to be part of an ongoing process that may require changes to, and interpretations of, current SSTSs in recognition of the accelerating rate of change in tax laws and the continued importance of tax practice to members. The original Interpretations No. 1-1, "Realistic Possibility of Success," and No. 1-2, "Tax Planning," were adopted in 2000 and 2003, respectively, and updated in 2010. The TEC adopted the updated Interpretations No. 1-1, "Reporting and Disclosure Standards," and No. 1-2, "Tax Planning," on August 15, 2011, effective on January 31, 2012.<sup>1</sup>

The SSTSs have been written in as simple and objective a manner as possible. However, by their nature, ethical standards provide for an appropriate range of behavior that recognizes the need for interpretations to satisfy a broad range of personal and professional situations. The SSTSs recognize this need by, in some sections, providing relatively subjective rules and leaving certain terms undefined. These terms and concepts are generally rooted in tax concepts and, therefore, they should be readily understood by tax practitioners. It is, therefore, recognized that the enforcement of these rules, as part of the AICPA Code of Professional Conduct, Rule 201, *General Standards* (ET sec. 201 par. .01), and Rule 202, *Compliance With Standards* (ET sec. 202 par. .01), will be undertaken with flexibility in mind and handled on a case-by-case basis. Members are expected to comply with them.

### **Preface**

SSTS No. 1, *Tax Return Positions* (sec. 100), provides that a member should not recommend a tax return position or take a position on a tax return that the member prepares unless that position satisfies applicable reporting and disclosure standards. The tax laws of various taxing jurisdictions contain similar limitations on the ability to recommend or take certain tax return positions. This preface provides an overview of the most common tax return reporting

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<sup>1</sup> These interpretations do not consider any impact of Section 1409 of the Health Care and Education Reconciliation Act of 2010, P.L. 111-152 (Codification of Economic Substance Doctrine and Penalties). Under Section 7701(o) of the Internal Revenue Code (IRC), in the case of any transaction to which the economic substance doctrine is relevant, the transaction shall be treated as having economic substance only if the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such transaction. Understatements of tax attributable to a failure to satisfy the economic substance doctrine, where relevant, can result in substantial taxpayer penalties.

standards and issues to be considered in determining if the applicable reporting standards and disclosure requirements have been satisfied.

## Description of Various Reporting Standards

A brief description of the most common tax return reporting standards follows.<sup>2</sup>

**More likely than not.** The more likely than not standard generally is satisfied if it is reasonable to conclude in good faith that there is a greater than 50 percent likelihood that the position will be upheld on its merits if it is challenged.<sup>3</sup>

**Substantial authority.** The substantial authority standard is an objective standard and is satisfied if the weight of the authorities supporting the position is substantial in relation to the weight of authorities supporting a contrary treatment.<sup>4</sup> In practice, the substantial authority standard generally is interpreted as requiring approximately a 40 percent likelihood that the position will be upheld on its merits if it is challenged.<sup>5</sup>

**Realistic possibility of success.** The realistic possibility of success standard generally is satisfied if there is approximately a 1-in-3 (33 percent) likelihood that the position will be upheld on its merits if it is challenged.<sup>6</sup>

**Reasonable basis.** The reasonable basis standard is satisfied if the position is reasonably based on one or more authorities, taking into account the relevance and persuasiveness of those authorities. The reasonable basis standard is lower than the realistic possibility of success standard but is "significantly higher than not frivolous or not patently improper . . . [and] is not satisfied by a return position that is merely arguable or that is merely a colorable claim."<sup>7</sup> In practice, the reasonable basis standard generally is interpreted as requiring that there be approximately a 20 percent likelihood that the position will be upheld on its merits if it is challenged.<sup>8</sup>

## Nature of the Analysis

The analysis used in determining if a reporting standard has been satisfied should involve a well-reasoned application of the relevant authorities to all pertinent facts and circumstances. The weight to be given to a particular authority depends on its relevance and persuasiveness. For example, all else being

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<sup>2</sup> In some cases, the taxing authority may require that more than one standard be satisfied with respect to a return position. For example, in the case of a listed transaction or other reportable transaction with a significant tax avoidance purpose, a taxpayer penalty may apply under IRC Section 6662A unless the taxpayer reasonably believed the position satisfied the more likely than not standard, and the position does or did, in fact, satisfy the substantial authority standard.

<sup>3</sup> Treasury Regulation Section 1.6662-4(g)(4).

<sup>4</sup> Treasury Regulation Section 1.6662-4(d).

<sup>5</sup> Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring And Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) (July 22, 1999), 1:152.

<sup>6</sup> Treasury Regulation Section 1.6694-2(b) (prior to the revisions made by T.D. 9436, which became effective December 22, 2008).

<sup>7</sup> Treasury Regulation Section 1.6662-3(b)(3).

<sup>8</sup> Joint Committee on Taxation, *supra* at 152, assigns a 20 percent likelihood of success for the reasonable basis standard.

equal, more weight is given to a case or ruling that has facts similar to those at issue than to a case or ruling that has distinguishable facts. Similarly, more weight may be given to a case or ruling that provides an analysis of the facts and law, as opposed to one that merely states a conclusion. Assuming the same or similar issues, the type of authority also is significant; for example, more weight is given to a case or revenue ruling than to a private letter ruling issued to a third party, and more weight is given to an appellate court decision than to a lower court decision. For additional examples, see Treasury Regulation Section 1.6662-4(d)(3), which deals with the analysis used to determine if the substantial authority standard is satisfied for purposes of the federal taxpayer substantial understatement penalty.<sup>9</sup>

Note also that what constitutes an "authority" for purposes of the analysis can vary. For example, in determining if the realistic possibility of success standard and the reasonable basis standard of paragraph 5 of SSTS No. 1 have been satisfied, a member may rely on well-reasoned treatises, articles in recognized professional tax publications, and other reference tools and sources of analysis commonly used by tax advisers and return preparers. In contrast, these authorities cannot be relied upon in determining if the substantial authority or more likely than not standards have been satisfied for purposes of Internal Revenue Code (IRC) Section 6662 (or 6694).

## Appropriate Disclosure

In some instances, a member can satisfy the reporting and disclosure requirements of the applicable taxing authority or of SSTS No. 1 only if the particular tax position at issue is appropriately disclosed. The laws and regulations of the applicable taxing authority should be followed to ensure that pertinent disclosure provisions are satisfied. A member should consider all the facts and circumstances in evaluating whether a position is appropriately disclosed. SSTS No. 1 notes that, in the case of a nonsigning preparer, the adequate disclosure requirement is satisfied if the member advises the taxpayer regarding appropriate disclosure.

For purposes of the federal tax return preparer penalty provisions of IRC Section 6694(a), in general, a signing preparer satisfies the disclosure requirement if one of the following actions is taken:

1. The position is disclosed on Form 8275, "Disclosure Statement," or Form 8275-R, "Regulation Disclosure Statement," as appropriate, or in accordance with the requirements set forth in the annual revenue procedure regarding disclosure.
2. The preparer provides the taxpayer with a return that includes the appropriate disclosure.

Similarly, a nonsigning preparer who provides advice to a taxpayer satisfies the disclosure requirement for IRC Section 6694 purposes by (1) advising the taxpayer of any opportunity to avoid accuracy-related penalties that could apply with respect to the position and of the requirements for any applicable disclosure, and (2) contemporaneously documenting that advice in the files.<sup>10</sup>

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<sup>9</sup> Treasury Regulation Section 1.6694-2(b) incorporates this analysis in applying preparer standards for federal income tax purposes.

<sup>10</sup> Treasury Regulation Section 1.6694-2(d)(3).

## Interpretation No. 1-1, "Reporting and Disclosure Standards," of Statement on Standards for Tax Services No. 1, *Tax Return Positions*

### Background

**.01** SSTS No. 1 contains the standards a member should follow when recommending tax return positions or preparing or signing tax returns.

**.02** A member should determine and comply with the reporting and disclosure standards, if any, that are imposed by the applicable taxing authority with respect to recommending a tax return position or preparing or signing a tax return.

If the applicable taxing authority has no written standards that apply with respect to recommending a tax return position or preparing or signing a tax return or if its standards are lower than the standards set forth in this paragraph, the following standards will apply:

- a. A member should not recommend a tax return position or prepare or sign a tax return taking a position unless the member has a good-faith belief that the position has at least a realistic possibility of being sustained administratively or judicially on its merits, if challenged (commonly referred to as the *realistic possibility of success* standard).
- b. Notwithstanding paragraph .02a, a member may *recommend a tax return position* if the member (i) concludes that there is a reasonable basis for the position, and (ii) advises the taxpayer to appropriately disclose that position. Notwithstanding paragraph .02a, a member may *prepare or sign a tax return* that reflects a position if (i) the member concludes there is a reasonable basis for the position, and (ii) the position is appropriately disclosed.

**.03** Federal, state, local, and other taxing authorities may impose specific reporting and disclosure standards with respect to recommending tax return positions or preparing or signing tax returns that apply in addition to the AICPA standards. These standards vary among taxing jurisdictions and by type of tax. A member should refer to the current version of IRC Section 6694, "Understatement of Taxpayer's Liability by Tax Return Preparer," and the regulations thereunder to determine the reporting and disclosure standards applicable to preparers of federal tax returns.

**.04** When recommending a tax return position, or when preparing or signing a tax return on which a position is taken, a member should, when relevant, advise the taxpayer regarding the potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**.05** A member should not recommend a tax return position or prepare or sign a tax return reflecting a position that the member knows exploits the audit selection process of a taxing authority or serves as a mere arguing position advanced solely to obtain leverage in a negotiation with a taxing authority.

**.06** When recommending a tax return position, a member has both the right and the responsibility to be an advocate for the taxpayer with respect to any position satisfying the aforementioned standards.

**.07** A member also should consider SSTS No. 3, *Certain Procedural Aspects of Preparing Returns* (sec. 300), regarding the obligation to examine or verify certain supporting data or consider information related to another taxpayer, when preparing a taxpayer's tax return.

## General Interpretation

**.08** As described in the preface, the realistic possibility of success standard is a lower standard than the substantial authority standard and the more likely than not standard, but it is a higher standard than the reasonable basis standard. Therefore, if the standard of the applicable taxing authority is, for example, substantial authority, more likely than not, or some other standard that is higher than the realistic possibility of success standard, then the member should comply with that higher standard. In that case, the member is held to a standard higher than realistic possibility of success.

If the standard of the applicable taxing authority is lower than the realistic possibility of success standard, then the member should comply with the realistic possibility of success standard, which is reflected in paragraph .02a of this interpretation, or the reasonable basis standard with appropriate disclosure, which is reflected in paragraph .02b of this interpretation.

For purposes of this interpretation, the reporting and disclosure standards that apply in a given situation in accordance with SSTS No. 1 and this interpretation will be referred to as the *required reporting and disclosure standards*.

**.09** A member should determine and comply with the rules of the applicable taxing authority regarding reliance on authorities (cases, rulings, regulations, treatises, and so forth). However, notwithstanding the rules of the applicable taxing authority, in determining whether a tax return position satisfies the realistic possibility of success standard or the reasonable basis standard with appropriate disclosure for purposes of paragraph .02a–b of this interpretation, a member may rely on authorities in addition to those evaluated when determining whether substantial authority exists for a return position or whether a position is more likely than not to prevail under IRC Section 6662. For purposes of paragraph .02a–b of this interpretation, a member may rely on well-reasoned treatises, articles in recognized professional tax publications, and other reference tools and sources of tax analyses commonly used by tax advisers and preparers of returns. A member should exercise caution in relying on materials, such as treatises, that may not be accepted as authorities in all situations, such as under federal tax law.

**.10** If particular facts and circumstances lead a member to believe that a taxpayer penalty could be asserted, then the member should so advise the taxpayer and should discuss with the taxpayer the opportunity, if any, to avoid such penalty by disclosing the position on the tax return. Although a member should so advise the taxpayer with respect to disclosure, it is the taxpayer's responsibility to decide whether and how to disclose.

**.11** In determining if the required reporting and disclosure standards have been satisfied, a member should do all of the following:

- Establish the relevant background facts.
- Consider the reasonableness of the assumptions and representations.
- Consider applicable regulations and standards regarding reliance on information and advice received from a third party.

- Apply the pertinent authorities to the relevant facts.
- Consider the business purpose and economic substance of the transaction, if relevant to the tax consequences of the transaction. (Mere reliance on a representation that there is a business purpose or economic substance generally is insufficient.)
- Consider whether the issue involves a listed transaction or a reportable transaction (or their equivalents) as defined by the applicable taxing authority.<sup>11</sup>
- Arrive at a conclusion supported by the authorities.

**.12** A member should consider the weight of each authority to determine whether the required reporting and disclosure standards have been satisfied. In determining the weight of an authority, a member should consider its source, relevance, and persuasiveness. Therefore, the type of authority is a significant factor. Other important factors include whether the facts stated by the authority are distinguishable from those of the taxpayer's situation and whether the authority contains an analysis of the issue or merely states a conclusion.

**.13** A standard may be satisfied despite the absence of certain types of authority. For example, a member may conclude that the substantial authority standard has been satisfied when the position is supported only by a well-reasoned construction of the applicable statutory provision.

**.14** In determining whether the required reporting and disclosure standards have been satisfied, the extent of research required is left to the professional judgment of the member, given the facts and circumstances known to the member. A member may conclude that more than one position satisfies a given reporting standard, such as the substantial authority standard.

## Specific Illustrations

**.15** The following illustrations address general fact patterns only. Accordingly, the application of guidance, as discussed in the previous section, "General Interpretation," to variations in such general fact patterns or to particular facts or circumstances may lead to different conclusions. In each illustration, no authority exists other than that which is indicated. A decision regarding what are the required reporting and disclosure standards for tax return positions should be consistent with the provisions of SSTS No. 1, as explained in the previous section, "Background."

### ***Determination of the Standards***

**.16** *Illustration 1.* A member is preparing a U.S. income tax return at a time when the federal reporting standard is substantial authority for undisclosed positions and reasonable basis for disclosed positions.<sup>12</sup> One of the issues the member needs to address in preparing the return is the deductibility of a particular expenditure.

**.17** *Conclusion.* The federal standard of substantial authority is higher than the realistic possibility of success standard; therefore, the member is required to comply with the federal standard of substantial authority for undisclosed positions on the return. If the member analyzes the law and applicable authorities regarding whether the expenditure is deductible and concludes that

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<sup>11</sup> See, for example, Treasury Regulation Section 1.6011-4(b).

<sup>12</sup> See the preface for a description of the various reporting standards.

there is not substantial authority to support taking a deduction for the expenditure, the member should not prepare the return taking the deduction as an undisclosed position.

If the member concludes that there is sufficient authority to provide a reasonable basis for claiming the deduction, the member may prepare the return claiming the deduction if that position is appropriately disclosed.

**.18 Illustration 2.** A member is preparing a state inheritance tax return and needs to address the deductibility of a particular expenditure. The state does not have specific tax return reporting standards that apply.

**.19 Conclusion.** Because the applicable taxing authority (the state) does not have written tax return reporting standards that apply, the realistic possibility of success standard for an undisclosed position and the reasonable basis standard for an appropriately disclosed position apply. The member can prepare the return claiming the deduction if either of these is satisfied.

**.20 Illustration 3.** A taxpayer wants to take a position that a member has determined does not satisfy the reasonable basis standard. The taxpayer maintains that even if the taxing authority examines the return, the issue will not be raised.

**.21 Conclusion.** The member should not consider the likelihood of the issue being raised on examination when determining whether any reporting or disclosure standard has been satisfied. The member should not prepare or sign a return that contains a position that does not satisfy the reasonable basis standard, even if the position is disclosed.

**.22 Illustration 4.** A taxpayer wants to take a position on a federal tax return without disclosure; the member concludes that the position satisfies the substantial authority standard provided an assumption regarding an underlying nontax legal issue is appropriate. The member recommends that the taxpayer seek advice from its legal counsel, and the taxpayer's attorney gives an opinion on the nontax legal issue that is consistent with the assumption.

**.23 Conclusion.** A member may, in general, rely on a legal opinion on a nontax legal issue. A member should use professional judgment when relying on a legal opinion. If, on its face, the opinion of the taxpayer's attorney appears to be unreasonable, unsubstantiated, or unwarranted, the member, with appropriate consents from the taxpayer, should consult the member's attorney before relying on the opinion. A member should also refer to the illustrations in Interpretation No. 1-2, "Tax Planning," of SSTS No. 1 (sec. 9100 par. .50-.99), regarding the circumstances in which it is appropriate to rely on an opinion of legal counsel.

**.24 Illustration 5.** A taxpayer has obtained from its attorney an opinion on the tax treatment of an item and requests that a member rely on the opinion.

**.25 Conclusion.** If a member is satisfied about the source (for example, the knowledge and expertise of the issuer), relevance, and persuasiveness of the legal opinion, then the member may rely on that opinion when determining whether the required reporting and disclosure standards have been satisfied. The member should also refer to the illustrations in Interpretation No. 1-2 of SSTS No. 1 regarding the circumstances in which it is appropriate to rely on an opinion of legal counsel.

### ***Application of the Taxing Authority's Standards***

**.26** As noted previously, SSTS No. 1 requires a member to determine and comply with the required reporting and disclosure standards, if any, that are imposed by the applicable taxing authority with respect to recommending a tax return position or preparing or signing a tax return. These standards, and the

methods in which they are to be applied, vary among taxing authorities based on the laws and regulations of the relevant jurisdictions; therefore, illustrating all specific taxing authority standards is beyond the scope of this interpretation. To assist members in their analysis of whether the standards of an applicable taxing authority have been satisfied, the preface contains a description of the most common tax return reporting standards, the nature of the analysis to be applied, and the common requirements for appropriate disclosure.

### ***Application of the Realistic Possibility of Success and the Reasonable Basis Standards***

**.27** If the applicable taxing authority has no written tax return reporting or disclosure standards that apply or if its standards are lower than the realistic possibility of success standard for undisclosed positions or the reasonable basis standard for appropriately disclosed positions, SSTS No. 1 requires a member to comply with these latter standards, as stated in paragraph .02a–b of this interpretation.

The following illustrations pertain to situations in which a member is required to comply with these standards because the applicable taxing authority either has no written standards that apply or has standards that are lower than those described in paragraph .02a–b of this interpretation.

**.28 Illustration 6.** A taxpayer has engaged in a transaction that is adversely affected by a new statutory provision. Prior law supports a position favorable to the taxpayer. The taxpayer believes, and the member concurs, that the new statute is inequitable as applied to the taxpayer's situation. The statute is constitutional, clearly drafted, and unambiguous. The legislative history discussing the new statute contains general comments that do not specifically address the taxpayer's situation.

**.29 Illustration 6.** A taxpayer has engaged in a transaction that is adversely affected by a new statutory provision. Prior law supports a position favorable to the taxpayer. The taxpayer believes, and the member concurs, that the new statute is inequitable as applied to the taxpayer's situation. The statute is constitutional, clearly drafted, and unambiguous. The legislative history discussing the new statute contains general comments that do not specifically address the taxpayer's situation.

**.30 Illustration 7.** The facts are the same as in illustration 6 except that the legislative history discussing the new statute specifically addresses the taxpayer's situation and supports a position favorable to the taxpayer.

**.31 Conclusion.** In a case in which the statute is clearly and unambiguously against the taxpayer's position but a contrary position exists based on legislative history specifically addressing the taxpayer's situation, a return position based either on the statutory language or on the legislative history satisfies the realistic possibility of success standard. (It also may satisfy the substantial authority standard.) A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**.32 Illustration 8.** The facts are the same as in illustration 6 except that the legislative history can be interpreted to provide some evidence or authority in support of the taxpayer's position; however, the legislative history does not specifically address the taxpayer's situation.

**.33 Conclusion.** In a case in which the statute is clear and unambiguous, a contrary position based on an interpretation of the legislative history that does not explicitly address the taxpayer's situation does not satisfy the realistic possibility of success standard. However, because the legislative history

provides some support or evidence for the taxpayer's position, a member may recommend the position to the taxpayer if the member determines that there is a reasonable basis for the position and advises the taxpayer to appropriately disclose the position. Also, a member may prepare a return for the taxpayer taking such a position if the member determines that there is a reasonable basis for the position, and the position is appropriately disclosed. A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**.34 *Illustration 9.*** A taxpayer is faced with an issue involving the interpretation of a new statute. Following its passage, the statute was widely recognized to contain a drafting error, and a technical correction proposal has been introduced. The taxing authority issues a pronouncement indicating how it will administer the provision. The pronouncement interprets the statute in accordance with the proposed technical correction.

**.35 *Conclusion.*** A return position based on either the existing statutory language or the taxing authority's pronouncement satisfies the realistic possibility of success standard. (It also may satisfy the substantial authority standard.) A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**.36 *Illustration 10.*** The facts are the same as in illustration 9 except that no taxing authority pronouncement has been issued.

**.37 *Conclusion.*** In the absence of a taxing authority pronouncement interpreting the statute in accordance with the proposed technical correction, only a return position based on the existing statutory language will satisfy the realistic possibility of success standard. A member may recommend the position to the taxpayer if, based on the facts and circumstances, the member determines that a reasonable basis exists for the position and advises the taxpayer to appropriately disclose the position. Also, a member may prepare a return for the taxpayer taking such a position if, based on the facts and circumstances, the member determines that there is a reasonable basis for the position, and the position is appropriately disclosed. A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**.38 *Illustration 11.*** A taxpayer is seeking advice from a member regarding a recently amended statute. The member has reviewed the statute, the legislative history that specifically addresses the issue, and a recently published notice issued by the taxing authority. No cases, rulings, or other pronouncements exist regarding the statute. The member has concluded in good faith that, based on the statute and the legislative history, the taxing authority's position as stated in the notice does not reflect legislative intent.

**.39 *Conclusion.*** A return position supported by the statute and the legislative history satisfies the realistic possibility of success standard. (It also may satisfy the substantial authority standard.) A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**.40 *Illustration 12.*** The facts are the same as in illustration 11 except that the taxing authority's pronouncement is a temporary regulation.

**.41 *Conclusion.*** In determining whether a tax return position satisfies the realistic possibility of success standard, a member should determine the weight to be given the temporary regulation by analyzing factors, such as whether the

regulation is legislative or interpretative and if it is consistent with the statute. If the member concludes that the position does not satisfy the realistic possibility of success standard, the member may still recommend the position if the member determines that it satisfies the reasonable basis standard, and the member advises the taxpayer to appropriately disclose the position. The member may prepare a return for the taxpayer taking that position if the member determines that the position satisfies the reasonable basis standard, and the position is adequately disclosed. A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**.42 Illustration 13.** A statute is passed requiring the capitalization of certain expenditures. The taxpayer believes, and the member concurs, that to comply fully, the taxpayer will have to acquire new computer hardware and software and implement a number of new accounting procedures. The taxpayer and member agree that the costs of full compliance will be significantly greater than the resulting increase in tax due under the new provision. Because of these cost considerations, the taxpayer makes no effort to comply. The taxpayer wants the member to prepare and sign a return on which the new requirement is simply ignored.

**.43 Conclusion.** The return position desired by the taxpayer is frivolous, a standard below reasonable basis. The member should not prepare or sign the return.

**.44 Illustration 14.** The facts are the same as in illustration 13 except that the taxpayer has made a good-faith effort to comply with the law by calculating an estimate of expenditures to be capitalized under the new provision.

**.45 Conclusion.** In this situation, assuming the taxpayer complied with the statutory and regulatory provisions classifying expenditures to be capitalized and those to be expensed and made a good-faith effort to determine the appropriate amounts to be capitalized and expensed, the realistic possibility of success standard would be satisfied for the return positions. (The substantial authority standard also may be satisfied.) When using estimates in the preparation of a return, a member should refer to SSTS No. 4, *Use of Estimates* (sec. 400). A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**.46 Illustration 15.** On a given issue, a member has located and weighed two authorities concerning the treatment of a particular expenditure. The taxing authority has issued an administrative ruling that requires the expenditure to be capitalized and amortized over several years. On the other hand, a court opinion permits the current deduction of the expenditure. The member has concluded that these are the relevant authorities, considered the source of both authorities, and concluded that both are persuasive and relevant.

**.47 Conclusion.** The realistic possibility of success standard is met by either position. (Either or both also may satisfy the substantial authority standard.) A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**.48 Illustration 16.** A tax statute is silent on the treatment of an item. However, the legislative history explaining the statute directs the taxing authority to issue regulations that will require a specific treatment of the item. No regulations have been issued at the time the member must recommend a position on the tax treatment of the item.

**.49 Conclusion.** The position supported by the legislative history satisfies the realistic possibility of success standard. A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

## Interpretation No. 1-2, "Tax Planning," of Statement on Standards for Tax Services No. 1, *Tax Return Positions*

### Background

**.50** SSTs are enforceable standards that govern the conduct of AICPA members in tax practice. A significant area of many members' tax practices involves assisting taxpayers in tax planning. Two of the seven SSTs issued as of the date of this interpretation's release (that is, the revised SSTs that became effective on January 1, 2010) directly set forth standards that affect the most common activities in tax planning. Several other SSTs set forth standards related to specific factual situations that may arise while a member is assisting a taxpayer in tax planning. The two SSTs that are most typically relevant to tax planning are SST No. 1, including Interpretation No. 1-1, "Reporting and Disclosure Standards," of SST No. 1 (sec. 9100 par. .01-.49), and SST No. 7, *Form and Content of Advice to Taxpayers* (sec. 700).

**.51** Taxing authorities, courts, the AICPA, and other professional organizations have struggled with defining and regulating *tax shelters* and *abusive transactions*. Crucial to the debate is the difficulty of clearly distinguishing between transactions that are abusive and transactions that are aggressive and legitimate. At the same time, it must be recognized that taxpayers have a legitimate interest in arranging their affairs so that they pay no more than the taxes they owe. Tax professionals, including AICPA members, have a role to play in advancing these efforts.

**.52** This interpretation is part of the AICPA's continuing efforts at self-regulation of its members in tax practice. It has its origins in the AICPA's desire to provide adequate guidance to its members with respect to providing services in connection with tax planning. This interpretation does not change or elevate any level of conduct prescribed by any standard. Its goal is to clarify existing standards, recognizing the compelling need for a comprehensive interpretation of a member's responsibilities in connection with *tax planning*. This guidance is intended to clarify how those standards would apply across the spectrum of tax planning, including those situations involving *tax shelters*, regardless of how that term is defined.

### General Interpretation

**.53** *Tax planning* encompasses a wide variety of situations. It includes situations in which the member provides advice on prospective or completed transactions, whether or not the advice reflects favorable or unfavorable treatment to the taxpayer. When providing professional services that include tax planning, a member should determine and comply with any applicable standards for reporting and disclosing tax return positions or for providing written tax advice. See SST No. 1 and Interpretation No. 1-1; SST No. 7; U.S. Treasury Department Circular 230, *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, Enrolled Retirement Plan Agents, and Appraisers before the Internal Revenue Service*,<sup>13</sup> and

<sup>13</sup> Title 31, *Money and Finance: Treasury* of U.S. Code of Federal Regulations.

any other standards that may apply. A member may still recommend a position that does not satisfy the realistic possibility standard if (a) a reasonable basis exists for the position, (b) the member recommends appropriate disclosure, and (c) a higher standard is not required under applicable taxing authority rules. For purposes of this interpretation, the reporting and disclosure standards that apply in a given situation in accordance with SSTS No. 1 and Interpretation No. 1-1 will be referred to as the *required reporting and disclosure standards*.

**.54** For purposes of this interpretation, *tax planning* includes, both with respect to prospective and completed transactions, recommending or expressing an opinion (whether written or oral) on (a) a tax return position or (b) a specific tax plan developed by the member, the taxpayer, or a third party. For tax planning with respect to a completed transaction, the member may be considered a nonsigning tax return preparer with respect to the items for which the tax planning is undertaken that subsequently are reflected on the taxpayer's tax return. The member should comply with tax return preparer standards promulgated by the applicable taxing authority.

**.55** When issuing an opinion to reflect the results of the tax planning service, a member should do all of the following:

- Establish the relevant background facts.
- Consider the reasonableness of the assumptions and representations.
- Consider applicable regulations and standards regarding reliance on information and advice received from a third party.
- Apply the pertinent authorities to the relevant facts.
- Consider the business purpose and economic substance of the transaction, if relevant to the tax consequences of the transaction. (Mere reliance on a representation that there is a business purpose or economic substance generally is insufficient.)
- Consider whether the issue involves a *listed transaction* or a *reportable transaction* (or their equivalents) as defined by the applicable taxing authority.<sup>14</sup>
- Consider other regulations and standards applicable to written tax advice promulgated by the applicable taxing authority.
- Arrive at a conclusion supported by the authorities.

The member also should consider SSTS No. 1, SSTS No. 7, Treasury Department Circular 230, and any other standards that may apply.

**.56** In assisting a taxpayer in a tax planning transaction in which the taxpayer has obtained an opinion from a third party and is looking to the member for an evaluation of the opinion, the member should be satisfied about the source (for example, the knowledge and expertise of the issuer), relevance, and persuasiveness of the opinion, which would include considering whether the opinion indicates the third party did all of the following:

- Established the relevant background facts.
- Considered the reasonableness of the assumptions and representations.
- Considered applicable regulations and standards.

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<sup>14</sup> See, for example, Treasury Regulation Section 1.6011-4(b).

- Applied the pertinent authorities to the relevant facts.
- Considered the business purpose and economic substance of the transaction, if relevant to the tax consequences of the transaction. (Mere reliance on a representation that a business purpose or economic substance exists generally is insufficient.)
- Considered whether the issue involves a listed transaction or a reportable transaction (or their equivalents) as defined by the applicable taxing authority.<sup>15</sup>
- Arrived at a conclusion supported by the authorities.

**.57** In conducting the due diligence necessary to establish the relevant background facts, the member should consider whether it is appropriate to rely on an assumption concerning facts in lieu of either (a) other procedures to support the advice, or (b) a representation from the taxpayer or another person. A member should also consider whether the member's tax advice might be communicated to third parties, particularly if those third parties may not be knowledgeable or may not be receiving independent tax advice with respect to a transaction.

**.58** In tax planning, members often rely on assumptions and representations. Although such reliance is often necessary, the member should take care to assess whether such assumptions and representations are reasonable. In deciding whether an assumption or representation is reasonable, the member should consider its source (for example, the knowledge and expertise of the issuer), and consistency with other information known to the member. For example, depending on the circumstances, it may be reasonable for a member to rely on a representation made by the taxpayer but not on a representation made by a person who is selling, or otherwise promoting, the transaction to the taxpayer.

**.59** When engaged in tax planning, the member should understand the business purpose and economic substance of the transaction when relevant to the tax consequences. If a transaction has been proposed by a party other than the taxpayer, the member should consider whether the assumptions made by the third party are consistent with the facts of the taxpayer's situation. If written advice is to be rendered concerning a transaction, the business purpose for the transaction generally should be described. If the business reasons are relevant to the tax consequences, it is not sufficient to assume merely that a transaction is entered into for valid business reasons without specifying what those reasons are. Similarly, if economic substance is relevant to the tax consequences, it is insufficient to assume merely that a transaction has economic substance without specifying the basis for making that determination. In providing written advice on these issues, the member should consider the written advice regulations and standards, if any, promulgated by the applicable taxing authority. The member also should consider SSTS No. 1, SSTS No. 7, Treasury Department Circular 230, and any other standards that may apply.

**.60** The scope of the engagement should be appropriately determined, and the member should consider the necessity for an engagement letter. The member should be diligent in applying such procedures as are appropriate under the circumstances to understand and evaluate the entire transaction. The specific procedures to be performed in this regard will vary with the circumstances and the scope of the engagement.

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<sup>15</sup> See footnote 2.

## Specific Illustrations

.61 The following illustrations address general fact patterns. Accordingly, the application of the guidance that is discussed in the previous section, "General Interpretation," to variations in such general fact patterns or to particular facts or circumstances, may lead to different conclusions. In each illustration, no authority exists other than that which is indicated.

.62 *Illustration 1.* The relevant tax code imposes penalties on taxpayers for substantial underpayments that are not associated with *tax shelters* as defined in such code, unless the positions resulting in the underpayments are supported by substantial authority.

.63 *Conclusion.* In assisting the taxpayer in tax planning in which any associated underpayment would be considered substantial, the member should inform the taxpayer of the penalty risks associated with the tax return position recommended with respect to any plan under consideration if that position does not satisfy the substantial authority standard. The member also should inform the taxpayer of the opportunities, if any, to avoid such penalties through appropriate disclosure. In such a situation, applicable standards may prohibit the member from preparing the tax return without appropriate disclosure.

.64 *Illustration 2.* The relevant tax code imposes penalties on taxpayers for underpayments attributable to *tax shelters* as defined in such code unless the taxpayer concludes that a position taken on a tax return associated with such a tax shelter is more likely than not the correct position.

.65 *Conclusion.* In assisting the taxpayer in tax planning, the member should inform the taxpayer of the penalty risks associated with the tax return position recommended with respect to any plan under consideration if that position satisfies the substantial authority standard but does not satisfy the more likely than not standard. This would also include advice regarding whether penalties can be avoided through disclosure by the taxpayer.<sup>16</sup> In such a situation, applicable standards may prohibit the member from preparing the tax return without appropriate disclosure.

.66 *Illustration 3.* The relevant tax code imposes penalties on tax return preparers advising on return positions attributable to potentially abusive arrangements that are designated as listed transactions or reportable transactions with a significant purpose of avoidance or evasion of income tax, if there is a related understatement of income tax. The penalty does not apply if the preparer concludes that the position is more likely than not the correct position. The member advising the taxpayer in planning a transaction is later retained to prepare and sign the taxpayer's income tax return for the period that includes the taxpayer's participation in the transaction.

.67 *Conclusion.* A member engaged to prepare a return reflecting a transaction that the member assisted in planning should reevaluate the need to satisfy the more likely than not standard to avoid penalties (including potential sanction or discipline) as a preparer and whether potential penalties may be avoided through appropriate disclosure. The member also should consider whether a separate disclosure is required to avoid penalties under other statutory provisions (in addition to penalties applicable to understatement of tax). The member should inform the taxpayer of the taxpayer's penalty risks, as described in illustrations 1 and 2 of this interpretation. The member also should consider SSTS No. 1 and Interpretation No. 1-1.

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<sup>16</sup> The IRC Section 6662 substantial understatement penalty cannot be avoided by disclosure in the context of a tax shelter.

**.68 Illustration 4.** The relevant tax regulation provides that the details of (or certain information regarding) a specific transaction are required to be attached to the tax return, regardless of the level of authority supporting the associated tax return position (for example, even if there is substantial authority or a higher level of confidence for the position). While preparing the taxpayer's return for the year, the member is aware that an attachment is required.

**.69 Conclusion.** In general, if the taxpayer agrees to include the attachment required by the regulation, the member may sign the return if the member concludes the associated tax return position satisfies the required reporting and disclosure standards. However, if the taxpayer refuses to include the attachment, the member should not sign the return unless the member concludes the associated tax return position satisfies the required reporting and disclosure standards, and reasonable grounds exist for the taxpayer's position with respect to the attachment. In this regard, the member should consider SSTS No. 2, *Answers to Questions on Returns* (sec. 200), which provides that the term *questions*, as used in the standard, "includes requests for information on the return, in the instructions, or in the regulations, whether or not stated in the form of a question," and that a "member should not omit an answer merely because it might prove disadvantageous to a taxpayer." The member also should consider SSTS No. 1 and Interpretation No. 1-1.

**.70 Illustration 5.** The relevant tax regulations provide that the details of certain potentially abusive transactions that are designated as listed transactions are required to be disclosed in attachments to tax returns (enhanced disclosure), regardless of the support for the associated tax return position (for example, even if the applicable taxing authority's standard is satisfied). Under the regulations, if the enhanced disclosure requirements for a listed transaction are not satisfied, the taxpayer will have additional penalty risks, including the possibility of a nonrescindable penalty. While researching the tax consequences of a proposed transaction, a member concludes that the transaction is a listed transaction.

**.71 Conclusion.** Notwithstanding the member's conclusion that the transaction is a listed transaction, the member may still recommend a tax return position with respect to the transaction if he or she concludes that the position satisfies the required reporting and disclosure standards (other than the enhanced disclosure). However, the member should inform the taxpayer of the enhanced disclosure requirements of listed transactions and the additional penalty risks for noncompliance, including the potential for enhanced or nonrescindable penalties or both.

**.72 Illustration 6.** The same regulations apply as in illustration 5. The member first becomes aware that a taxpayer entered into a transaction while preparing the taxpayer's return for the year of the transaction. While researching the tax consequences of the transaction, the member concludes that the taxpayer's transaction is a listed transaction.

**.73 Conclusion.** The member should inform the taxpayer of the enhanced disclosure requirements and the additional penalty risks for noncompliance. If the taxpayer agrees to make the enhanced disclosure required by the regulation, the member may sign the return if the member concludes the associated tax return position also satisfies the required reporting and disclosure standards. The member should not sign the return if the enhanced disclosure requirements are not satisfied. If the member is a nonsigning preparer of the return, the member should recommend that the taxpayer comply with the enhanced disclosure requirements regarding the transaction.

**.74 Illustration 7.** The same regulations apply as in illustration 5. The member first becomes aware that a taxpayer entered into a transaction while preparing the taxpayer's return for the year of the transaction. While researching the tax consequences of the transaction, the member concludes that there is uncertainty about whether the taxpayer's transaction is a listed transaction.

**.75 Conclusion.** The member should inform the taxpayer of the enhanced disclosure requirements and the additional penalty risks for noncompliance. If the taxpayer agrees to make the enhanced disclosure required by the relevant regulations, the member may sign the return if the member concludes the associated tax return position also satisfies the required reporting and disclosure standards. If the taxpayer does not want to provide the enhanced disclosure of the transaction because of the uncertainty about whether it is a listed transaction, the member may sign the return if the member concludes the associated tax return position satisfies the required reporting and disclosure standards (other than the enhanced disclosure requirements), and reasonable grounds exist for the taxpayer's position with regard to not providing enhanced disclosure of the transaction. In this regard, the member should consider SSTS No. 2, which indicates that the degree of uncertainty regarding the meaning of a question on a return may affect whether reasonable grounds exist for not responding to the question.

**.76 Illustration 8.** A member advises a taxpayer concerning the tax consequences of a proposed transaction involving a loan from a U.S. bank. In the process of reviewing documents associated with the proposed transaction, the member uncovers a reference to a deposit the taxpayer will make with an overseas branch of the U.S. bank. The transaction documents appear to indicate that this deposit is linked to the U.S. bank's issuance of the loan.

**.77 Conclusion.** The member should consider the effect, if any, of the deposit in advising the taxpayer about the tax consequences of the proposed transaction and with respect to other tax compliance matters reasonably likely to be at issue (for example, foreign bank account reporting).

**.78 Illustration 9.** Under the relevant tax law, the tax consequences of a leasing transaction depend on whether the property to be leased is reasonably expected to have a residual value of 15 percent of its value at the beginning of the lease. The member has relied on a taxpayer's instruction to use a particular assumption concerning the residual value.

**.79 Conclusion.** Such reliance on the taxpayer's instructions may be appropriate if the assumption is supported by the expertise of the taxpayer, by the member's review of information provided by the taxpayer or a third party, or through the member's own knowledge or analysis.

**.80 Illustration 10.** A member is assisting a taxpayer with evaluating a proposed equipment leasing transaction in which the estimated residual value of the equipment at the end of the lease term is critical to the tax consequences of the lease. The broker arranging the leasing transaction has prepared an analysis that sets out an explicit assumption concerning the equipment's estimated residual value.

**.81 Conclusion.** The member should consider whether it is appropriate to rely on the broker's assumption concerning the estimated residual value of the equipment instead of obtaining a representation from the broker concerning estimated residual value or performing other procedures to validate the amount to be used as an estimate of residual value in connection with the member's advice. In evaluating the appropriateness of the broker's assumption, the member should consider, for example, factors such as the broker's experience in the area,

the broker's methodology, and whether alternative sources of information are reasonably available.

**.82 Illustration 11.** The tax consequences of a particular reorganization depend, in part, on the majority shareholder of a corporation not disposing of stock received in the reorganization in a manner that would prevent the transaction from qualifying as a reorganization.

**.83 Conclusion.** The member should consider whether it is appropriate in rendering tax advice to assume that such a disposition will not occur or whether, under the circumstances, it is appropriate to request written representations regarding the intent of the shareholder and any other parties to the reorganization concerning this requirement, as a condition to issuing an opinion on the reorganization.

**.84 Illustration 12.** A taxpayer is considering a proposed transaction. The taxpayer and the taxpayer's attorney advise the member that the member is responsible for advising the taxpayer on the tax consequences of the transaction.

**.85 Conclusion.** In addition to complying with the requirements of paragraph .55 of this interpretation, the member generally should review all relevant draft transaction documents in formulating the member's tax advice relating to the transaction.

**.86 Illustration 13.** A member is responsible for advising a taxpayer on the tax consequences of the taxpayer's estate plan.

**.87 Conclusion.** Under the circumstances, the member should review the will and all other relevant documents to assess whether there appear to be any tax issues raised by the formulation or implementation of the estate plan.

**.88 Illustration 14.** A member is assisting a taxpayer in connection with a proposed transaction that has been recommended by an investment bank. To support its recommendation, the investment bank offers a law firm's opinion on the tax consequences. The member reads the opinion and notes that it is based on a hypothetical statement of facts rather than the taxpayer's facts.

**.89 Conclusion.** The member may rely on the law firm's opinion when determining whether the required reporting and disclosure standards have been satisfied with respect to the tax consequences of the hypothetical transaction if the member is satisfied about the source (for example, the knowledge and expertise of the issuer), relevance, and persuasiveness of the opinion. However, the member should be diligent in taking such steps as are appropriate under the circumstances to understand and evaluate the transaction as it applies to the taxpayer's specific situation. See paragraph .56 of this interpretation.

**.90 Illustration 15.** A member is assisting a taxpayer in connection with a proposed transaction that has been recommended by an investment bank. To support that recommendation, the investment bank offers a law firm's opinion about the tax consequences. The member reads the opinion and notes that unlike the opinion described in illustration 14, it is carefully tailored to the taxpayer's facts.

**.91 Conclusion.** The member may rely on the opinion when determining whether the required reporting and disclosure standards have been satisfied with respect to the taxpayer's participation in the transaction if the member is satisfied about the source (for example, the knowledge and expertise of the issuer), relevance, and persuasiveness of the opinion. In making that determination, the member should consider whether the opinion indicates the law firm performed the steps listed in paragraph .56 of this interpretation.

**.92 Illustration 16.** A member is assisting a taxpayer with year-end planning in connection with the taxpayer's proposed contribution of stock in a closely held corporation to a charitable organization. The taxpayer instructs the member to calculate the anticipated tax savings assuming a contribution of 500 shares to a tax-exempt organization and assuming the stock has a fair market value of \$100 per share. The member is aware that on the taxpayer's gift tax returns for the prior year, the taxpayer reported that her stock in the corporation, gifted to her daughter, was worth \$50 per share.

**.93 Conclusion.** The member's calculation of the anticipated tax savings is subject to the general interpretations described in paragraphs .57 and .58 of this interpretation. Accordingly, even though this potentially may be a case in which the value of the stock substantially appreciated during the year, the member should consider the reasonableness of the assumption and consistency with other information known to the member in connection with preparing the projection. The member should consider whether to document discussions concerning the increase in value of the stock with the taxpayer. The member also should consider the applicability of the SSTs.

**.94 Illustration 17.** The tax consequences to Target Corporation's shareholders of an acquisition turn, in part, on Acquiring Corporation's continuance of the trade or business of Target Corporation for some time after the acquisition. The member is preparing a tax opinion addressed to Target's shareholders. The opinion is based on a written representation from Acquiring Corporation that Acquiring Corporation will continue Target's business for two years following the acquisition.

**.95 Conclusion.** In conducting the due diligence necessary to establish the relevant background facts, the member should consider the reasonableness of the representation before determining that it is appropriate to rely on the representation from Acquiring Corporation.

**.96 Illustration 18.** The member receives a telephone call from a taxpayer who is the sole shareholder of a corporation. The taxpayer indicates that he is thinking about exchanging his stock in the corporation for stock in a publicly traded business. During the call, the member explains how the transaction could be structured so it will qualify as a tax-free acquisition.

**.97 Conclusion.** Although oral advice may serve a taxpayer's needs appropriately in routine matters or in well-defined areas, written communications are recommended in important, unusual, substantial dollar-value, or complicated transactions. The member should use professional judgment about the need to document oral advice. (See SSTs No. 7.)

**.98 Illustration 19.** The member receives a telephone call from a taxpayer who wants to know whether he or she should lease or purchase a car. During the call, the member explains how the arrangement should be structured so that it helps achieve the taxpayer's objectives.

**.99 Conclusion.** In this situation, the member's response is in conformity with this interpretation in view of the routine nature of the inquiry and the well-defined tax issues. However, the member should evaluate whether other considerations, such as avoiding misunderstanding with the taxpayer, suggest that the conversation should be documented.

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## TS Section 200

# Answers to Questions on Returns

Source: SSTS No. 2

Effective date, unless  
otherwise indicated:  
January 2010

## Introduction

.01 This statement sets forth the applicable standards for members when signing the preparer's declaration on a tax return if one or more questions on the return have not been answered. The term *questions* includes requests for information on the return, in the instructions, or in the regulations, whether or not stated in the form of a question.

## Statement

.02 A member should make a reasonable effort to obtain from the taxpayer the information necessary to provide appropriate answers to all questions on a tax return before signing as preparer.

## Explanation

.03 It is recognized that the questions on tax returns are not of uniform importance, and often they are not applicable to the particular taxpayer. Nevertheless, there are at least three reasons why a member should be satisfied that a reasonable effort has been made to obtain information to provide appropriate answers to the questions on the return that are applicable to a taxpayer:

- a. A question may be of importance in determining taxable income or loss, or the tax liability shown on the return, in which circumstance an omission may detract from the quality of the return.
- b. A request for information may require a disclosure necessary for a complete return or to avoid penalties.
- c. A member often must sign a preparer's declaration stating that the return is true, correct, and complete.

.04 Reasonable grounds may exist for omitting an answer to a question applicable to a taxpayer. For example, reasonable grounds may include the following:

- a. The information is not readily available and the answer is not significant in terms of taxable income or loss, or the tax liability shown on the return.
- b. Genuine uncertainty exists regarding the meaning of the question in relation to the particular return.
- c. The answer to the question is voluminous; in such cases, a statement should be made on the return that the data will be supplied upon examination.

**.05** A member should not omit an answer merely because it might prove disadvantageous to a taxpayer.

**.06** A member should consider whether the omission of an answer to a question may cause the return to be deemed incomplete or result in penalties.

**.07** If reasonable grounds exist for omission of an answer to an applicable question, a taxpayer is not required to provide on the return an explanation of the reason for the omission.

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## TS Section 300

# *Certain Procedural Aspects of Preparing Returns*

Source: SSTS No. 3

Effective date, unless  
otherwise indicated:  
January 2010

## Introduction

**.01** This statement sets forth the applicable standards for members concerning the obligation to examine or verify certain supporting data or to consider information related to another taxpayer when preparing a taxpayer's tax return.

## Statement

**.02** In preparing or signing a return, a member may in good faith rely, without verification, on information furnished by the taxpayer or by third parties. However, a member should not ignore the implications of information furnished and should make reasonable inquiries if the information furnished appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to the member. Further, a member should refer to the taxpayer's returns for one or more prior years whenever feasible.

**.03** If the tax law or regulations impose a condition with respect to deductibility or other tax treatment of an item, such as taxpayer maintenance of books and records or substantiating documentation to support the reported deduction or tax treatment, a member should make appropriate inquiries to determine to the member's satisfaction whether such condition has been met.

**.04** When preparing a tax return, a member should consider information actually known to that member from the tax return of another taxpayer if the information is relevant to that tax return and its consideration is necessary to properly prepare that tax return. In using such information, a member should consider any limitations imposed by any law or rule relating to confidentiality.

## Explanation

**.05** The preparer's declaration on a tax return often states that the information contained therein is true, correct, and complete to the best of the preparer's knowledge and belief based on all information known by the preparer. This type of reference should be understood to include information furnished by the taxpayer or by third parties to a member in connection with the preparation of the return.

**.06** The preparer's declaration does not require a member to examine or verify supporting data; a member may rely on information furnished by the taxpayer unless it appears to be incorrect, incomplete, or inconsistent. However, there is a need to determine by inquiry that a specifically required condition,

such as maintaining books and records or substantiating documentation, has been satisfied and to obtain information when the material furnished appears to be incorrect, incomplete, or inconsistent. Although a member has certain responsibilities in exercising due diligence in preparing a return, the taxpayer has the ultimate responsibility for the contents of the return. Thus, if the taxpayer presents unsupported data in the form of lists of tax information, such as dividends and interest received, charitable contributions, and medical expenses, such information may be used in the preparation of a tax return without verification unless it appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to a member.

**.07** Even though there is no requirement to examine underlying documentation, a member should encourage the taxpayer to provide supporting data where appropriate. For example, a member should encourage the taxpayer to submit underlying documents for use in tax return preparation to permit full consideration of income and deductions arising from security transactions and from pass-through entities, such as estates, trusts, partnerships, and S corporations.

**.08** The source of information provided to a member by a taxpayer for use in preparing the return is often a pass-through entity, such as a limited partnership, in which the taxpayer has an interest but is not involved in management. A member may accept the information provided by the pass-through entity without further inquiry, unless there is reason to believe it is incorrect, incomplete, or inconsistent, either on its face or on the basis of other facts known to the member. In some instances, it may be appropriate for a member to advise the taxpayer to ascertain the nature and amount of possible exposure to tax deficiencies, interest, and penalties by taxpayer contact with management of the pass-through entity.

**.09** A member should make use of a taxpayer's returns for one or more prior years in preparing the current return whenever feasible. Reference to prior returns and discussion of prior-year tax determinations with the taxpayer should provide information to determine the taxpayer's general tax status, avoid the omission or duplication of items, and afford a basis for the treatment of similar or related transactions. As with the examination of information supplied for the current year's return, the extent of comparison of the details of income and deduction between years depends on the particular circumstances.

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## TS Section 400

### *Use of Estimates*

Source: SSTS No. 4

Effective date, unless  
otherwise indicated:  
January 2010

#### Introduction

.01 This statement sets forth the applicable standards for members when using the taxpayer's estimates in the preparation of a tax return. A member may advise on estimates used in the preparation of a tax return, but the taxpayer has the responsibility to provide the estimated data. Appraisals or valuations are not considered estimates for purposes of this statement.

#### Statement

.02 Unless prohibited by statute or by rule, a member may use the taxpayer's estimates in the preparation of a tax return if it is not practical to obtain exact data and if the member determines that the estimates are reasonable based on the facts and circumstances known to the member. The taxpayer's estimates should be presented in a manner that does not imply greater accuracy than exists.

#### Explanation

.03 Accounting requires the exercise of professional judgment and, in many instances, the use of approximations based on judgment. The application of such accounting judgments, as long as not in conflict with methods set forth by a taxing authority, is acceptable. These judgments are not estimates within the purview of this statement. For example, a federal income tax regulation provides that if all other conditions for accrual are met, the exact amount of income or expense need not be known or ascertained at year end if the amount can be determined with reasonable accuracy.

.04 When the taxpayer's records do not accurately reflect information related to small expenditures, accuracy in recording some data may be difficult to achieve. Therefore, the use of estimates by a taxpayer in determining the amount to be deducted for such items may be appropriate.

.05 When records are missing or precise information about a transaction is not available at the time the return must be filed, a member may prepare a tax return using a taxpayer's estimates of the missing data.

.06 Estimated amounts should not be presented in a manner that provides a misleading impression about the degree of factual accuracy.

.07 Specific disclosure that an estimate is used for an item in the return is not generally required; however, such disclosure should be made in unusual circumstances where nondisclosure might mislead the taxing authority regarding

the degree of accuracy of the return as a whole. Some examples of unusual circumstances include the following:

- a.* A taxpayer has died or is ill at the time the return must be filed.
  - b.* A taxpayer has not received a Schedule K-1 for a pass-through entity at the time the tax return is to be filed.
  - c.* There is litigation pending (for example, a bankruptcy proceeding) that bears on the return.
  - d.* Fire, computer failure, or natural disaster has destroyed the relevant records.
-

## TS Section 500

# ***Departure From a Position Previously Concluded in an Administrative Proceeding or Court Decision***

Source: SSTS No. 5

Effective date, unless  
otherwise indicated:  
January 2010

### **Introduction**

.01 This statement sets forth the applicable standards for members in recommending a tax return position that departs from the position determined in an administrative proceeding or in a court decision with respect to the taxpayer's prior return.

.02 For purposes of this statement, *administrative proceeding* includes an examination by a taxing authority or an appeals conference relating to a return or a claim for refund.

.03 For purposes of this statement, *court decision* means a decision by any court having jurisdiction over tax matters.

### **Statement**

.04 The tax return position with respect to an item as determined in an administrative proceeding or court decision does not restrict a member from recommending a different tax position in a later year's return, unless the taxpayer is bound to a specified treatment in the later year, such as by a formal closing agreement. Therefore, the member may recommend a tax return position or prepare or sign a tax return that departs from the treatment of an item as concluded in an administrative proceeding or court decision with respect to a prior return of the taxpayer provided the requirements of TS section 100, *Tax Return Positions*, are satisfied.

### **Explanation**

.05 If an administrative proceeding or court decision has resulted in a determination concerning a specific tax treatment of an item in a prior year's return, a member will usually recommend this same tax treatment in subsequent years. However, departures from consistent treatment may be justified under such circumstances as the following:

- a. Taxing authorities tend to act consistently in the disposition of an item that was the subject of a prior administrative proceeding but generally are not bound to do so. Similarly, a taxpayer is not bound to follow the tax treatment of an item as consented to in an earlier administrative proceeding.

- b.* The determination in the administrative proceeding or the court's decision may have been caused by a lack of documentation. Supporting data for the later year may be appropriate.
- c.* A taxpayer may have yielded in the administrative proceeding for settlement purposes or not appealed the court decision, even though the position met the standards in TS section 100.
- d.* Court decisions, rulings, or other authorities that are more favorable to a taxpayer's current position may have developed since the prior administrative proceeding was concluded or the prior court decision was rendered.

**.06** The consent in an earlier administrative proceeding and the existence of an unfavorable court decision are factors that the member should consider in evaluating whether the standards in TS section 100 are met.

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## TS Section 600

# ***Knowledge of Error: Return Preparation and Administrative Proceedings***

Source: SSTS No. 6

Effective date, unless  
otherwise indicated:  
January 2010

### **Introduction**

**.01** This statement sets forth the applicable standards for a member who becomes aware of (a) an error in a taxpayer's previously filed tax return; (b) an error in a return that is the subject of an administrative proceeding, such as an examination by a taxing authority or an appeals conference; or (c) a taxpayer's failure to file a required tax return. As used herein, the term *error* includes any position, omission, or method of accounting that, at the time the return is filed, fails to meet the standards set out in TS section 100, *Tax Return Positions*. The term *error* also includes a position taken on a prior year's return that no longer meets these standards due to legislation, judicial decisions, or administrative pronouncements having retroactive effect. However, an error does not include an item that has an insignificant effect on the taxpayer's tax liability. The term *administrative proceeding* does not include a criminal proceeding.

**.02** This statement applies whether or not the member prepared or signed the return that contains the error.

**.03** Special considerations may apply when a member has been engaged by legal counsel to provide assistance in a matter relating to the counsel's client.

### **Statement**

**.04** A member should inform the taxpayer promptly upon becoming aware of an error in a previously filed return, an error in a return that is the subject of an administrative proceeding, or a taxpayer's failure to file a required return. A member also should advise the taxpayer of the potential consequences of the error and recommend the corrective measures to be taken. Such advice and recommendation may be given orally. The member is not allowed to inform the taxing authority without the taxpayer's permission, except when required by law.

**.05** If a member is requested to prepare the current year's return and the taxpayer has not taken appropriate action to correct an error in a prior year's return, the member should consider whether to withdraw from preparing the return and whether to continue a professional or employment relationship with the taxpayer. If the member does prepare such current year's return, the member should take reasonable steps to ensure that the error is not repeated.

**.06** If a member is representing a taxpayer in an administrative proceeding with respect to a return that contains an error of which the member is aware, the member should request the taxpayer's agreement to disclose the error to

the taxing authority. Lacking such agreement, the member should consider whether to withdraw from representing the taxpayer in the administrative proceeding and whether to continue a professional or employment relationship with the taxpayer.

## Explanation

**.07** While performing services for a taxpayer, a member may become aware of an error in a previously filed return or may become aware that the taxpayer failed to file a required return. The member should advise the taxpayer of the error and the potential consequences, and recommend the measures to be taken. Similarly, when representing the taxpayer before a taxing authority in an administrative proceeding with respect to a return containing an error of which the member is aware, the member should advise the taxpayer to disclose the error to the taxing authority and of the potential consequences of not disclosing the error. Such advice and recommendation may be given orally.

**.08** It is the taxpayer's responsibility to decide whether to correct the error. If the taxpayer does not correct an error, a member should consider whether to withdraw from the engagement and whether to continue a professional or employment relationship with the taxpayer. Although recognizing that the taxpayer may not be required by statute to correct an error by filing an amended return, a member should consider whether a taxpayer's decision not to file an amended return or otherwise correct an error may predict future behavior that might require termination of the relationship.

**.09** Once the member has obtained the taxpayer's consent to disclose an error in an administrative proceeding, the disclosure should not be delayed to such a degree that the taxpayer or member might be considered to have failed to act in good faith or to have, in effect, provided misleading information. In any event, disclosure should be made before the conclusion of the administrative proceeding.

**.10** A conflict between the member's interests and those of the taxpayer may be created by, for example, the potential for violating Code of Professional Conduct Rule 301, *Confidential Client Information* (ET sec. 301 par. .01) (relating to the member's confidential client relationship); the tax law and regulations; or laws on privileged communications, as well as by the potential adverse impact on a taxpayer of a member's withdrawal. Therefore, a member should consider consulting with his or her own legal counsel before deciding upon recommendations to the taxpayer and whether to continue a professional or employment relationship with the taxpayer.

**.11** If a member believes that a taxpayer may face possible exposure to allegations of fraud or other criminal misconduct, the member should advise the taxpayer to consult with an attorney before the taxpayer takes any action.

**.12** If a member decides to continue a professional or employment relationship with the taxpayer and is requested to prepare a tax return for a year subsequent to that in which the error occurred, the member should take reasonable steps to ensure that the error is not repeated. If the subsequent year's tax return cannot be prepared without perpetuating the error, the member should consider withdrawal from the return preparation. If a member learns that the taxpayer is using an erroneous method of accounting and it is past the due date to request permission to change to a method meeting the standards of TS section 100, the member may sign a tax return for the current year, providing the tax return includes appropriate disclosure of the use of the erroneous method.

**.13** Whether an error has no more than an insignificant effect on the taxpayer's tax liability is left to the professional judgment of the member based on all the facts and circumstances known to the member. In judging whether an erroneous method of accounting has more than an insignificant effect, a member should consider the method's cumulative effect, as well as its effect on the current year's tax return or the tax return that is the subject of the administrative proceeding.

**.14** If a member becomes aware of the error while performing services for a taxpayer that do not involve tax return preparation or representation in an administrative proceeding, the member's responsibility is to advise the taxpayer of the existence of the error and to recommend that the error be discussed with the taxpayer's tax return preparer. Such recommendation may be given orally.

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## TS Section 700

# *Form and Content of Advice to Taxpayers*

Source: SSTS No. 7

Effective date, unless  
otherwise indicated:  
January 2010

### Introduction

.01 This statement sets forth the applicable standards for members concerning certain aspects of providing advice to a taxpayer and considers the circumstances in which a member has a responsibility to communicate with a taxpayer when subsequent developments affect advice previously provided. The statement does not, however, cover a member's responsibilities when the expectation is that the advice rendered is likely to be relied on by parties other than the taxpayer.

### Statement

.02 A member should use professional judgment to ensure that tax advice provided to a taxpayer reflects competence and appropriately serves the taxpayer's needs. When communicating tax advice to a taxpayer in writing, a member should comply with relevant taxing authorities' standards, if any, applicable to written tax advice. A member should use professional judgment about any need to document oral advice. A member is not required to follow a standard format when communicating or documenting oral advice.

.03 A member should assume that tax advice provided to a taxpayer will affect the manner in which the matters or transactions considered would be reported or disclosed on the taxpayer's tax returns. Therefore, for tax advice given to a taxpayer, a member should consider, when relevant (a) return reporting and disclosure standards applicable to the related tax return position and (b) the potential penalty consequences of the return position. In ascertaining applicable return reporting and disclosure standards, a member should follow the standards in TS section 100, *Tax Return Positions*.

.04 A member has no obligation to communicate with a taxpayer when subsequent developments affect advice previously provided with respect to significant matters, except while assisting a taxpayer in implementing procedures or plans associated with the advice provided or when a member undertakes this obligation by specific agreement.

### Explanation

.05 Tax advice is recognized as a valuable service provided by members. The form of advice may be oral or written and the subject matter may range from routine to complex. Because the range of advice is so extensive and because advice should meet the specific needs of a taxpayer, neither a standard format nor guidelines for communicating or documenting advice to the taxpayer can be established to cover all situations.

**.06** Although oral advice may serve a taxpayer's needs appropriately in routine matters or in well-defined areas, written communications are recommended in important, unusual, substantial dollar value, or complicated transactions. The member may use professional judgment about whether, subsequently, to document oral advice.

**.07** In deciding on the form of advice provided to a taxpayer, a member should exercise professional judgment and should consider such factors as the following:

- a. The importance of the transaction and amounts involved
- b. The specific or general nature of the taxpayer's inquiry
- c. The time available for development and submission of the advice
- d. The technical complexity involved
- e. The existence of authorities and precedents
- f. The tax sophistication of the taxpayer
- g. The need to seek other professional advice
- h. The type of transaction and whether it is subject to heightened reporting or disclosure requirements
- i. The potential penalty consequences of the tax return position for which the advice is rendered
- j. Whether any potential applicable penalties can be avoided through disclosure
- k. Whether the member intends for the taxpayer to rely upon the advice to avoid potential penalties

**.08** A member may assist a taxpayer in implementing procedures or plans associated with the advice offered. When providing such assistance, the member should review and revise such advice as warranted by new developments and factors affecting the transaction.

**.09** Sometimes a member is requested to provide tax advice but does not assist in implementing the plans adopted. Although such developments as legislative or administrative changes or future judicial interpretations may affect the advice previously provided, a member cannot be expected to communicate subsequent developments that affect such advice unless the member undertakes this obligation by specific agreement with the taxpayer.

**.10** Taxpayers should be informed that (a) the advice reflects professional judgment based upon the member's understanding of the facts, and the law existing as of the date the advice is rendered and (b) subsequent developments could affect previously rendered professional advice. Members may use precautionary language to the effect that their advice is based on facts as stated and authorities that are subject to change.

**.11** In providing tax advice, a member should be cognizant of applicable confidentiality privileges.

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## TS Section Appendix

### *Cross-Reference of Previous and Revised Statements*

<i>Previous Statement No.</i>	<i>Previous Section</i>	<i>Changes</i>	<i>1988 Revised Section</i>	<i>2000 Revised Section</i>	<i>2010 Revised Section</i>
1	111	Withdrawn 1982	—		
2	121	Withdrawn 1982	—		
3	131	Superseded by Statement No. 2, August 1988	122		
3	131	Superseded by Statement No. 2, August 2000		200	
3	131	Superseded by Statement No. 2, January 2010			200
4	141	Superseded by Statement No. 5, August 1988	152		
4	141	Superseded by Statement No. 5, August 2000		500	
4	141	Superseded by Statement No. 5, January 2010			500
5	151	Superseded by Statement No. 4, August 1988	142		
5	151	Superseded by Statement No. 4, August 2000		400	
5	151	Superseded by Statement No. 4, January 2010			400

(continued)

<i>Previous Statement No.</i>	<i>Previous Section</i>	<i>Changes</i>	<i>1988 Revised Section</i>	<i>2000 Revised Section</i>	<i>2010 Revised Section</i>
6	161	Superseded by Statement No. 6, August 1988; Revised May 1991	162		
6	161	Superseded by Statement No. 6, August 2000		600	
6	161	Superseded by Statement No. 6, January 2010			600
7	171	Superseded by Statement No. 7, August 1988; Revised May 1991	172		
7	171	Superseded by Statement No. 7, August 2000		700	
7	171	Superseded by Statement No. 6, January 2010			600
8	181	Superseded by Statement No. 8, August 1988	182		
8	181	Superseded by Statement No. 8, August 2000		800	
8	181	Superseded by Statement No. 7, January 2010			700
9	191	Superseded by Statement No. 3, August 1988	132		
9	191	Superseded by Statement No. 3, August 2000		300	
9	191	Superseded by Statement No. 3, January 2010			300

<i>Previous Statement No.</i>	<i>Previous Section</i>	<i>Changes</i>	<i>1988 Revised Section</i>	<i>2000 Revised Section</i>	<i>2010 Revised Section</i>
10	201	Superseded by Statement No. 1, August 1988	112		
10	201	Superseded by Statement No. 1, August 2000		100	
10	201	Superseded by Statement No. 1, January 2010			100

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## PFP Section

# PERSONAL FINANCIAL PLANNING

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## STATEMENT ON STANDARDS IN PERSONAL FINANCIAL PLANNING SERVICES

### Acknowledgments

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### Foreword

The Personal Financial Planning Executive Committee (PFP EC) has issued Statement on Standards in Personal Financial Planning Services No. 1 (the statement) to provide guidance to members and a framework for delivering PFP services with the highest levels of integrity, professionalism, objectivity, and competence so that a CPA financial planner can serve the best interests of

his or her clients and the public. The PFP EC is the senior committee of the AICPA designated to promulgate enforceable standards of PFP practice.<sup>1</sup>

The statement applies to all members providing PFP services regardless of the jurisdictions in which they practice. Interpretations of the statement may be issued by the PFP EC as guidance to assist in understanding and applying the statement. The PFP EC interpretations are recommendations on the application of the statement. The statement and its interpretations are intended to complement other laws, regulations, and professional standards of PFP practice.

The statement is written in as simple and objective a manner as possible. However, by their nature, practice standards provide for an appropriate range of behaviors and need to be interpreted to address a broad range of personal and professional situations. Accordingly, enforcement of these rules, as part of the AICPA's Code of Professional Conduct "General Standards Rule" (ET sec. 1.300.001 and 2.300.001) and "Compliance with Standards Rule" (ET sec. 1.310.001 and 2.310.001) as well as paragraphs .02–.05 of the "Application of the AICPA Code" (ET sec. 0.200.020), will be undertaken on a case-by-case basis.

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<sup>1</sup> Per AICPA Bylaw Section 360R, *Implementing Resolutions Under Section 3.6 Committees*, the Personal Financial Planning Executive Committee (PFP EC) is an AICPA senior committee. The PFP EC is designated as a body that may promulgate technical standards under the "General Standards Rule" (ET sec. 1.300.001 and 2.300.001) and the "Compliance with Standards Rule" (ET sec. 1.310.001 and 2.310.001).

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## PFP Section 100

# ***Statement on Standards in Personal Financial Planning Services***

*(Supersedes the Statement on Responsibilities in Personal Financial Planning Practice.)*

**Source: Statement on Standards in Personal Financial Planning Services No. 1.**

**January 2014; revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.**

### **Scope**

**.01** Statement on Standards in Personal Financial Planning Services No. 1 (the statement) addresses the responsibilities of AICPA members (members) who are described in paragraph .04 that follows. The statement applies when personal financial planning (PFP) services are provided, even if part of another engagement.

**.02** The statement establishes the applicable standards for members with regard to PFP engagements. (Ref: par. .A1)

### **Nature of PFP Services**

**.03** PFP is the process of identifying personal financial goals and resources, designing financial strategies, and making personalized recommendations (Ref: par. .12) (whether written or oral) that, when implemented, assist the client in achieving these goals. This process may include implementation of recommendations or monitoring or updating the engagement. PFP services encompass one or more of the following activities:

- a.* Cash flow planning
- b.* Risk management and insurance planning
- c.* Retirement planning
- d.* Investment planning
- e.* Estate, gift, and wealth transfer planning
- f.* Elder planning
- g.* Charitable planning
- h.* Education planning
- i.* Tax planning

### **Applicability**

**.04** The statement applies when a member provides PFP services as defined in paragraph .12, and (Ref: par. .A2)

- a.* represents to the public or clients that the member provides PFP services,

- b. engages in activities that would require registration as an investment adviser under federal or state law,<sup>1</sup> or
- c. sells a product as a result of an engagement.

**.05** The statement does not supersede other applicable AICPA professional standards, such as (Ref: par. .A2–.A3, .A11)

- a. the Statement on Standards for Accounting and Review Services (SSARS) No. 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (AR sec. 600), with regard to the compilation of personal financial statements;
- b. the Statements on Standards for Tax Services (SSTSs) with regard to tax services; and
- c. the Statement on Standards for Valuation Services (SSVS) No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (VS sec. 100), with regard to valuation services.

## Objective

**.06** The statement provides authoritative guidance and establishes enforceable standards for members who provide PFP services to assist them in fulfilling their professional responsibilities.

## Authority of the Statement

**.07** The statement contains requirements designed to enable the member to meet the stated objective. It also includes related guidance in the form of application and other explanatory material that provides context relevant to a proper understanding of the statement and definitions.

**.08** The requirements of the statement are expressed using the word *should*. If a standard provides that a member "should" perform an action, then unless prevailing facts and circumstances dictate otherwise, this action is required. If a standard provides that a procedure or action is one that the member "should consider," the consideration of the procedure or action is required, whereas carrying out the specified procedure or action is not. The professional requirements of the statement are to be understood and applied in the context of the explanatory material that provides guidance for their application.

**.09** The "Application Material" section and other explanatory material provide further explanation of the requirements and guidance for carrying them out.

**.10** The words *may*, *might*, and *could*, among others, are used to describe actions and procedures that are recommended but not required. Although such guidance does not, in itself, impose a requirement, it is relevant to the proper application of the requirements.

**.11** The statement includes, under the heading "Definitions," a description of the meanings attributed to certain terms for purposes of the statement. These are provided to assist with the consistent application and interpretation of the statement and are not intended to override definitions that may be established for other purposes, whether by law or regulation.

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<sup>1</sup> Reference The CPA's Guide to Investment Advisory Business Models published by AICPA.

## Definitions

.12 For purposes of the statement, the following terms have the meanings attributed:

**Personal financial planning services.** The process of identifying personal financial goals and resources, designing financial strategies, and making personalized recommendations that, when implemented, assist the client in achieving these goals. (Ref: par. .03)

**Personal financial planning engagement.** An engagement in which a member provides PFP services and the statement applies. (Ref: par. .03–.04)

**Implementation engagement.** A PFP engagement that involves assisting the client in taking action on recommendations developed during the PFP engagement.

**Monitoring engagement.** A PFP engagement that involves tracking and communicating the client's progress in achieving established PFP goals.

**Updating engagement.** A PFP engagement that involves revising the client's existing financial plan and financial planning recommendations as the member and client agree upon.

**Personalized recommendation.** Financial advice directing a client to take action based on the client's personal financial information disclosed to the member. (Ref: par. .03)

## Requirements

### General Professional Responsibilities

.13 The member should read the entire statement, including its application and other explanatory material, to understand its objective and apply its requirements properly.

.14 The proper application of the requirements established by the statement is expected to provide a sufficient basis for the achievement of the objective. However, because circumstances vary widely and all such circumstances cannot be anticipated, the member should consider whether, due to the existence of particular matters or circumstances, procedures in addition to those required by the statement are needed to meet the stated objective.

.15 The member must comply with each requirement of the statement unless,

- a. in the circumstances of the engagement, the requirement is not relevant because it is conditional, and the condition does not exist.
- b. the member judges it necessary to depart from a requirement. In such circumstances, the member should perform alternative procedures to achieve the intent of that requirement and document the justification for that departure.

.16 The member should consider applicable interpretive publications when providing PFP services. (Ref: par. .A5)

### Independence and PFP Services

.17 If PFP services are performed for a client for which the member or member's firm also performs an *attest engagement* (ET sec. 0.400.04), the member should meet the requirements of the "Nonattest Services" subtopic

(ET sec. 1.295) under the "Independence Rule" (ET sec. 1.200.001) so as not to impair the member's independence with respect to the client.

## **Responsibilities of Members in PFP Engagements (Ref: par. .A6–.A13)**

**.18** The member should comply with relevant ethical requirements. (Ref: par. .A7)

**.19** The member should possess a level of knowledge of PFP principles and theory, and a level of skill in the application of such principles, that will enable him or her to (Ref: par. .A8)

- a. identify client goals and objectives;
- b. gather and analyze relevant information;
- c. consider and apply appropriate planning approaches and methods; and
- d. use professional judgment when developing financial recommendations.

**.20** The member should evaluate whether any conflicts of interest exist with regard to the engagement as follows: (Ref: par. .A9–.A10)

- a. If the member determines conflicts of interest exist, the member should determine whether the engagement can be performed objectively.
- b. If the member determines the engagement can be performed objectively, the member should disclose all known conflicts of interest and obtain consent as required under the "Conflicts of Interest" interpretations (ET sec. 1.110.010 and 2.110.010) under the "Integrity and Objectivity Rule" (ET sec. 1.100.001 and 2.100.001).
- c. If the member determines that the engagement cannot be performed objectively, the engagement should be terminated.

**.21** The member should comply with applicable federal, state, and other laws and regulations. The member should comply with professional standards applicable to the PFP engagement unless superseded by laws or regulations. When there is a conflict between the statement and laws or regulations, the laws or regulations will prevail unless less stringent than the statement. (Ref: par. .A11–.A12)

**.22** Prior to beginning the engagement, and throughout the engagement as circumstances dictate, the member should disclose in writing all compensation the member and the member's firm or affiliates will receive for services rendered or products sold (Ref: par. .A6, .A13). The disclosure should include

- a. the method of compensation, including the impact of indirect compensation;
- b. the amount of compensation;
- c. the time period over which compensation will be received; and
- d. the compensation, including noncash benefits, received by the member for referrals to other providers.

**.23** If compensation alternatives are offered, the member should disclose the differences in these alternatives in writing.

## Planning the PFP Engagement (Ref: par. .A14–.A15)

**.24** The member should document and communicate to the client the scope and nature of services to be provided and disclose the member's agreed upon compensation for such services. This communication should be documented in the file and include descriptions of the following when applicable to the engagement:

- a.* Engagement objectives
- b.* Scope of services to be provided
- c.* Roles and responsibilities of the member, client, and other service providers
- d.* Timing of the engagement
- e.* Scope limitations and other constraints
- f.* Conflicts of interest (Ref: par. .20)
- g.* Responsibility, or lack thereof, for helping the client implement planning decisions
- h.* Responsibility, or lack thereof, for monitoring the client's progress in achieving goals
- i.* Responsibility, or lack thereof, for updating the plan and proposing new action

**.25** The member should evaluate the appropriateness of the original engagement as the engagement proceeds and document and communicate needed changes to the client.

**.26** If the member is aware of a service needed to complete the engagement and does not, or will not, provide that service, the member should limit the scope of the engagement accordingly and recommend that the client engage another service provider for that service in writing.

**.27** If the client declines to engage another service provider for services identified in paragraph .26, the member should consider whether this limitation impairs the ability to provide PFP services:

- a.* If the member determines that the ability to meet the standards established by the statement is impaired, the member should terminate the engagement in writing.
- b.* If the member determines that the ability to meet the standards established by the statement is not impaired, the member should communicate in writing that this limitation could affect the conclusions and recommendations developed in the engagement.

## Obtaining and Analyzing Information

**.28** The member should use professional judgment when obtaining and analyzing relevant information necessary to develop recommendations based on the stated engagement objectives.

**.29** If the member is unable to collect sufficient relevant information to establish a reasonable basis for recommendations, the engagement scope may be restricted to those matters for which sufficient information is available. This scope limitation should be communicated to the client in writing, including that this limitation should be taken into account in the assessment of conclusions and recommendations developed. (Ref: par. .A16)

**.30** If sufficient information does not exist to proceed as agreed, the member should terminate or modify the engagement through mutual agreement

with the client. This engagement modification or termination should be communicated in writing.

**.31** When analyzing information obtained while performing the engagement, the member should

- a.* evaluate the reasonableness of estimates and assumptions that are significant to the plan;
- b.* use assumptions that are appropriate and consistent with each other; and
- c.* consider the interrelationship of various PFP activities (Ref: par. .03).

## **Developing and Communicating Recommendations (Ref: par. .A16–.A20)**

**.32** The member should establish a reasonable basis for PFP recommendations.

**.33** The member should develop recommendations derived from analyses of relevant information, client goals, and the client's overall financial circumstances. Even when an engagement addresses a limited number of personal financial goals, the member should consider the client's overall known financial circumstances.

**.34** The nature and extent of analyses and other procedures performed when establishing a basis for recommendations are affected by the scope and objectives of the engagement and should be documented.

**.35** The member should communicate to the client the assumptions and estimates that are significant to the recommendations. This should be documented and include the following:

- a.* A summary of the client's goals
- b.* Significant assumptions
- c.* Estimates
- d.* Recommendations
- e.* A description of limitations on the work performed
- f.* The recommendations in the engagement should contain qualifications to the recommendations if the effects of certain planning areas on the client's overall financial picture were not considered

## **Implementation Engagements (Ref: par. .A21–.A24)**

**.36** The member should document his or her understanding of the implementation engagement, including the roles and responsibilities of the member, the client, and other service providers. This documentation should include the following:

- a.* A summary of the planning decisions being implemented
- b.* A summary of recommended actions to be taken
- c.* A description of limitations on the work performed in the implementation engagement

**.37** The member should communicate in writing the level of responsibility, if any, for the following:

- a.* Selecting and acquiring products

- b.* Selecting service providers
  - c.* Establishing selection criteria
  - d.* Coordinating or reviewing the delivery of services or products by other service providers
- .38** A member who is engaged to establish selection criteria should
- a.* identify those criteria that are required to accomplish the client's objectives, subject to any constraints that result from the client's circumstances or as identified by the client.
  - b.* assist the client in evaluating the relative importance of criteria so that available alternatives can be compared.
- .39** A member who is engaged to participate in recommending products should
- a.* gather information that establishes a reasonable basis for determining whether a product meets the selection criteria.
  - b.* communicate this evaluation in writing, along with product recommendations.
  - c.* disclose in writing any compensation received for recommending products.
- .40** A member who is engaged to assist the client in taking action on planning decisions developed in a PFP engagement in which the member did not participate should obtain an understanding of the planning decisions made.
- .41** All other relevant guidance under the statement relating to providing PFP services should be followed in an implementation engagement.

### **Monitoring and Updating Engagements (Ref: par. .A25–.A28)**

- .42** In a monitoring engagement, the member should document the nature and extent of the member's services, including
- a.* the frequency and time period of measuring the client's progress toward reaching the stated goals.
  - b.* utilization of monitoring criteria that are appropriate to, and consistent with, the criteria used to establish the goals being monitored.
  - c.* the criteria that are important to the achievement of the financial planning goals being monitored.
  - d.* the member's evaluation of progress toward achieving the client's financial planning goals, including whether the client's existing financial plan and specific financial planning recommendations should be updated.
- .43** In an updating engagement, the member should document the nature and extent of the member's services, including
- a.* the determination of whether the goals, objectives, information, and assumptions used as a basis for existing planning recommendations are still valid.
  - b.* the evaluation of the impact of revising recommendations on the client's ability to achieve other financial planning goals.
- .44** All other relevant guidance under the statement relating to providing PFP services should be followed in a monitoring or an updating engagement.

## Working With Other Service Providers

- .45** When referring another service provider to a client, the member should
- consider the professional qualifications of another service provider before referring the client to that service provider;
  - disclose, in writing, any compensation received for making such referrals; and
  - communicate, in writing, the extent to which the member will or will not evaluate the work performed by the service provider.

## Using Advice Provided By Other Service Providers

**.46** When the member uses the advice of another service provider when carrying out the PFP engagement, the member should understand the impact of the service provider's advice.

**.47** If the member has evaluated the advice of the other service provider, and

- if the member concurs with the other service provider's advice, the member need not communicate this concurrence to the client because concurrence is implied by its use, or
- if the member does not concur with the other service provider's advice, the member should communicate this non-concurrence to the client in writing.

## Application Material

### Scope

**.A1** The "Compliance With Standards Rule" (ET sec. 1.310.001 and 2.310.001) requires an AICPA member who performs a PFP engagement to comply with standards promulgated by the Personal Financial Planning Executive Committee (PFP EC). The PFP EC develops and issues standards in the form of statements through a process that includes deliberation in meetings open to the public, public exposure of statements, and a formal vote. The statements are codified in AICPA *Professional Standards*. (Ref: par. .02)

### Applicability (Ref: par. .03–.05)

**.A2** If any of the activities listed in paragraph .03 are provided as part of a PFP engagement, the activity is covered by the statement and should be considered in conjunction with the requirements set forth in the "Applicability" section (Ref: par. .04). In addition, depending on the nature of the service, other standards may apply (Ref: par. .05). For example, any personal income tax services provided as part of a PFP engagement are covered by the statement and are subject to the SSTSSs.

**.A3** Examples of activities not covered by the statement include the following: (Ref: par. .03–.05)

- Tax advice: Advising a client regarding his or her income tax matters or gift and estate tax matters when PFP services as defined in paragraph .03 are not provided. These services are, however, subject to the SSTSSs.

- b. Valuation services: Any engagement that would be considered a valuation service under SSVS No. 1 when PFP services as defined in paragraph .03 are not provided. These services are, however, subject to SSVS No. 1.
- c. Business succession planning
  - i. Planning to prepare for a vacancy in a key position resulting from a sudden departure, disability, or death and no advice is given to an individual.
  - ii. Planning to prepare for the sale to another firm and no advice is given to an individual.
- d. Educational discussions or presentations covering PFP
  - i. A workshop presented to a group of company employees on a PFP activity (Ref: par. .03) that does not include personalized recommendations.
  - ii. A discussion with an individual that covers one or more PFP activities (Ref: par. .03) that does not result in a personalized recommendation.
- e. Mechanical computations
  - i. Computation of the current income tax deduction for a client's contribution of assets to a charitable remainder trust.
  - ii. Computation of the current yield on a client's investment portfolio.
  - iii. Computation of the gift tax on a transfer of an asset.

**.A4** A member may identify and create an analysis of historical spending and income activity for a client as a purely mechanical computation, which would not be considered PFP services. However, extension of this analysis to future periods based on the judgment of the member that entails the use of assumptions and personalized recommendations regarding investing would be considered PFP services.

## General Professional Responsibilities

**.A5** Interpretive publications are not standards on PFP practice. Interpretive publications are recommendations on the application of the statement in specific circumstances. An interpretive publication is issued under the authority of the PFP EC after all members have been provided an opportunity to consider and comment on whether the interpretive publication is consistent with the statement. (Ref: par. .16)

## Responsibilities of Members in PFP Engagements (Ref: par. .18–.23)

**.A6** The member is required to comply with the "Commissions and Referral Fees Rule" (ET sec. 1.520.001). (Ref: par. .22)

**.A7** The member is subject to relevant ethical requirements relating to PFP engagements (Ref: par. .18). Ethical requirements consist of the AICPA Code of Professional Conduct, rules of state boards of accountancy from which the member holds a license, and applicable regulatory agencies that are more stringent. The AICPA Code of Professional Conduct establishes the fundamental principles of professional ethics, which include the following:

- a. Responsibilities
- b. The public interest
- c. Integrity
- d. Objectivity and independence
- e. Due care
- f. Scope and nature of services

**.A8** The "General Standards Rule" (ET sec. 1.300.001 and 2.300.001) explains that professional competence means that a member shall "undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence." (Ref: par. .19)

**.A9** The "Objectivity and Independence" principle (ET sec. 0.300.050) states that objectivity is a state of mind. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free from conflicts of interest. (Ref: par. .20)

**.A10** The member is required to comply with AICPA's Code of Professional Conduct "Conflicts of Interest" interpretations (ET sec. 1.110.010 and 2.110.010). (Ref: par. .20)

**.A11** Laws, regulations, and professional standards applicable to engagements to perform PFP services include, but are not necessarily limited to, the following: (Ref: par. .21, .A5)

- a. Investment Advisers Act of 1940; see Securities and Exchange Commission Interpretive Release IA-1092
- b. Treasury Department Circular No. 230
- c. State boards of accountancy
- d. AICPA Code of Professional Conduct
- e. Statements on Standards for Tax Services (SSTs)
- f. Statement on Standards for Valuation Services (SSVS) No. 1
- g. Statement on Standards for Consulting Services No. 1
- h. Statements on Standards for Accounting and Review Services (SSARS) No. 6
- i. Maintaining adequate data protection safeguards regarding a client's nonpublic personal information
- j. Maintaining client confidentiality in accordance with the applicable rules of professional conduct and federal and state laws and regulations

**.A12** Compliance with the AICPA Code of Professional Conduct depends primarily on the member's understanding and voluntary actions, secondarily on reinforcement by peers and public opinion, and ultimately on disciplinary proceedings, when necessary, against members who fail to comply with the rules. (Ref: par. .21)

**.A13** The member is not required to follow a standard format when communicating or documenting communication.

## Planning the Engagement (Ref: par. .24–.27)

**.A14** An understanding of the client may include understanding matters such as the client's family situation, commitment to the planning process, current cash flow and assets available, personal preferences, and relationships

with other professionals. This understanding may be obtained through comprehensive information gathering or may result from knowledge gained during a long-term relationship with the client.

**.A15** Additional services that require understanding and agreement by the client include the following:

- a. Implementing plan recommendations
- b. Monitoring the client's progress in achieving goals
- c. Updating recommendations

## Developing and Communicating Recommendations (Ref: par. .32–.35)

**.A16** Developing a reasonable basis for recommendations involves the following (Ref: par. .29):

- a. Collecting relevant quantitative and qualitative information. The nature and amount of information will depend on the scope and complexity of the engagement. This information may include, but is not limited to
  - i. the client's goals, existing financial situation, and available resources;
  - ii. nonfinancial factors, such as client attitudes, risk tolerance, family considerations, age, health, and life expectancy;
  - iii. external factors, such as estimates of inflation, taxes, economic conditions, legislative activity, investment markets, and interest rates; and
  - iv. reasonable estimates, projections, and assumptions furnished by the client, provided by other service providers, or developed by the member.
- b. Analyzing the client's current situation as it relates to the client's goals and objectives and identifying strengths and weaknesses of the existing financial situation.
- c. Formulating, evaluating, and recommending appropriate strategies for achieving the client's goals after due consideration of appropriate alternatives.

**.A17** The member's knowledge and experience also contribute to the basis for recommendations.

**.A18** PFP recommendations are suggested actions developed to help the client achieve personal financial goals.

**.A19** Recommendations are based on analyses and other procedures conducted prior to, and in preparation for, developing suggested actions.

**.A20** The member should help the client prioritize recommended tasks that are essential to enabling the client to act on planning decisions.

## Implementation Engagements (Ref: par. .36–.41)

**.A21** Implementation may include such activities as assisting the client in selecting other advisors, restructuring debt, obtaining new or updated estate documents, establishing cash reserves, preparing budgets, and selecting and acquiring specific investments and insurance products.

**.A22** In those situations in which the member may be functioning in a fiduciary or agency relationship, state law will control.

**.A23** The member may be engaged to assist the client in taking action on planning decisions, which may include the member doing one or more of the following:

- a. Taking responsibility for the selection and acquisition of products<sup>2</sup>
- b. Taking responsibility for the selection of service providers
- c. Establishing selection criteria
- d. Coordinating or reviewing the delivery of services or products by other service providers

**.A24** Implementation is typically completed when products are acquired or services are rendered based on the recommendations developed during the PFP engagement.

### **Monitoring and Updating Engagements (Ref: par. .42–.44)**

**.A25** A member may be engaged to assist the client in tracking progress in achieving established PFP goals or revising an existing personal financial plan, or both.

**.A26** The member may be specifically engaged by a client to provide monitoring services, updating services, or both. The member would typically have informed the client during a PFP engagement, in which planning recommendations are developed, that monitoring and updating are important elements of the financial planning process and that the member is not responsible for undertaking these services except by specific agreement with the client.

**.A27** Monitoring and updating engagements are typically undertaken after implementation of actions and recommendations developed during a PFP engagement. Monitoring and updating engagements may be either separate or combined engagements.

**.A28** Monitoring engagements vary in complexity, scope, and the nature and extent of assistance to be provided by the member. In other words, the member may undertake some or all of the monitoring services, coordinate or review monitoring services performed by other service providers, or monitor progress toward goals in a financial plan developed by other service providers.

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<sup>2</sup> Members advising clients on the selection or acquisition of products (such as investments or insurance policies) should determine whether they meet the qualifications and licensing requirements established by applicable federal and state laws.

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# CONTINUING PROFESSIONAL EDUCATION

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These standards have been approved by the Joint AICPA/NASBA CPE Standards Committee and the Board of Directors of both the AICPA and NASBA. Effective implementation dates are as follows:

- July 1, 2012, for group programs and independent study
- July 1, 2012, for self-study programs in development as of December 31, 2011, being published for the first time, or both
- March 1, 2014, for self-study programs already in existence as of December 31, 2011

The old standards are in effect through June 30, 2012 (except for self-study programs already in existence as of December 31, 2011, for which they are effective until February 28, 2014) and can be found at [www.aicpa.org/CPEAndConferences/CPERequirements/Pages/CPERequirements.aspx](http://www.aicpa.org/CPEAndConferences/CPERequirements/Pages/CPERequirements.aspx).

Continuing Professional Education (CPE) is required for CPAs to maintain their professional competence and provide quality professional services. CPAs are responsible for complying with all applicable CPE requirements, rules, and regulations of state boards of accountancy, as well as those of membership associations and other professional organizations.

The Statement on Standards for CPE Programs (*Standards*) is published jointly by the AICPA and the National Association of State Boards of Accountancy (NASBA) to provide a framework for the development, presentation, measurement, and reporting of CPE programs. The standards were last revised in 2002.

In May 2010, NASBA and the CPE Advisory Committee provided a forum for an open and candid discussion of the *Standards*. A key outcome of the forum was to develop a task force to help review, analyze and implement suggestions and changes to the *Standards*.

The NASBA CPE Advisory Committee, with input from NASBA leadership, selected 13 task force participants. Careful consideration was given as to the composition of the task force to ensure that all facets of the CPE community were represented. The task force is comprised of CPE program sponsors; CPE Advisory Committee members; state board of accountancy members; state society members; educators; and a representative of the AICPA (provider side).

The task force developed its recommended revisions to the *Standards* and presented its recommendations to a Joint CPE Standards Committee made up of representatives from the AICPA and NASBA. The Joint CPE Standards Committee presented its recommendation to the respective AICPA and NASBA Boards of Directors. In August 2011, the *Standards* exposure draft was released for comment. The revisions to the *Standards* were approved by the AICPA Board of Directors and the NASBA Board of Directors in January 2012.

The *Standards* are intended to be an "evergreen" document. As questions arise related to implementation and application of the *Standards*, the questions will be presented to the CPE Standards Working Group whose composition will be

similar to that of the task force. The CPE Standards Working Group will meet quarterly and scheduled meeting dates will be posted on the NASBA website, LearningMarket.org. NASBA will communicate the findings of the CPE Standards Working Group to the specific CPE program sponsor. Authoritative interpretations will only be issued by the CPE Advisory Committee in limited cases when the matter is not addressed in the *Standards*, cannot be addressed specifically with the CPE program sponsor, or cannot be addressed in the Best Practices document. All interpretations issued by the CPE Advisory Committee will be reviewed and considered by the Joint AICPA/NASBA CPE Standards Committee upon the next revision of the *Standards*.

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## CPE Section 100

### *Preamble*

Revised, January 2012.

**.01** The right to use the title "Certified Public Accountant" (CPA) is regulated by each state's board of accountancy in the public interest and imposes a duty to maintain public confidence and current knowledge, skills, and abilities in all areas in which they provide services. CPAs must accept and fulfill their ethical responsibilities to the public and the profession regardless of their fields of employment.<sup>1</sup>

**.02** The profession of accountancy is characterized by an explosion of relevant knowledge, ongoing changes and expansion, and increasing complexity. Advancing technology, globalization of commerce, increasing specialization, proliferating regulations, and the complex nature of business transactions have created a dynamic environment that requires CPAs to continuously maintain and enhance their knowledge, skills, and abilities.

**.03** The continuing development of professional competence involves a program of lifelong educational activities. *Continuing Professional Education (CPE)* is the term used in these standards to describe the educational activities that assist CPAs in achieving and maintaining quality in professional services.

**.04** The following standards have been broadly stated in recognition of the diversity of practice and experience among CPAs. They establish a framework for the development, presentation, measurement, and reporting of CPE programs and thereby help to ensure that CPAs receive the quality CPE necessary to satisfy their obligations to serve the public interest. These standards may also apply to other professionals by virtue of employment or membership. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit.

**.05** Advances in technology, delivery and workplace arrangements may lead to innovative learning techniques. Learning theory may evolve to include more emphasis on outcome based learning. These standards anticipate innovation in CPE in response to these advances. Sponsors must ensure innovative learning techniques are in compliance with the standards. CPE program sponsors are encouraged to consult with the National Association of State Boards of Accountancy (NASBA) with questions related to compliance with the standards when utilizing innovative techniques.

**.06** These standards create a basic foundation for sound educational programs. Sponsors may wish to provide enhanced educational and evaluative techniques to all programs.

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<sup>1</sup> The term *CPAs* is used in these standards to identify all persons who are licensed or regulated by boards of accountancy.



## CPE Section 200

# General Guidelines for CPAs

Revised, January 2012.

### Professional Competence

**.01** All CPAs should participate in learning activities that maintain or improve their professional competence.<sup>1</sup>

**.02** Selection of learning activities should be a thoughtful, reflective process addressing the individual CPA's current and future professional plans, current knowledge and skills level, and desired or needed additional competence to meet future opportunities or professional responsibilities or both.

**.03** CPAs fields of employment do not limit the need for Continuing Professional Education (CPE). CPAs performing professional services need to have a broad range of knowledge, skills, and abilities. Thus, the concept of professional competence may be interpreted broadly. Accordingly, acceptable continuing education encompasses programs contributing to the development and maintenance of professional skills.

**.04** The fields of study represent the primary knowledge and skill areas needed by CPAs to perform professional services in all fields of employment.

**.05** To help guide their professional development, CPAs may find it useful to develop a learning plan. Learning plans are structured processes that help CPAs guide their professional development. They are dynamic instruments used to evaluate and document learning and professional competence development. They may be reviewed regularly and modified as CPAs' professional competence needs change. Plans include: a self-assessment of the gap between current and needed knowledge, skills, and abilities; a set of learning objectives arising from this assessment; and learning activities to be undertaken to fulfill the learning plan.

### CPE Compliance

**.06** CPAs must comply with all applicable CPE requirements.

**.07** CPAs are responsible for compliance with all applicable CPE requirements, rules, and regulations of state licensing bodies, other governmental entities, membership associations, and other professional organizations or bodies. CPAs should contact each appropriate entity to which they report to determine its specific requirements or any exceptions it may have to the standards presented herein.

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<sup>1</sup> The terms *should* and *must* are intended to convey specific meanings within the context of the *Joint AICPA/NASBA Statement on Standards for Continuing Professional Education Programs*. The term *must* is used in the standards applying to CPAs and Continuing Professional Education (CPE) program sponsors to convey that CPAs and CPE program sponsors are not permitted any departure from those specific standards. The term *should* is used in the standards applying to both CPAs and CPE program sponsors and is intended to convey that CPAs and CPE program sponsors are encouraged to follow such standards as written.

.08 Periodically, CPAs participate in learning activities which do not comply with all applicable CPE requirements, for example specialized industry programs offered through industry sponsors. If CPAs propose to claim credit for such learning activities, they must retain all relevant information regarding the program to provide documentation to state licensing bodies or all other professional organizations or bodies that the learning activity is equivalent to one which meets all these standards.

## CPE Credits Record Documentation

.09 CPAs are responsible for accurate reporting of the appropriate number of CPE credits earned and must retain appropriate documentation of their participation in learning activities.

.10 To protect the public interest, regulators require CPAs to document maintenance and enhancement of professional competence through periodic reporting of CPE. For convenience, measurement is expressed in CPE credits. However, the objective of CPE must always be maintenance/enhancement of professional competence, not attainment of credits. Compliance with regulatory and other requirements mandates that CPAs keep documentation of their participation in activities designed to maintain or improve professional competence. In the absence of legal or other requirements, a reasonable policy is to retain documentation for a minimum of five years from the end of the year in which the learning activities were completed.

.11 Participants must document their claims of CPE credit. Examples of acceptable evidence of completion include

- for group and independent study programs, a certificate or other verification supplied by the CPE program sponsor.
- for self-study programs, a certificate supplied by the CPE program sponsor after satisfactory completion of an examination.
- for instruction credit, appropriate supporting documentation that complies with the requirements of the respective state boards subject to the guidelines in "Standard 15 in Standards for CPE Program Measurement" section 300 par. .57).
- for a university or college course that is successfully completed for credit, a record or transcript of the grade the participant received.
- for university or college noncredit courses, a certificate of attendance issued by a representative of the university or college.
- for published articles, books, or CPE programs, (a) a copy of the publication (or in the case of a CPE program, course development documentation) that names the writer as author or contributor, (b) a statement from the writer supporting the number of CPE hours claimed, and (c) the name and contact information of the independent reviewer(s) or publisher.

## Reporting CPE Credits

.12 CPAs who complete sponsored learning activities that maintain or improve their professional competence must claim no more than the CPE credits recommended by CPE program sponsors subject to the state board regulations.

.13 CPAs may participate in a variety of sponsored learning activities, such as workshops, seminars and conferences, self-study courses, Internet-based programs, and independent study. While CPE program sponsors determine credits,

CPAs must claim credit only for activities through which they maintained or improved their professional competence. CPAs who participate in only part of a program must claim CPE credit only for the portion they attended or completed.

## Independent Study

**.14** CPAs may engage in independent study under the direction of a CPE program sponsor who has met the applicable standards for CPE program sponsors when the subject matter and level of study maintain or improve their professional competence.

**.15** Independent study is an educational process designed to permit a participant to learn a given subject under the guidance of a CPE program sponsor. Participants in an independent study program must

- enter into a written learning contract with a CPE program sponsor that must comply with the applicable standards for CPE program sponsors. A learning contract
  1. specifies the nature of the independent study program and the time frame over which it is to be completed, not to exceed 15 weeks.
  2. specifies that the output must be in the form of a written report that will be reviewed by the CPE program sponsor or a qualified person selected by the CPE program sponsor.
  3. outlines the maximum CPE credit that will be awarded for the independent study program, but limits credit to actual time spent.
- accept the written recommendation of the CPE program sponsor as to the number of credits to be earned upon successful completion of the proposed learning activities. CPE credits will be awarded only if
  1. all the requirements of the independent study as outlined in the learning contract are met,
  2. the CPE program sponsor reviews and signs the participant's report,
  3. the CPE program sponsor reports to the participant the actual credits earned, and
  4. the CPE program sponsor provides the participant with contact information.

The maximum credits to be recommended by an independent study CPE program sponsor must be agreed upon in advance and must be equated to the effort expended to improve professional competence. The credits cannot exceed the time devoted to the learning activities and may be less than the actual time involved.

- retain the necessary documentation to satisfy regulatory requirements as to the content, inputs, and outcomes of the independent study.



## CPE Section 300

# *Standards for CPE Program Sponsors*

Revised, January 2012.

## General Standards

**.01 Standard No. 1. Continuing Professional Education (CPE) program sponsors are responsible for compliance with all applicable standards and other CPE requirements.**

**.02 S1-01. CPE requirements of licensing bodies and others.** CPE program sponsors may have to meet specific CPE requirements of state licensing bodies, other governmental entities, membership associations, or other professional organizations or bodies. Professional guidance for CPE program sponsors is available from the National Association of State Boards of Accountancy (NASBA); state-specific guidance is available from the state boards of accountancy. CPE program sponsors should contact the appropriate entity to determine requirements.

## Standards for CPE Program Development

**.03 Standard No. 2. Sponsored learning activities must be based on relevant learning objectives and outcomes that clearly articulate the knowledge, skills, and abilities that can be achieved by participants in the learning activities.**

**.04 S2-01. Program knowledge level.** Learning activities provided by CPE program sponsors for the benefit of CPAs must specify the knowledge level, content, and learning objectives so that potential participants can determine if the learning activities are appropriate to their professional competence development needs. Knowledge levels consist of basic, intermediate, advanced, update, and overview (see definitions in Glossary [section 400]).

**.05 Standard No. 3. CPE program sponsors must develop and execute learning activities in a manner consistent with the prerequisite education, experience, or advance preparation of participants.**

**.06 S3-01. Prerequisite education and experience.** To the extent it is possible to do so, CPE program sponsors should make every attempt to equate program content and level with the backgrounds of intended participants. All programs must clearly identify prerequisite education, experience, and/or advance preparation, if any, in precise language so that potential participants can readily ascertain whether they qualify for the program.

**.07 Standard No. 4. CPE program sponsors must use activities, materials, and delivery systems that are current, technically accurate, and effectively designed. All courses must contain the most recent publication, revision or review date. Courses must be revised as soon as feasible following changes to relative codes, laws, rulings, decisions, interpretations, and the like. Courses in subjects that undergo frequent changes must be reviewed by an individual with subject matter expertise at least once a year to verify the currency of the content. Other courses must be reviewed at least every two years.**

**.08 S4-01. Developed by a subject matter expert.** Learning activities must be developed by individuals or teams having expertise in the subject matter. Expertise may be demonstrated through practical experience or education.

**.09 Standard No. 5. CPE program sponsors of group and self-study programs must ensure learning activities are reviewed by qualified persons other than those who developed the programs to assure that the program is technically accurate and current and addresses the stated learning objectives.** These reviews must occur before the first presentation of these materials and again after each significant revision of the CPE programs. The participation of at least one CPA is required in the development of every program in accounting and auditing. The participation of a CPA, tax attorney, or IRS enrolled agent is required in the development of each program in the field of study of taxes. As long as this requirement is met at some point during the development process, a program would be in compliance. Whether to have this individual involved during the development or the review process is at the CPE program sponsor's discretion.

**.10 S5-01. Qualifications of reviewers.** Individuals or teams qualified in the subject matter must review programs. When it is impractical to review certain programs in advance, such as lectures given only once, greater reliance should be placed on the recognized professional competence of the instructors or presenters. Using independent reviewing organizations familiar with these standards may enhance quality assurance.

**.11 Standard No. 6. CPE program sponsors of independent study learning activities must be qualified in the subject matter.**

**.12 S6-01. Requirements of independent study sponsor.** A CPE program sponsor of independent study learning activities must have expertise in the specific subject area related to the independent study. The CPE program sponsor must also

- review, evaluate, approve, and sign the proposed independent study learning contract, including agreeing in advance on the number of credits to be recommended upon successful completion.
- review and sign the written report developed by the participant in independent study.
- retain the necessary documentation to satisfy regulatory requirements as to the content, inputs, and outcomes of the independent study.

**.13 Standard No. 7. Group internet-based programs must employ learning methodologies that clearly define learning objectives, guide the participant through the learning process, and provide evidence of a participant's satisfactory completion of the program.**

**.14 S7-01. Live instructor during program presentation.** Group internet-based programs must have a live instructor while the program is being presented. Program participants must be able to interact with the live instructor while the course is in progress (including the opportunity to ask questions and receive answers during the presentation). Once a group internet-based program is recorded or archived for future presentation, it will continue to be considered a group internet-based program only where a live subject matter expert facilitates the recorded presentation. Any future presentations that do not include a live subject matter expert will be considered a self-study program and must meet all self-study delivery method requirements with the exception

of the basis for CPE credit. CPE credit for an archived group program will be equal to the CPE credit awarded to the original presentation.

**.15 Standard No. 8. Self-study programs must use learning methodologies that clearly define learning objectives, guide the participant through the learning process, and provide evidence of a participant's satisfactory completion of the program.**

**.16 S8-01. Guide participant through learning process.** To guide participants through a learning process, CPE program sponsors of self-study programs must elicit participant responses to test for understanding of the material. Learners must participate in activities during instruction to demonstrate achievement of learning objectives. Appropriate feedback must be provided. Achievement of learning objectives must be confirmed after the course through a final assessment.

**.17 S8-02. Use of review questions.** Review questions must be placed at the end of each learning activity throughout the program in sufficient intervals to allow the learner the opportunity to evaluate the material that needs to be re-studied. If objective type questions are used, at least three review questions per CPE credit must be included or two review questions if the program is marketed for one-half CPE credits.

**.18 S8-03. Evaluative and reinforcement feedback on review questions.** If the multiple choice method is used, evaluative feedback for each incorrect response must explain why each response is wrong and reinforcement feedback must be provided for correct responses. If rank order or matching questions are used, then it is permissible to provide single feedback to explain the correct response. Simulations and other innovative tools that guide participants through structured decisions could provide feedback at irregular intervals or at the end of the learning experience. In those situations, single feedback would be permissible. True/false questions are allowed as review questions but are not included in the number of review questions required per CPE credit. Forced choice questions, when used as part of an overall learning strategy, are allowed as review questions and can be counted in the number of review questions required per CPE credit. There is no minimum passing rate required for review questions.

**.19 S8-04. Final examination requirements.** To provide evidence of satisfactory completion of the course, CPE program sponsors of self-study programs must require participants to successfully complete a final examination with a minimum-passing grade of at least 70 percent before issuing CPE credit for the course. Examinations may contain questions of varying format (for example, multiple-choice, essay, and simulations). At least five questions/scored responses per CPE credit must be included on the final examination or three final exam questions if the program is marketed for one-half CPE credits. For example, the final examination for a five-credit course must include at least 25 questions. Alternatively, a five and one-half credit course must include at least 28 questions. Except in courses where recall of information is the learning strategy, duplicate review and final exam questions are not allowed. True/false questions are not permissible on the final examination in accordance with the implementation effective dates of these standards.

**.20 S8-05. Feedback on final examination.** Providing feedback on the final examination is at the discretion of the CPE program sponsor. If the CPE program sponsor chooses to provide feedback and utilizes a test bank, then the CPE program sponsor must ensure that the question test bank is of sufficient size to minimize overlap of questions on the final examination for the typical repeat test-taker. Feedback may comply with the feedback for review questions

as described in S8-03, or take the form of identifying correct and incorrect answers.

**.21** Does not utilize a test bank, whether or not feedback can be given depends on whether the learner passes the final examination, then

- on a failed examination, the CPE program sponsor may not provide feedback to the test-taker.
- on examinations passed successfully, CPE program sponsors may choose to provide participants with feedback. This feedback may comply with the type of feedback for review questions as described in S8-03, or take the form of identifying correct and incorrect answers.

**.22 S8-06. Program/course expiration date.** All courses must include an expiration date (the time by which the learner must complete the final examination). For individual courses, the expiration date is no longer than one year from the date of purchase or enrollment. For a series of courses to achieve an integrated learning plan, the expiration date may be longer.

**.23 S8-07. Based on materials developed for instructional use.** Self-study programs must be based on materials specifically developed for instructional use and not on third party materials. Self-study programs requiring only the reading of general professional literature, IRS publications, or reference manuals followed by a test will not be acceptable. However, the use of the publications and reference materials in self-study programs as supplements to the instructional materials could qualify if the self-study program complies with each of the CPE standards.

**.24** Instructional materials for self-study include teaching materials which are written for instructional educational purposes. These materials must demonstrate the expertise of the author(s). At a minimum, instructional materials must include the following items:

1. An overview of topics;
2. The ability to find information quickly;
3. The definition of key terms;
4. Instructions to participants;
5. Review questions with feedback; and
6. Final exam.

## Standards for CPE Program Presentation

**.25 Standard No. 9. CPE program sponsors must provide descriptive materials that enable CPAs to assess the appropriateness of learning activities. For CPE program sponsors whose courses are developed for sale or for external audiences (not internal training), CPE program sponsors must make the following information available in advance:**

- **Learning objectives.**
- **Instructional delivery methods.**
- **Recommended CPE credit and recommended field of study.**
- **Prerequisites.**
- **Program level.**
- **Advance preparation.**
- **Program description.**

- **Course registration requirements.**
- **Refund policy for courses sold for a fee/cancellation policy.**
- **Complaint resolution policy.**
- **Official NASBA sponsor statement, if an approved NASBA sponsor (explaining final authority of acceptance of CPE credits).**

**For CPE program sponsors whose courses are purchased or developed for internal training only, CPE program sponsors must make the following information available in advance:**

- **Learning objectives.**
- **Instructional delivery methods.**
- **Recommended CPE credit and recommended field of study.**
- **Prerequisites.**
- **Advance preparation.**
- **Program level (for optional internal courses only).**
- **Program description (for optional internal course only).**

**.26 S9-01. Disclose significant features of program in advance.** For potential participants to effectively plan their CPE, the program sponsor must disclose the significant features of the program in advance (such as through the use of brochures, website, electronic notices, invitations, direct mail, or other announcements). When CPE programs are offered in conjunction with noneducational activities, or when several CPE programs are offered concurrently, participants must receive an appropriate schedule of events indicating those components that are recommended for CPE credit. The CPE program sponsor's registration policies and procedures must be formalized, published, and made available to participants and include refund/cancellation policies as well as complaint resolution policies.

**.27 S9-02. Disclose advance preparation and prerequisites.** CPE program sponsors must distribute program materials in a timely manner and encourage participants to complete any advance preparation requirements. All programs must clearly identify prerequisite education, experience, and advance preparation requirements, if any, in the descriptive materials. Prerequisites, if any, must be written in precise language so that potential participants can readily ascertain whether they qualify for the program.

**.28 Standard No. 10. CPE program sponsors must ensure instructors are qualified with respect to both program content and instructional methods used.**

**.29 S10-01. Qualifications of instructors.** Instructors are key ingredients in the learning process for any group program. Therefore, it is imperative that CPE program sponsors exercise great care in selecting qualified instructors for all group programs. Qualified instructors are those who are capable, through training, education, or experience of communicating effectively and providing an environment conducive to learning. They must be competent and current in the subject matter, skilled in the use of the appropriate instructional methods and technology, and prepared in advance.

**.30 S10-02. Evaluation of instructors' performance.** CPE program sponsors should evaluate the instructor's performance at the conclusion of each program to determine the instructor's suitability to serve in the future.

**.31 Standard No. 11. CPE program sponsors must employ an effective means for evaluating learning activity quality with respect to content and presentation, as well as provide a mechanism for participants to assess whether learning objectives were met.**

**.32 S11-01. Required elements of evaluation.** The objectives of evaluation are to assess participant satisfaction with specific programs and to increase subsequent program effectiveness. Evaluations, whether written or electronic, must be solicited from participants and instructors for each program session, including self-study, to determine, among other things, whether

- stated learning objectives were met.
- stated prerequisite requirements were appropriate and sufficient.
- program materials were relevant and contributed to the achievement of the learning objectives.
- time allotted to the learning activity was appropriate.
- if applicable, individual instructors were effective.

**.33 S11-02. Evaluation results.** CPE program sponsors must periodically review evaluation results to assess program effectiveness and should inform developers and instructors of evaluation results.

**.34 Standard No. 12. CPE program sponsors must ensure instructional methods employed are appropriate for the learning activities.**

**.35 S12-01. Evaluate instructional method in context of program presentation.** CPE program sponsors must evaluate the instructional methods employed for the learning activities to determine if the delivery is appropriate and effective.

**.36 S12-02. Facilities and technology appropriateness.** Learning activities must be presented in a manner consistent with the descriptive and technical materials provided. Integral aspects in the learning environment that should be carefully monitored include the number of participants and the facilities and technologies employed in the delivery of the learning activity.

## Standards for CPE Program Measurement

**.37 Standard No. 13. Sponsored learning activities are measured by actual program length, with one 50-minute period equal to one CPE credit. Sponsors may recommend one-half CPE credits under the following scenarios:**

- **Group**—after the first credit has been earned.
- **Self-study**—one-half increments (equal to 25 minutes) are permitted.

**The CPA claiming CPE credits should refer to respective state board requirements regarding acceptability of one-half CPE credits.**

**.38 S13-01. Learning activities with individual segments.** For learning activities in which individual segments are less than 50 minutes, the sum of the segments would be considered one total program. For example, five 30-minute presentations would equal 150 minutes and would be counted as three CPE credits. When the total minutes of a sponsored learning activity are greater than 50, but not equally divisible by 50, the CPE credits granted must be rounded down to the nearest one-half credit, if one-half credits are awarded.

Thus, learning activities with segments totaling 140 minutes would be granted two and one-half CPE credits.

**.39 S13-02. Responsibility to monitor attendance.** While it is the participant's responsibility to report the appropriate number of credits earned, CPE program sponsors must monitor group learning participation to assign the correct number of CPE credits.

**.40 S13-03. Monitoring mechanism for group internet-based programs.** In addition to meeting all other applicable group program standards and requirements, group internet-based programs must employ some type of monitoring mechanism to verify that participants are participating during the duration of the course. The monitoring mechanism must be of sufficient frequency and lack predictability to provide assurance that participants have been engaged throughout the program. If polling questions are used as a monitoring mechanism, at least three polling questions must be used per CPE credit hour. CPE program sponsors should verify with respective state boards on specific polling requirements.

**.41 S13-04. Small group viewing of group internet-based programs.** In situations where small groups view a group internet-based program such that one person logs into the program and asks questions on behalf of the group, documentation of attendance is required in order to award CPE credits to the group of participants. Participation in the group must be documented and verified by the small group facilitator or administrator in order to authenticate attendance for program duration.

**.42 S13-05. University or college credit course.** For university or college credit courses that meet these CPE Standards, each unit of college credit shall equal the following CPE credits:

- Semester System—15 credits
- Quarter System—10 credits

**.43 S13-06. University or college noncredit course.** For university or college noncredit courses that meet these CPE standards, CPE credit shall be awarded only for the actual classroom time spent in the noncredit course.

**.44 S13-07. Participant preparation time.** Credit is not granted to participants for preparation time.

**.45 S13-08. Committee or staff meetings qualification for CPE credits.** Only the portions of committee or staff meetings that are designed as programs of learning and comply with these standards qualify for CPE credit.

**.46 Standard No. 14. CPE credit for self-study learning activities must be based on one of the following educationally sound and defensible methods:**

**Method 1: Pilot test of the representative completion time.**

**Method 2: Computation using the prescribed word count formula.**

**.47 S14-01. Method 1—Sample group of pilot testers.** A sample of intended professional participants must be selected to test program materials in an environment and manner similar to that in which the program is to be presented. The sample group must consist of at least three qualified individuals who are independent of the program development group. For those courses whose target audience includes CPAs, the sample group must be licensed CPAs currently subject to state CPE requirements as defined by state board requirements and possess the appropriate level of knowledge before taking the program. For those sponsors who are subject to various regulatory requirements

that mandate a minimum number of CPE credits and offer courses to non-CPAs, those courses do not have to be pilot tested by licensed CPAs.

**.48 S14-02. Method 1—CPE credit based on representative completion time.** The sample does not have to ensure statistical validity; however, if the results of pilot testing are inconsistent, then the sample must be expanded or any inconsistent results eliminated. CPE credit must be recommended based on the representative completion time for the sample. Completion time includes the time spent taking the final examination and does not include the time spent completing the course evaluation. Pilot testers must not be informed about the length of time the program is expected to take to complete. If substantive changes are subsequently made to program materials, further pilot tests of the revised program materials must be conducted to affirm or amend, as appropriate, the representative completion time.

**.49 S14-03. Method 1—Requirement for re-pilot testing.** If, subsequent to course release, actual participant completion time warrants a change in CPE credit hours, re-pilot testing is required to substantiate a change in CPE credit prospectively.

**.50 S14-04. Method 1—Pilot testing when course is purchased from vendor or other developer.** CPE program sponsors may purchase courses from other vendors or course developers. For purchased courses where pilot tests were conducted and provided, CPE program sponsors must review results of the course developer's pilot test results to ensure that the results are appropriate. For purchased courses where no pilot tests were conducted or provided, CPE program sponsors must conduct pilot testing or perform the word count formula as prescribed in method 2.

**.51 S14-05. Method 2—Basis for prescribed word count formula.** The prescribed word count formula begins with a word count of the number of words contained in the text of the required reading of the self-study program and should exclude any material not critical to the achievement of the stated learning objectives for the program. Examples of information material that are not critical and therefore *excluded* from the word count are: course introduction; instructions to the learner; author/course developer biographies; table of contents; glossary; and appendices containing supplementary reference materials.

**.52** Again, only course content text that is critical to the achievement of stated learning objectives should be included in the word count formula. If an author/course developer determines, for example, that including the entire accounting rule or tax regulation is beneficial to the learner, the accounting rule or tax regulation should be included as an appendix to the course as supplementary reference material and excluded from the word count formula. Only pertinent paragraphs or sections of the accounting rule or tax regulation required for the achievement of stated learning objectives should be included in the actual text of the course and therefore included in the word count formula.

**.53** Review questions, exercises and final examination questions are considered separately in the calculation and should not be included in the word count.

**.54 S14-06. Method 2—Consideration of audio and video segments in word count formula.** If audio and video segments of a self-study program constitute additional learning for the participant (not narration of the text), then the actual audio/video duration time may be added to the time calculation as provided in the prescribed word count formula.

**.55 S14-07. Method 2—Calculation of CPE credit using the prescribed word count formula.** The word count for the text of the required reading of the program is divided by 180, the average reading speed of adults. The total number of review questions, exercises and final examination questions is multiplied by 1.85, which is the estimated average completion time per question. These two numbers plus actual audio/video duration time, if any, are then added together and the result divided by 50 to calculate the CPE credit for the self-study program. When the total minutes of a self-study program are not equally divisible by 50, the CPE credits granted must be rounded down to the nearest one-half credit.

$$[(\# \text{ of words}/180) + \text{actual audio/video duration time} + (\# \text{ of questions} \times 1.85)]/50 = \text{CPE credit}$$

**.56 S14-08. Method 2—Word count formula when course is purchased from vendor or other developer.** CPE program sponsors may purchase courses from other vendors or course developers. For purchased courses where the word count formula was calculated, CPE program sponsors must review the results of the course developer's word count formula calculation to ensure that results are appropriate. For purchased courses where the word count formula calculation was not performed or provided, CPE program sponsors must perform the word count formula calculation or conduct pilot testing as described in method 1.

**.57 Standard No. 15. Instructors or discussion leaders of learning activities may receive CPE credit for their preparation and presentation time to the extent the activities maintain or improve their professional competence and meet the requirements of these CPE standards.**

**.58 S15-01. Instructor CPE credit parameters.** Instructors, discussion leaders, or speakers who present a learning activity for the first time may receive CPE credit for actual preparation time up to two times the number of CPE credits to which participants would be entitled, in addition to the time for presentation, subject to regulations and maximums established by the state boards. For example, for learning activities in which participants could receive 8 CPE credits, instructors may receive up to 24 CPE credits (16 for preparation plus 8 for presentation). For repeat presentations, CPE credit can be claimed only if it can be demonstrated that the learning activity content was substantially changed and such change required significant additional study or research.

**.59 S15-02. Authoring and presenting a program.** The CPA claiming CPE credits should refer to respective state board requirements.

**.60 Standard No. 16. Writers of published articles, books, or CPE programs may receive CPE credit for their research and writing time to the extent it maintains or improves their professional competence.**

**.61 S16-01. Requirement for review from independent party.** Writing articles, books, or CPE programs for publication is a structured activity that involves a process of learning. For the writer to receive CPE credit, the article, book, or CPE program must be formally reviewed by an independent party. CPE credits should be claimed only upon publication.

**.62 S16-02. Authoring and presenting a program.** As a general rule, receiving CPE credits for authoring and presenting the same program should not be allowed. The CPA claiming CPE credits should refer to respective state board requirements.

**.63 Standard No. 17. CPE credits recommended by a CPE program sponsor of independent study must not exceed the time the participant devoted to complete the learning activities specified in the learning contract.**

**.64 S17-01. CPE credits agreed to in advance.** The maximum credits to be recommended by an independent study CPE program sponsor must be agreed upon in advance and must be equated to the effort expended to improve professional competence. The credits cannot exceed the time devoted to the learning activities and may be less than the actual time involved.

## Standards for CPE Program Reporting

**.65 Standard No. 18. CPE program sponsors must provide program participants at or after the conclusion of the program with documentation (electronic or paper) of their participation (certificate of completion), which includes the following:**

- CPE program sponsor name and contact information
- Participant's name
- Course title
- Course field of study
- Date offered or completed
- If applicable, location
- Type of instructional/delivery method used
- Amount of CPE credit recommended
- Verification by CPE program sponsor representative
- Sponsor identification number or registration number, if required by the state boards
- NASBA time statement stating that CPE credits have been granted on a 50-minute hour
- Any other statements required by state boards

**.66 S18-01. Entity to award CPE credits and acceptable documentation.** The CPE program sponsor is the individual or organization responsible for issuing the certificate of completion and maintaining the documentation required by these standards. The entity whose name appears on the certificate of completion is responsible for validating the CPE credits claimed by a participant. CPE program sponsors must provide participants with documentation (electronic or paper) to support their claims of CPE credit. Acceptable evidence of completion includes

- for group and independent study programs, a certificate or other verification supplied by the CPE program sponsor.
- for self-study programs, a certificate supplied by the CPE program sponsor after satisfactory completion of an examination.
- for instruction credit, appropriate supporting documentation that complies with the requirements of the respective state boards subject to the guidelines in Standard 15 in "Standards for CPE Program Measurement" (section 300 par. .57).
- for a university or college course that is successfully completed for credit, a record or transcript of the grade the participant received.

- for university or college noncredit courses, a certificate of attendance issued by a representative of the university or college.
- for published articles, books, or CPE programs, (1) a copy of the publication (or in the case of a CPE program, course development documentation) that names the writer as author or contributor, (2) a statement from the writer supporting the number of CPE hours claimed, and (3) the name and contact information of the independent reviewer(s) or publisher.

**.67 Standard No. 19. CPE program sponsors must retain adequate documentation (electronic or paper) for a minimum of five years to support their compliance with these standards and the reports that may be required of participants.**

**.68 S19-01. Required documentation elements.** Evidence of compliance with responsibilities set forth under these standards which is to be retained by CPE program sponsors includes, but is not limited to

- records of participation.
- dates and locations.
- instructor names and credentials.
- number of CPE credits earned by participants.
- results of program evaluations.

**.69** Information to be retained by developers includes copies of program materials, evidence that the program materials were developed and reviewed by qualified parties, and a record of how CPE credits were determined.

**.70 S19-02. Maintenance of documentation as basis for CPE credit for self-study programs.** For CPE program sponsors using method 1 (pilot tests) as the basis for CPE credit for self-study programs, appropriate pilot test records must be retained regarding the following:

- When the pilot test was conducted
- The intended participant population
- How the sample of pilot testers was selected
- Names and credentials and relevant experience of sample pilot test participants
- A summary of pilot test participants' actual completion time
- Statement from each pilot tester to confirm that the pilot tester is independent from the course development group and that the pilot tester was not informed in advance of the expected completion time

**.71** For CPE program sponsors using method 2 (word count formula) as the basis for CPE credit for self-study programs, the word count formula calculation as well as the supporting documentation for the data used in the word count formula (such as, word count; number of review questions, exercises and final examination questions; duration of audio or video segments, if applicable; and actual calculation) must be retained.

## Effective Dates

**.72** Unless otherwise established by state licensing bodies or other professional organizations, these standards are to be effective as follows:

1. For group programs and independent study—July 1, 2012.
  2. For self-study programs in development as of December 31, 2011, or being published for the first time, or both—July 1, 2012.
  3. For self-study programs already in existence as of December 31, 2011—March 1, 2014.
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## CPE Section 400

### Glossary

Revised, January 2012.

**.01 Advanced.** Program knowledge level most useful for individuals with mastery of the particular topic. This level focuses on the development of in-depth knowledge, a variety of skills, or a broader range of applications. Advanced level programs are often appropriate for seasoned professionals within organizations; however, they may also be beneficial for other professionals with specialized knowledge in a subject area.

**.02 Archived.** A learning activity through which a group program has been recorded for future use.

**.03 Basic.** Program knowledge level most beneficial to CPAs new to a skill or an attribute. These individuals are often at the staff or entry level in organizations, although such programs may also benefit a seasoned professional with limited exposure to the area.

**.04 Continuing Professional Education (CPE).** An integral part of the lifelong learning required to provide competent service to the public. The set of activities that enables CPAs to maintain and improve their professional competence.

**.05 CPE credit hour.** Fifty minutes of participation in a program of learning.

**.06 CPE program sponsor.** The individual or organization responsible for issuing the certificate of completion, and maintaining the documentation required by these standards. The term *CPE program sponsor* may include associations of CPAs, whether formal or informal, as well as employers who offer in-house programs.

**.07 Evaluative feedback.** Specific response to incorrect answers to questions in self-study programs.

**.08 Group internet-based program.** An educational process designed to permit a participant to learn a given subject through interaction with an instructor by using the Internet.

**.09 Group live program.** An educational process designed to permit a participant to learn a given subject through interaction with an instructor and other participants either in a classroom or conference setting.

**.10 Group program.** Any group live or group internet-based programs.

**.11 Independent study.** An educational process designed to permit a participant to learn a given subject under a learning contract with a CPE program sponsor.

**.12 Instructional methods.** Delivery strategies such as case studies, computer-assisted learning, lectures, group participation, programmed instruction, teleconferencing, use of audiovisual aids, or work groups employed in group, self-study, or independent study programs or other innovative programs.

**.13 Intermediate.** Program knowledge level that builds on a basic program, most appropriate for CPAs with detailed knowledge in an area. Such

persons are often at a mid-level within the organization, with operational or supervisory responsibilities.

**.14 Internet-based programs.** A learning activity through a group program or a self-study program that is designed to permit a participant to learn the given subject matter via the Internet. To qualify as either a group or self-study program, the Internet learning activity must meet the respective standards.

**.15 Learning activity.** An educational endeavor that maintains or improves professional competence.

**.16 Learning contract.** A written contract signed by an independent study participant and a qualified CPE program sponsor prior to the commencement of the independent study.

**.17 Learning objectives.** Specifications on what participants should accomplish in a learning activity. Learning objectives are useful to program developers in deciding appropriate instructional methods and allocating time to various subjects.

**.18 Overview.** Program knowledge level that provides a general review of a subject area from a broad perspective. These programs may be appropriate for professionals at all organizational levels.

**.19 Pilot test.** Sampling of at least three individuals independent of the development team and representative of the intended participants to measure the representative completion time as one method to determine the recommended CPE credit for self-study programs.

**.20 Professional competence.** Having requisite knowledge, skills, and abilities to provide quality services as defined by the technical and ethical standards of the profession. The expertise needed to undertake professional responsibilities and to serve the public interest.

**.21 Program of learning.** A collection of learning activities that are designed and intended as continuing education and that comply with these standards.

**.22 Reinforcement feedback.** Specific responses to correct answers to questions in self-study programs.

**.23 Self-study program.** An educational process designed to permit a participant to learn a given subject without involvement of an instructor.

**.24 Word count formula.** A method, detailed under S14-05 Method 2, to determine the recommended CPE credit for self-study programs that uses a formula including word count of learning material, number of questions and exercises, and duration of audio and video segments.

**.25 Update.** Program knowledge level that provides a general review of new developments. This level is for participants with a background in the subject area who desire to keep current.

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