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AICPA audit and accounting manual : nonauthoritative technical practice aids, as of June 1, 1996

American Institute of Certified Public Accountants. Accounting and Auditing Publications Division

AICPA AUDIT AND ACCOUNTING MANUAL

As of June 1, 1996

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Nonauthoritative Practice Aids

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American Institute of Certified Public Accountants

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Nonauthoritative Practice Aids

Edited by:
Accounting and Auditing Publications Division

As of June 1, 1996

AICPA
American Institute of
Certified Public Accountants

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HOW TO USE THIS REPORTER

NOTICE TO READERS

As part of the continuing effort to improve this publication, the Accounting and Auditing Publications Division is currently undertaking a comprehensive project to reexamine the content of the AICPA Audit and Accounting Manual (AAM) for accuracy and relevance. The project will be conducted over a twelve month period and will entail updating the material for new pronouncements, clairifying existing guidance, and expanding existing guidance to have a broader applicability.

As of June 1, 1996, the first installment of the update will be completed, including revised internal control sections to reflect the issuance of Statement on Auditing Standards No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, and the new Audit Guide *Consideration of Internal Control in a Financial Statement Audit*. The internal control sections have been revised to recognize the definition and description of internal control contained in the *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report). Over the next year, the AAM will continue to be updated for new pronouncements and further improvements will be made.

Questions on this project may be directed to Linda Delahanty, Technical Manager, Accounting and Auditing Publications, phone: (201) 938-3416; fax (201) 938-3345; Internet 1delahanty@aicpa.org.

Scope of the Reporter . . .

This volume, which is a reprint of the looseleaf edition, brings together for continuing reference a set of nonauthoritative audit tools and illustrations prepared by the staff of the Accounting and Auditing Publications Division of the American Institute of Certified Public Accountants.

How This Volume Is Arranged . . .

The contents of this Volume are arranged as follows:

Introduction

Compilation and Review

Engagement Planning and Administration

Internal Control

Audit Approach and Programs

Working Papers

Correspondence, Confirmations & Representations

Audit Risk Alerts

Supervision, Review and Report Processing

Accountants' Reports

Quality Control Forms and Aids

State and Local Governments

How to Use This Volume . . .

The arrangement of material is indicated in the general table of contents at the front of the Volume. There is a detailed table of contents covering the material within each major division.

The major divisions are subdivided into sections, each with its own section number. Each paragraph within a section is decimally numbered. For example, AAM section 7100.01 refers to the first paragraph of section 7100, *Control of Confirmations and Correspondence.* Section and paragraph numbers located on each page are provided as corner references at the bottom of each page.

The AICPA *Professional Standards* is referenced by the use of the following abbreviations: AU (Auditing), AT (Attestation Standards), AR (Accounting and Review Services), ET (Code of Professional Conduct), BL (Bylaws), QC (Quality Control), and PR (Peer Review).

The FASB *Accounting Standards Current Text* is referenced in a similar manner by the use of the abbreviation AC before the section and paragraph numbers. The *Current Text* contains an abridged version of the currently effective financial and reporting standards, as amended.

Quotations of accounting standards in this volume are derived from the original pronouncements and may have been editorially changed in the *Current Text.*

AAM Section 1000
Introduction

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AAM Section 1100
Introduction

.01 This manual has been prepared by the staff of the American Institute of Certified Public Accountants and issued as a nonauthoritative practice aid. The materials included in it are intended primarily as a reference source for conducting audit, review, and compilation engagements. The objective is to provide practitioners with the tools needed to help plan, perform, and report on their engagements. *The manual is not intended to serve as a complete or comprehensive quality control system.* The materials are not intended as a substitute for the professional judgments that must be applied by practitioners. The manual, where practicable, offers choices and alternatives rather than particular positions. The manual is not a substitute for the authoritative technical literature and users are urged to refer directly to applicable authoritative pronouncements for the text of technical standards.

.02 Some sections of the manual include quotations from Statements on Auditing Standards and other authoritative pronouncements. Those quotations are intended only to illustrate certain matters, not to serve as a substitute for careful study of the relevant pronouncements. References are made throughout the manual to the original authoritative pronouncements and to their section numbers in AICPA *Professional Standards* and the FASB *Accounting Standards Current Text* to help users locate those authoritative pronouncements.

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

.04 Explanation of References:

AC =	Reference to section number in FASB *Accounting Standards Current Text*
APB =	AICPA Accounting Principles Board Opinion
AR =	Reference to section number in AICPA *Professional Standards* (vol. 2)
ARB =	AICPA Accounting Research Bulletin
AT =	Reference to section number in AICPA *Professional Standards* (vol. 1)
AU =	Reference to section number in AICPA *Professional Standards* (vol. 1)
EITF =	Emerging Issues Task Force consensus
FASBI =	FASB Interpretation
PB =	AcSEC Practice Bulletin
QC =	Reference to section number in AICPA *Professional Standards* (vol. 2)
SAS =	AICPA Statement on Auditing Standards
SFAS =	FASB Statement of Financial Accounting Standards
SOP =	AICPA Statement of Position
SQCS =	Statement on Quality Control Standards
SSAE =	Statement on Standards for Attestation Engagements
SSARS =	Statement on Standards for Accounting and Review Services

.05 The manual is in looseleaf format in anticipation of updating and expansion. Changes are expected to arise from three main sources:

(1) Comments and suggestions from practitioners. Since this manual is a product of AICPA staff, not of a committee of practitioners, it is particularly important that practitioners advise the staff on any suggestions for material that could be improved or added.

(2) Issuance of new official pronouncements.

(3) Other additions to or deletions from the manual as a result of continued staff study.

Comments and suggestions should be addressed to:

Accounting and Auditing Publications
AICPA
Harborside Financial Center
201 Plaza III
Jersey City, NJ 07311-3881

or call Linda Delahanty at (201) 938-3416.

.06 For disclosure checklists and illustrative financial statements, obtain the AICPA looseleaf service entitled *Financial Statement Preparation Manual* (FSP). The FSP includes disclosure checklists and illustrative financial statements for the following:

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Investment Companies
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Property and Liability Insurance Companies
Prospective Financial Statements
Real Estate Ventures
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(800) TO-AICPA ((800) 862-4272)

This service is free to AICPA members.

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AAM Section 1200

How to Use the Audit and Accounting Manual

Overview

.01 The Audit and Accounting Manual (AAM) is designed to provide practitioners with the tools needed to help plan, perform, and report on audit, review, and compilation engagements. *The AAM is not intended to serve as a complete or comprehensive quality control system.* The AAM is comprised of the following sections:

Section No.	*Section Name*
2000	Compilation and Review
3000	Engagement Planning & Administration
4000	Internal Control
5000	Audit Approach & Programs
6000	Working Papers
7000	Correspondence, Confirmations & Representations
8000	Audit Risk Alerts
9000	Supervision, Review & Report Processing
10,000	Accountants' Reports
11,000	Quality Control Forms and Aids
12,000	State and Local Governments

Audits

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

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

.04 The standards of field work address the manner used by the auditor to perform the audit. This standard begins with the appointment of the auditor and ends with the auditor communicating to those responsible for the oversight of financial reporting of the entity being audited.

.05 The standards of reporting are concerned with the opinion the auditor renders on the client's financial statements.

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

a. The Quality Control Forms and Aids section [AAM section 11,000] includes sample forms which can be used by a firm to document its adherence to the AICPA requirement for a System of Quality Control for a CPA Firm. Included in this section are forms that relate to the nine elements of Quality Control:

Independence	Assigning Personnel to Engagements
Consultation	Supervision
Hiring	Professional Development
Advancement	Acceptance and Continuance of Clients
Inspection	

> As this edition of the manual went to print, the AICPA had just issued Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (QC section 20), and SQCS No. 3, *Monitoring a CPA Firm's Accounting and Auditing Practice* (QC section 30). SQCS No. 2 (QC section 20) supersedes SQCS No. 1, *System of Quality Control for a CPA Firm* (QC section 10), and its interpretations (QC section 10-1). Both standards are effective as of January 1, 1997. Please refer to AAM section 11,100.03 and .04 for further information on the standards and revised practice aids.

b. The Engagement Planning & Administration section [AAM section 3000] provides guidance in the planning stage. Included in this section are various formats of audit assignment controls, engagement letters, and planning checklists.

c. The Internal Control section [AAM section 4000] has been updated to conform to the *Internal Control—Integrated Framework,* published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report) and the new Audit Guide *Consideration of Internal Control in a Financial Statement Audit.* This section provides guidance in evaluating internal control by utilizing checklists, questionnaires, and other generalized aids..

d. The Audit Approach & Programs section [AAM section 5000] explains how the auditor should design audit programs as well as providing an illustrative audit program which can be used to assist the auditor in designing an audit program for specific clients.

e. The Working Papers section [AAM section 6000] provides the auditor with a general discussion of the purpose of working papers.

f. The Correspondence, Confirmations & Representations section [AAM section 7000] provides the auditor with numerous examples of confirmations, illustrative inquiries to legal counsel, representation letters, communications with audit committees, as well as a reliance letter.

g. The Supervision, Review & Report Processing section [AAM section 9000] provides the auditor with an overview of supervision and review procedures as well as engagement review programs for the in-charge accountant and the partner responsible for the engagement. It also provides procedures for processing the report.

h. The Accountants' Reports section [AAM section 10,000] addresses the format of the accountants' report and numerous examples of the auditor's report. This section has been updated to reflect current guidance through SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements (AU section 508).

Compilation and Review Services

.07 To perform either a review or compilation engagement in accordance with Statements on Standards for Accounting and Review Services (SSARS), an accountant must comply with the standards promulgated by the Accounting and Review Services Committee. There have been seven statements issued.

.08 SSARS 1, *Compilation and Review of Financial Statements* (AR section 100), provides guidance to accountants concerning the standards and procedures applicable to compilation and review services for a nonpublic entity. The statement also provides examples of standard single year reports and departures from those reports.

.09 SSARS 2, *Reporting on Comparative Financial Statements* (AR section 200), establishes standards for reporting on comparative financial statements of a nonpublic entity when one or more prior periods have been compiled or reviewed in accordance with SSARS 1 (AR section 100).

.10 SSARS 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AR section 300), provides an alternative form of standard compilation report when reporting on a prescribed form calls for a departure from generally accepted accounting principles (GAAP).

.11 SSARS 4, *Communications Between Predecessor and Successor Accountants* (AR section 400), provides guidance to a successor accountant who communicates with a predecessor accountant regarding acceptance of an engagement to compile or review financial statements of a nonpublic entity.

.12 SSARS 5 (Deleted by SSARS 7).

.13 SSARS 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (AR section 600), provides an exemption from SSARS 1 for personal financial plans.

.14 SSARS 7, *Omnibus Statement on Standards for Accounting and Review Services—1992.*

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

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

b. The Working Papers section [AAM section 2300] provides sample procedures for both compilation and review engagements, representation letters, and checklists.

c. The Form and Content of Financial Statements [AAM section 2400] provides guidance on the statements, notes, supplementary information, and subsequent discovery of facts.

d. The Accountants' Reports section [AAM section 2500] includes examples of several reports for the engagement.

e. The Special Areas section [AAM section 2600] addresses prescribed forms and specified elements.

.16 It is suggested that the accountant also review the following areas when performing compilation and review engagements for additional guidance:

Correspondence, Confirmations & Representations [AAM section 7000]

Quality Control Forms and Aids [AAM section 11,000]

Audit Risk Alerts

.17 The Audit Risk Alerts section [AAM section 8000] is intended to provide accountants with an overview of recent economic, professional, and regulatory developments that may affect their engagements.

[*The next page is 2001.*]

AAM Section 2000
Compilation and Review

This manual is a nonauthoritative kit of practice aids and, accordingly, does not include extensive explanation or discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate.

The exhibits are for illustrative purposes only. They are included as conveniences for users of this manual who may want points of reference when preparing working papers or a report for a compilation or review engagement.

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AAM Section 2100
Introduction

.01 Statements on Standards for Accounting and Review Services (SSARS) are issued by the American Institute of Certified Public Accountants (AICPA) Accounting and Review Services Committee (ARSC), the senior technical committee of the AICPA designated by its Council to issue pronouncements in connection with unaudited financial statements and other unaudited financial information of nonpublic entities (a complete listing of SSARS and the full text can be found in AICPA *Professional Standards,* volume 2, section AR). A nonpublic entity is defined as any entity other than (a) one whose securities trade in a public market either on a stock exchange or over the counter, (b) one that files with a regulatory agency in preparation for the sale of any class of its securities in a public market, or (c) any entity controlled by an entity covered by (a) or (b).

.02 Although, SSARS applies only to engagements involving nonpublic entities, there are circumstances when an accountant may perform a review of financial statements of a public entity under SSARS. SSARS 7, *Omnibus Statement on Standards for Accounting and Review Services—1992,* paragraph 1 (AR section 100.01), notes that when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of Statements on Auditing Standards (SAS) No. 26, *Association With Financial Statements* (AU section 504.05).

.03 As of February 1994, ARSC had issued seven Statements on Standards for Accounting and Review Services. They are

- SSARS 1 *Compilation and Review of Financial Statements* [AR section 100] (12/78)
- SSARS 2 *Reporting on Comparative Financial Statements* [AR section 200] (10/79)
- SSARS 3 *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* [AR section 300] (12/81)
- SSARS 4 *Communications Between Predecessor and Successor Accountants* [AR section 400] (12/81)
- SSARS 5 (Deleted by SSARS 7)
- SSARS 6 *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* [AR section 600] (9/86)
- SSARS 7 *Omnibus Statement on Standards for Accounting and Review Services—1992* (11/92)

.04 SSARS 1 (AR section 100) defines a compilation of financial statements and a review of financial statements and is effective for compilations and reviews of financial statements for periods ending on or after July 1, 1979. A compilation of financial statements is defined as presenting in the form of financial statements information that is the representation of management without expressing any assurance on the statements. A review of financial statements involves performing inquiry and analytical procedures to provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements necessary for them to be in conformity with generally accepted accounting principles.

.05 SSARS 1, paragraph 4 (AR section 100.04) [in part, as amended by SSARS 7], defines a financial statement as:

> A presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with generally

accepted accounting principles [1] or a comprehensive basis of accounting other than generally accepted accounting principles.[2] Financial forecasts, projections and similar presentations,[3] and financial presentations included in tax returns are not financial statements for purposes of this statement. The following presentations are examples of financial statements: [4]

a. Balance sheet

b. Statement of income

c. Statement of retained earnings

d. Statement of cash flows

e. Statement of changes in owners' equity

f. Statement of assets and liabilities (with or without owners' equity accounts)

g. Statement of revenues and expenses

h. Summary of operations

i. Statement of operations by product lines

j. Statement of cash receipts and disbursements

.06 SSARS 2 (AR section 200) establishes the standards for reporting on comparative financial statements of a nonpublic entity when the statements of one or more periods have been compiled or reviewed under SSARS 1 (AR section 100). SSARS 2 is effective for reports on comparative financial statements for periods ending on or after July 1, 1979.

.07 SSARS 3 (AR section 300) amends SSARS 1 and 2 (AR sections 100 and 200) to provide an alternative form of compilation report when a prescribed form calls for a departure from generally accepted accounting principles (GAAP). SSARS 3, paragraph 2 (AR section 300.02), defines a prescribed form as any preprinted form designed or adopted by the body to which it is intended to be submitted (e.g., banks, governmental bodies, etc.). Since this statement contains no effective date, it became effective upon issuance.

.08 SSARS 3 (AR section 300) does not prohibit the accountant from issuing a SSARS 1 (AR Section 100) compilation report which identifies GAAP departures in accordance with SSARS 1, paragraphs 39 through 41 (AR section 100.39—.41). A SSARS 3 report is specifically designed to provide an alternative form of reporting when a prescribed form calls for a GAAP departure.

.09 SSARS 4 (AR section 400), as amended by SSARS 7, provides guidance on required as well as optional communications between predecessor and successor accountants. SSARS 7 amended SSARS 4 (AR section 400) to require the successor accountant to request the client to communicate with the predecessor accountant, if the successor accountant becomes aware of information that may require revision of financial statements reported on by the predecessor accountant.

.10 SSARS 5 (Deleted by SSARS 7).

[1] The definition of generally accepted accounting principles and the hierarchy of established accounting principles presented in SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AU section 411), is also applicable to compilations and reviews of financial statements performed under SSARSs.

[2] The term *comprehensive basis of accounting other than generally accepted accounting principles* is defined in SAS No. 62, *Special Reports,* paragraph 4 (AU section 623.04) . . . reference to generally accepted accounting principles . . . includes, where applicable, another comprehensive basis of accounting. . .

[3] Statement on Standards for Attestation Engagements No. 1, *Attestation Standards* (AT section 200), as well as the AICPA *Guide for Prospective Financial Information,* provide guidance on preparing and reporting on financial forecasts, projections, and similar presentations.

[4] SAS No. 62, paragraph 7 (AU section 623.07), provides guidance with respect to suitable titles for financial statements that are prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles.

.11 SSARS 6 (AR section 600) provides an exemption from SSARS 1 (AR section 100) for personal financial statements included in personal financial plans. SSARS 6 was issued with no effective date, therefore, it became effective upon issuance.

.12 Under SSARS 6 (AR section 600), an accountant may submit a written personal financial plan containing unaudited personal financial statements to a client without issuing a report under SSARS 1 (AR section 100), as amended, when—

a. The accountant establishes an understanding with the client that the financial statements (i) will be used solely to assist the client and the client's advisors to develop the client's personal financial goals and objectives and (ii) will not be used to obtain credit or for any purpose other than developing the aforementioned goals and objectives.

b. Nothing comes to the accountant's attention during the engagement that would cause him or her 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.

.13 An accountant following the exemption under SSARS 6 (AR section 600) should issue a written report stating that the unaudited financial statements—

a. Are designed solely to help develop the financial plan.

b. May be incomplete or contain departures from GAAP and should not be used to obtain credit or for any purpose other than developing the plan.

c. Have not been audited, reviewed, or compiled.

.14 SSARS 7, which is an omnibus statement—

a. Clarifies the applicability of SSARS 1 [AR section 100] by indicating that, in certain circumstances, an accountant may perform a review of a public company under the provisions of SSARSs.

b. Eliminates the prohibition against merely typing or reproducing financial statements without modification and defines the phrase *submission of financial statements*.

c. Makes explicit that the accountant is not required to communicate to a client errors that are not material and irregularities or illegal acts that are clearly inconsequential.

d. Modifies the SSARS review report to differentiate it from the review report presented in SAS No. 71, *Interim Financial Information* [AU section 722], as well as modifying the review and compilation report to clarify that the standards referred to in the reports are Statements on Standards for Accounting and Review Services.

e. Requires a client representation letter when performing a review engagement under SSARS.

f. Clarifies the accountant's reporting responsibilities in a compilation or review engagement when he or she decides there is an uncertainty about an entity's ability to continue as a going concern.

.15 Illustrative reports to be issued under the provisions of SSARS 1 through 7 can be found in AAM sections 10,400 and 10,500.

[The next page is 2201.]

AAM Section 2200
Engagement Planning and Administration

.01 It is important to remember that when engaged to provide compilation or review services, the accountant must comply with both Rules 201 and 202 of the AICPA's Code of Professional Conduct, *General Standards* and *Compliance With Standards*, respectively (ET sections 201.01 and 202.01). Rule 201 requires that an AICPA member comply with the following standards and any interpretations thereof by bodies designated by its 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 Rule 202 requires that an AICPA member who performs auditing, review, compilation, management advisory, tax or other professional services comply with standards promulgated by bodies designated by Council.

.03 Prior to accepting an engagement to perform a compilation or review for a prospective client, the accountant should consider if he or she wishes to be associated with the client. Factors such as the ability of the accountant to adequately serve the client, the fee arrangement, client integrity, etc., need to be considered. It is often useful to complete a "Client Acceptance Form" to assist in determining whether or not to accept a client. An illustrative client acceptance form can be found in AAM section 2200.27.

Understanding the Engagement

.04 SSARS 1, paragraph 8 (AR section 100.08), states that the accountant should establish an understanding with the entity regarding the services to be performed. This understanding should include a description of the nature and limitations of the services to be performed, and a description of the report the accountant expects to render. The understanding should also include an explanation that the engagement cannot be relied upon to disclose errors, irregularities, or illegal acts but should also indicate that if any such matters, that are not inconsequential, come to the accountant's attention, the appropriate level of management will be notified. It is preferable that the understanding be in writing.

.05 It is a requirement of SSARS 1 (AR section 100) that an accountant have a knowledge of the entity's business when performing a compilation or review of its financial statements. The accountant should also possess a level of knowledge of the accounting principles and practices in the industry in which the entity operates.

Engagement Letters

.06 An engagement letter provides a means of formalizing the understanding between the accountant and the client concerning the services to be rendered. A good engagement letter helps prevent misunderstandings between the client and the accountant as to the services to be provided, including the limitations. The engagement letter also sets forth the responsibilities of the client, and in most states it becomes a legally binding contract. There are other good reasons to obtain an engagement letter, including the following:

- *Reduces the risk of litigation.* Misunderstandings with clients regarding the nature and limitations of the services can result in litigation with the client.

- *Avoids misunderstandings by the staff.* The staff performing the work can review the engagement letter to obtain a clear understanding of the services to be provided and the required timing of the issuance of the report.

Overcoming Client Resistance to an Engagement Letter

.07 Presenting the engagement letter face-to-face usually is sufficient to overcome any resistance on the part of the client. The AICPA publishes a brochure, entitled *The Engagement Letter,* which may be used to explain the purpose of an engagement letter to the client.

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

How Often Should an Engagement Letter Be Obtained?

.09 Some firms have a policy of obtaining a new engagement letter annually. Others use an automatically renewing (evergreen) letter that is only updated when the services to be provided change or there is a significant change in management or ownership of the client. Another possibility is the use of a general service agreement with separate addendums to the agreement, issued periodically, to describe the services to be provided.

The Content of Engagement Letters

.10 The engagement letter should be tailored to the engagement, after the specific services have been agreed upon. A comprehensive engagement letter might include the following:

- A description of the nature of the services to be performed.
- A description of the client or entities involved.
- The period covered by the financial statements to which the accountant's report will relate.
- A description of the nature of the report.
- A statement of the limitations of the service in detecting errors, irregularities and illegal acts, with an indication that the accountant will inform the client of material errors or any irregularities or illegal acts that come to his or her attention, unless they are clearly inconsequential.
- An indication of what will happen if the accountant is unable to complete the engagement.
- If applicable, a statement that management will be requested to sign a representation letter.
- A description of any other services to be performed.

.11 Sample engagement letters for compilation and review engagements are presented in AAM section 2200.28–.31.

Practice Tip

Be careful when using a proposal or preliminary engagement letter for a client. If the letter describes additional services that are not finally agreed upon, it may be used in litigation as an indication of inadequate performance by you on the engagement. You should also make sure that a final engagement letter is always issued in such circumstances.

Using Engagement Letters to Minimize Liability to Third Parties

.12 The AICPA's task force on accountant's legal ability developed guidance on using engagement letters to minimize liability to third parties. The task force concluded that clarifying language added to an engagement letter may be useful in states in which the courts adhere to the privity concept of liability to third parties. This clarifying language should identify parties that are known by the accountant to be negotiating or contemplating a transaction with the client, and who will be obtaining a copy of the compiled or reviewed financial statements. An example of such language is as follows:

> We understand that you are negotiating with XYZ Bank for a loan in the amount of $25,000 and the purpose of our report on your financial statements is to enable you to present the (compiled) (reviewed) financial statements to XYZ Bank. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated.

Practice Tip

The clarifying language in AAM section 2200.12 added to an engagement letter is of questionable effectiveness in minimizing legal liability. However, if you decide to use it, you should consult with legal counsel to get advice on the specific wording that may be effective for your particular state.

.13 Accountants should try to avoid issuing privity letters. However, this is not always practical, particularly when the client's interests will be adversely affected. With this in mind, the following are some guidelines the authors recommend for accountants who must provide a privity letter:

- Name the third party that has informed the accountant that it intends to rely on the financial statements.
- Address the third party's responsibilities to undertake an investigation and due diligence review of the financial statements and condition of the company or to retain other professionals to assist it in that effort.
- Do not merely acknowledge a third party's intended reliance, but identify the various ways in which that reliance is qualified. This can be accomplished by asking the third party to provide a letter stating that it has performed other due diligence procedures, or by stating in the privity letter that the accountant assumes that the third party has performed due diligence procedures.
- Acknowledge the third party's intention to rely, not the actual reliance. Make it clear that you do not expect the third party to rely solely on your report on the financial statements as the basis for its decision.
- Contrast the scope of the work and level of assurance provided with the level of assurance and scope of an audit.
- State, as precisely as possible, the purpose of the third party's reliance. Avoid comments about the third party's intended after-the-fact general reliance.

.14 An accountant, contemplating use of a privity letter, should consult with legal counsel regarding its effectiveness in minimizing legal liability in the accountant's particular state. Because legal requirements vary from state to state, the accountant should also consult with legal counsel regarding the appropriate content of the letter.

Change in Engagement Level of Service

.15 An accountant who has been engaged to perform audit services with respect to financial statements may be requested by his or her client to change the level of service to be performed. SSARS 1, paragraphs 44 through 49 (AR section 100.44–.49), addresses changing the level of service to a lower level. A request to change the engagement to a review or a compilation may result from a change in circumstances affecting the entity's need for an audit (review), a misunderstanding of the nature of an audit, review, or compilation or a restriction on the scope of the audit (review), whether imposed by the client or caused by the circumstances.

.16 SSARS 1, paragraph 45 (AR section 100.45), states that before an accountant who was engaged to perform an audit or a review agrees to change the engagement to a review or compilation, at least the following factors should be considered:

a. The reason given for the client's request, particularly the implications of a restriction on the scope of the audit (review).

b. The additional audit effort required to complete the audit (review).

c. The estimated additional cost to complete the audit (review).

.17 A change in circumstances affecting the entity's need for an audit (review) or a misunderstanding of the nature of an audit, review, or compilation would normally be viewed as a reasonable basis for requesting a change in the level of service.

.18 The accountant should consider the implications of a restriction on the scope of the audit (review) and should evaluate the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory. The following two circumstances would ordinarily preclude an accountant from lowering his or her level of service—

a. 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 is precluded from issuing a review or compilation report on the financial statements.

b. For either an audit or review engagement, if the client refuses to provide the accountant with a signed representation letter, the accountant would be precluded from issuing a review report on the financial statements and would ordinarily be precluded from issuing a compilation report on the financial statements.

.19 SSARS 1, paragraph 48 (AR section 100.48), states that in all circumstances, if the auditing (review) procedures are virtually complete or the cost to complete such procedures is relatively insignificant, the accountant should consider the propriety of accepting a change in the engagement.

.20 If the accountant agrees that there is reasonable justification to change the engagement and he or she complies with the standards applicable to the changed engagement, the accountant should issue an appropriate review or compilation report. The report should not include reference to:

a. the original engagement,

b. any auditing or review procedures that may been performed, or

c. scope limitations that resulted in the changed engagement.

.21 Interpretation 1 of SSARS 1, "Omission of Disclosures in Reviewed Financial Statements" (AR section 9100.01–.02), requires an accountant who undertakes to review financial statements and subsequently finds that his client declines to include substantially all required disclosures, to include the disclosures in his review report. If the disclosures are not known, the report should specifically identify the nature of the omitted disclosures. However, SSARS 1, paragraph 19 [AR section 100.19], permits an accountant to compile financial statements that omit substantially all disclosures provided the omission is not undertaken with the intent to mislead.

.22 The issue of changing the level of an engagement to a higher level of service is not specifically addressed in SSARS 1 (AR section 100). It is generally agreed that a change to a higher level of service is acceptable. In such circumstances, the accountant should be certain that it is possible to comply with the applicable standards for the revised level of service. It is also wise to revise the accountant's understanding with the client of the changed engagement, preferably by amending the engagement letter.

Predecessor and Successor Accountant

.23 SSARS 4 (AR section 400), as amended by SSARS 7, provides guidance to a successor accountant who decides to communicate with a predecessor accountant regarding acceptance of a compilation or review engagement. This statement requires the predecessor accountant to respond promptly and fully in the event of such communications.

.24 It also requires that 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.

.25 The inquiries of the successor accountant will normally include questions concerning: (1) information that might bear on the integrity of management (owners); (2) disagreements with management (owners) about accounting principles or the necessity of performing certain procedures; (3) the cooperation of management in providing additional or revised information, when necessary; and (4) the predecessor's understanding of the reasons for the change of accountants.

.26 The predecessor accountant is expected to respond both promptly and fully to requests of the type cited above. Valid business reasons (e.g., unpaid fees) may preclude the predecessor from responding to the inquiries of the successor. The predecessor may also decide, due to unusual circumstances such as impending litigation, not to respond fully to the successor. In such an instance, the predecessor should indicate that the response is limited and the successor should consider both the reasons for and implications of such a response in deciding whether to undertake the engagement.

.27

Client Acceptance and Continuance Form—Part I

Client: ____________________

Financial Statement Date: ____________________

INSTRUCTIONS:

This form should be completed for all prospective clients for which audit, review, or compilation services are to be performed. The date on the form should be reviewed as a basis for initially accepting the client. The form should be updated and reviewed annually as a basis for deciding to retain the client.

CLIENT'S LEGAL NAME:

ADDRESS:

PHONE:

FEDERAL I.D. NO.:	STATE I.D. NO.:

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

2. Identify the type of entity (e.g., corporation, proprietorship, partnership, S corporation, or nonprofit):

(continued)

Client Acceptance and Continuance Form—Part I (continued)

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

Name	Percent Owned	Position	Family Relationship

4. Identify any related businesses or individuals:

Name	Nature of Relationship

5. Identify the client's predecessor accountants:

Name:
Address:
Contact Person:

6. Indicate the results of our inquiries of the predecessor accountant regarding the following:

a. Reasons for change of accountant: ____________________

____

____

b. Integrity of management ____________________

____

____

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

____

____

d. Fee disputes: ____________________

____

____

(continued)

Client Acceptance and Continuance Form—Part I (continued)

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

Name	Type of A/C's or Loans	Account Executive

8. Describe the services to be provided:

Service	How Often? Monthly	Quarterly	Annually	Report Deadlines

Other Services:

Consulting services: ______

Federal tax returns: ______

State tax returns: ______

Payroll tax returns: ______

Tax returns for principal owners: ______

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

Describe the use of the financial statements:

Client Acceptance and Continuance Form—Part I (continued)

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

11. Does the client have potential going-concern problems? ______________________
    If so, describe them:

12. Describe the client's major sources of financing:

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

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

Client Acceptance and Continuance Form—Part I (continued)

15. Identify the client's legal counsel:

Name:
Address:
Contact Person:

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

17. Describe the billing arrangements:

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

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

	19 ____	19 ____	19 ____	19 ____	19 ____
Prepared or updated by: In-Charge	____	____	____	____	____
Reviewed by: Engagement Executive	____	____	____	____	____

Client Acceptance and Continuance Form—Part II

Client: ____________________

Financial Statement Date: ____________________

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

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

Acceptance Decision:

Yes ____ No ____

Engagement Partner: ____________________ Date: __________

Concurring Partner: ____________________ Date: __________

.28 Illustrative Engagement Letter for a Compilation

TROLKA & ZAWORSKI, P.S. Certified Public Accountants

[Date]

Mr. Samuel Kirk, President
ZYXWV Freight Corporation
648 Crystal Lane
Bedford, Alabama 00000

Dear Mr. Kirk:

This will 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:

1. We will compile, from information you provide, the annual and interim balance sheets and related statements of income, retained earnings and cash flows of ZYXWV Freight Corporation for the year 19XX. We will not audit or review such financial statements. Our report on the annual financial statements of ZYXWV Freight Corporation is presently expected to read as follows:

    > We have compiled the accompanying balance sheet of ZYXWV Freight Corporation as of December 31, 19XX, and the related statements of income, retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
    >
    > A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

    Our report on your interim financial statements, which will omit substantially all disclosures, includes an additional paragraph that will read as follows:

    > Management has elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the 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.

    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.

2. We will assist your bookkeeper in adjusting the books of account so that he (she) will be able to prepare a working trial balance from which financial statements can be compiled. Your bookkeeper will provide us with a detailed trial balance and any supporting schedules we require.

3. We will also prepare the federal and state [*identify states*] income tax returns for ZYXWV Freight Corporation for the fiscal year ended December 31, 19XX.

Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts including fraud or defalcations, that may exist. However, we will inform the appropriate level of management of any material errors that come to our attention and any irregularities or illegal acts that come to our attention, unless they are clearly inconsequential.

Our fees for these services will be billed as work progresses and are based on the amount of time required plus 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, which will range from $X,XXX to $X,XXX.

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

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

We appreciate the opportunity to serve you and trust that our association will be a long and pleasant one.

Sincerely yours,

____

(Signature of Accountant)

Acknowledged:

ZYXWV Freight Corporation

____

President

____

Date

* Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing. . ." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement. . ."

.29 Illustrative Engagement Letter for a Review

SWIFT, MARCH & COMPANY Certified Public Accountants

[Date]

Mr. Tom Jones, President
ZYXWV Freight Corporation
648 Crystal Lane
Nowhere, Anystate 00000

Dear Mr. Jones:

This will 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:

1. We will review the balance sheet of ZYXWV Freight Corporation as of [*date*], and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Our review will consist primarily of inquiries of company personnel and analytical procedures and we will require a client representation letter from you. A review does not contemplate obtaining an understanding of the internal control structure or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that we will become aware of all significant matters that would be disclosed in an audit. Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However, we will inform the appropriate level of management of any material errors that come to our attention and any irregularities or illegal acts that come to our attention, unless they are clearly inconsequential. We will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, we will not express such an opinion on them.

Our report is presently expected to read as follows:

> We have reviewed the accompanying balance sheet of ZYXWV Freight Company as of [*date*], and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of ZYXWV Freight Company.
>
> A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly we do not express such an opinion.
>
> Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

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

2. We will provide your chief accountant with such consultation on accounting matters as may be required in adjusting and closing the books of account and in drafting financial statements for our review. Your

chief accountant also will provide us with a detailed trial balance and any supporting schedules we require.

3. We will also prepare the federal and state [*identify states*] income tax returns for ZYXWV Freight Company for the fiscal year ended [*date*].

Our fees for these services will be billed as work progresses and are based on the amount of time required plus 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, which will range from $X,XXX to $X,XXX.

We shall be pleased to discuss this letter with you at any time and appreciate the opportunity to serve you and trust that our association will be a long and pleasant one.

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:

ZYXWV Freight Corporation

____

President

____

Date

.30 Illustrative Engagement Letter for Compilation of Personal Financial Statements

SWIFT, MARCH & COMPANY Certified Public Accountants

[Date]

Mr. John Henry
643 Chisum Road
Lincoln, New Mexico 00000

Dear Mr. Henry:

This will 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 service(s):

1. We will compile, from information you provide, the statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. We will not audit or review such financial statements. Our report on the financial statements is presently expected to read as follows:

   [*Standard Compilation Report*]

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

2. We will also [*discussion of other services, if any*].

Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts including fraud or defalcations, that might exist. However, we will inform you of any material errors that come to our attention and any irregularities or illegal acts that come to our attention, unless they are clearly inconsequential.

Our fees for these services [*specify fees or terms*].

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

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

Sincerely yours,

____

[*Signature of Accountant*]

Acknowledged:

____

____

____

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

.31 Illustrative Engagement Letter for Review of Personal Financial Statements

SWIFT, MARCH & COMPANY Certified Public Accountants

[Date]

Mr. John Henry
643 Spring Road
Nowhere, Anystate 00000

Dear Mr. Henry:

This will 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 service(s):

1. We will review the statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Our review will consist primarily of inquiries of you and analytical procedures applied to financial data and we will require a representation letter from you.

   A review does not contemplate obtaining an understanding of internal control or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that we will become aware of all significant matters that would be disclosed in an audit. Our report on the financial statements is presently expected to read as follows:

   [*Standard Review Report*]

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

2. We will also [*discussion of other services, if any*].

Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts including fraud or defalcations, that may exist. However, we will inform you of any material errors that come to our attention and any irregularities or illegal acts that come to our attention, unless they are clearly inconsequential. We will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, we will not express such an opinion on them.

Our fees for these services [*specify fees or terms*].

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

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

Sincerely yours,

____

[*Signature of Accountant*]

Acknowledged:

____

____

____

[*Date*]

[Source: AICPA *Personal Financial Statements Guide.*]

[*The next page is 2301.*]

AAM Section 2300
Working Papers

Compilation Engagements

.01 SSARS 1 (AR section 100) does not address workpaper documentation for a compilation engagement. However, many accountants prefer compilation workpapers that include all necessary documentation to verify that compilation procedures were performed. In determining what workpapers the accountant will need, he or she should consider any peer review requirements that the firm will need to meet. AAM section 11,000 offers a discussion on compliance with the AICPA's quality control standards.

Compilation Procedures

.02 The following items are generally documented in a CPA's compilation workpapers:

- Documentation of the accountant's knowledge of the client's business and the accounting principles and practices of the industry in which the entity operates
- Documentation of the understanding with the client concerning the services to be rendered, usually in the form of an engagement letter
- Documentation that the accountant has read the compiled financial statements
- Support for a change in the level of service performed, if necessary
- Working trial balance
- Reasons for omitting substantially all disclosures
- Documentation of discussions of unusual items

.03 In addition, if the CPA prepares the financial statements as well as compiles them, he or she should also include in the workpapers the following:

- Support for information in the notes to the financial statements
- Copies of preliminary client records (e.g., working trial balance and adjustments) required to arrive at final compiled financial statements

Compilation Checklists

.04 Procedural checklists can serve as means of documenting in the workpapers that all the necessary procedures have been performed. When completing a procedural checklist, the accountant should refer to the specific workpaper documenting completion of the checklist step. An illustrative procedural checklist for a compilation can be found in AAM section 2300.14.

Review Engagements

.05 As noted in AAM section 2100, a review of financial statements involves performing inquiry and analytical procedures. SSARS 1, paragraph 30 (AR section 100.30), discusses workpaper documentation for review engagements. SSARS 1 (AR section 100) does not specify the form or content of the working papers in connection with a review engagement, but paragraph 30 does state that the working papers should describe the following:

a. The matters covered in the accountant's inquiry and analytical procedures

b. Unusual matters that the accountant considered during the performance of the review, including their disposition

Review Procedures—Inquiry

.06 SSARS 1, paragraph 27 (AR section 100.27), states that the accountant's inquiries should generally consist of the following:

a. Inquiries concerning the entity's accounting principles and practices and the methods followed in applying them.

b. Inquiries concerning the entity's procedures for recording, classifying, and summarizing transactions, and accumulating information for disclosure in the financial statements.

c. Inquiries concerning actions taken at meetings of stockholders, board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements.

d. Inquiries of persons having responsibility for financial and accounting matters concerning (1) whether the financial statements have been prepared in conformity with generally accepted accounting principles consistently applied, (2) changes in the entity's business activities or accounting principles and practices, (3) matters as to which questions have arisen in the course of applying the foregoing procedures, and (4) events subsequent to the date of the financial statements that would have a material effect on the financial statements.

.07 SSARS 1, Appendix A (AR section 100.52), contains illustrative inquiries in connection with a review engagement. These illustrative inquiries appear in AAM section 2300.15. These inquiries do not necessarily apply to all engagements, nor are they meant to be all-inclusive.

Review Procedures—Analytical

.08 SSARS 1, paragraph 27c (AR section 100.27c), states that analytical procedures consist of the following:

1. Comparison of the financial statements with statements for a comparable prior period(s)

2. Comparison of the financial statements with anticipated results, if available

3. Study of the relationship of the elements of the financial statements that would be expected to conform to a predictable pattern based on the entity's experience

.09 Three common forms of analytical procedures are ratio analysis, trend analysis, and tests for reasonableness of data. Once the accountant performs his analytical procedures, he or she must evaluate the results, usually against past historical results or industry averages. Illustrative analytical procedures workpapers can be found in AAM section 2300.16 and .17.

.10 SSARS 1, paragraph 27 (AR section 100.27), also suggests that the following review procedures be performed:

a. Reading the financial statements to consider, on the basis of information coming to the accountant's attention, whether the financial statements appear to conform with generally accepted accounting principles

b. Obtaining reports from other accountants, if any, who have been engaged to audit or review the financial statements of significant components of the reporting entity, its subsidiaries, and other investees

.11 The following items are usually included in the workpapers for a review engagement:

- Documentation of the accountant's knowledge of the client's business and the accounting principles and practices of the industry in which it operates
- An engagement letter
- Support for a change in the level of service, if any
- Documentation of all inquiries and respective responses
- Documentation of all analytical procedures
- A representation letter
- Documentation of discussions of unusual matters
- Copies of reports of other accountants who have performed services with respect to a subsidiary or other significant investee

Representation Letters

.12 SSARS 7 amended SSARS 1 to require representation letters in all review engagements performed under SSARS. An illustrative representation letter for a review engagement can be found in AAM sections 2300.18 and 7400.02.

Review Checklists

.13 In the same way that procedural checklists are suggested for compilation engagements, it is wise to prepare such a checklist for a review engagement. An illustrative procedural checklist for a review engagement can be found in AAM section 2300.19.

.14 Short-Form Checklist for a Compilation Engagement

	*AR Ref.**	*Initials*
1. Obtain an engagement letter or document an understanding of the engagement in a memorandum. (See section 3175.09 for a sample engagement memorandum.)	.08	________
2. Acquire the necessary knowledge of client's industry accounting principles and practices.	.10	________
3. Acquire a general understanding of the client's business transactions, the form of the accounting records, the stated qualifications of the accounting personnel, the accounting basis used, and the form and content of the financial statements. (It is not necessary to make inquiries or perform other procedures unless the information supplied is questionable.)	.11-.12	________
4. Read the financial statements and determine if they are appropriate in form and free from obvious material error.	.13	________
5. Consider whether all disclosures required by generally accepted accounting principles (GAAP) or an acceptable comprehensive basis of accounting are provided. If they are not, go to step 6. If they are, go to step 7.	.19	________
6. If substantially all disclosures required by GAAP or an other comprehensive basis of accounting are omitted, indicate this in a separate paragraph in your report; if a comprehensive basis of accounting other than GAAP is used, disclose this basis either in the financial statements or in your report. If the statement of cash flows is also omitted in GAAP statements, modify the scope paragraph and disclosure deficiency paragraph accordingly. If most, but not all, disclosures are omitted, notes to the financial statements should be labeled "Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included."	.19-.21	________
7. Consider whether the financial statements contain measurement departures from GAAP or other comprehensive basis of accounting. If they do, go to step 8. If they do not, go to step 9.	.39	________
8. Get client to revise the financial statements. Failing that, consider modifying your report by adding a separate paragraph or paragraphs. If the impact of the departure has been determined by management or is known by you, disclose the dollar effects in your report. (However, uncertainties and inconsistencies are not measurement departures if they are properly disclosed. See step 5.) Withdraw from the engagement if the GAAP departures are designed to mislead statement users.	.39-.40	________
9. Determine whether the firm is independent. If the firm is not, go to step 10. If the firm is, go to step 11.	.22	________
10. If the firm is not independent, add a separate paragraph to your report: "I am (we are) not independent with respect to XYZ Company."	.22	________
11. If the financial statements are accompanied by information presented for supplementary analysis purposes, include such other data in the compilation report.	.43	________
12. Mark each page of the financial statements, including any supplemental data, "See accountant's compilation report."	.16	________
13. Date your report using the date the compilation was completed.	.15	________
14. Issue the financial statements and related compilation report.	.14	________
15. If subsequent to the date of the report, facts that would possibly cause the financial statements to be misleading are discovered (and were in existence at the report date), consult SAS No. 1, section 561 (AU section 561), Interpretation No. 4 of SSARS No. 1 (AR section 9100.13—.15), and your attorney.	.42	________

Completed by ______________________________ Date: ______________

* The abbreviation "AR Ref" in this checklist means AR section 100. All references in this checklist are to paragraphs in AR section 100

.15 Review of Financial Statements—Illustrative Inquiries

1. General

   a. What are the procedures for recording, classifying, and summarizing transactions (relates to each section discussed below)?

   b. Do the general ledger control accounts agree with subsidiary records (for example, receivables, inventories, investments, property and equipment, accounts payable, accrued expenses, non-current liabilities)?

   c. Have accounting principles been applied on a consistent basis?

2. Cash

   a. Have bank balances been reconciled with book balances?

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

   c. Has a proper cutoff of cash transactions been made?

   d. Are there any restrictions on the availability of cash balances?

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

3. Receivables

   a. Has an adequate allowance been made for doubtful accounts?

   b. Have receivables considered uncollectible been written off?

   c. If appropriate, has interest been reflected?

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

   e. Are there any receivables from employees and related parties?

   f. Are any receivables pledged, discounted, or factored?

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

4. Inventories

   a. Have inventories been physically counted? If not, how have inventories been determined?

   b. Have general ledger control accounts been adjusted to agree with physical inventories?

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

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

   e. What is the basis of valuation?

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

   g. Have write-downs for obsolescence or cost in excess of net realizable value been made?

   h. Have proper cutoffs of purchases, goods in transit, and returned goods been made?

   i. Are there any inventory encumbrances?

5. Prepaid Expenses
   a. What is the nature of the amounts included in prepaid expenses?
   b. How are these amounts amortized?
6. Investments, Including Loans, Mortgages, and Intercorporate Investments
   a. Have gains and losses on disposal been reflected?
   b. Has investment income been reflected?
   c. Has appropriate consideration been given to the classification of investments between current and noncurrent, and the difference between the cost and market value of investments?
   d. Have consolidation or equity accounting requirements been considered?
   e. What is the basis of valuation of marketable equity securities?
   f. Are investments unencumbered?
7. Property and Equipment
   a. Have gains or losses on disposal of property or equipment been reflected?
   b. What are the criteria for capitalization of property and equipment? Have such criteria been applied during the fiscal period?
   c. Does the repairs and maintenance account only include items of an expense nature?
   d. Are property and equipment stated at cost?
   e. What are the depreciation methods and rates? Are they appropriate and consistent?
   f. Are there any unrecorded additions, retirements, abandonments, sales, or trade-ins?
   g. Does the entity have material lease agreements? Have they been properly reflected?
   h. Is any property or equipment mortgaged or otherwise encumbered?
8. Other Assets
   a. What is the nature of the amounts included in other assets?
   b. Do these assets represent costs that will benefit future periods? What is the amortization policy? Is it appropriate?
   c. Have other assets been properly classified between current and noncurrent?
   d. Are any of these assets mortgaged or otherwise encumbered?
9. Accounts and Notes Payable and Accrued Liabilities
   a. Have all significant payables been reflected?
   b. Are all bank and other short-term liabilities properly classified?
   c. Have all significant accruals, such as payroll, interest, and provisions for pension and profit-sharing plans been reflected?
   d. Are there any collateralized liabilities?
   e. Are there any payables to employees and related parties?

10. Long-Term Liabilities

    a. What are the terms and other provisions of long-term liability agreements?

    b. Have liabilities been properly classified between current and non-current?

    c. Has interest expense been reflected?

    d. Has there been compliance with restrictive covenants of loan agreements?

    e. Are any long-term liabilities collateralized or subordinated?

11. Income and Other Taxes

    a. Has provision been made for current and prior-year federal income taxes payable?

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

    c. Are there temporary differences? If so, have deferred taxes been reflected?

    d. Has provision been made for state and local income, franchise, sales, and other taxes payable?

12. Other Liabilities, Contingencies, and Commitments

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

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

    c. Are there any contingent liabilities, such as discounted notes, drafts, endorsements, warranties, litigation, and unsettled asserted claims? Are there any unasserted potential claims?

    d. Are there any material contractual obligations for construction or purchase of real property and equipment and any commitments or options to purchase or sell company securities?

13. Equity

    a. What is the nature of any changes in equity accounts?

    b. What classes of capital stock have been authorized?

    c. What is the par or stated value of the various classes of stock?

    d. Do amounts of outstanding shares of capital stock agree with subsidiary records?

    e. Have capital stock preferences, if any, been disclosed?

    f. Have stock options been granted?

    g. Has the entity made any acquisitions of its own capital stock?

    h. Are there any restrictions on retained earnings or other capital?

14. Revenue and Expenses

    a. Are revenues from the sale of major products and services recognized in the appropriate period?

    b. Are purchases and expenses recognized in the appropriate period and properly classified?

    c. Do the financial statements include discontinued operations or items that might be considered extraordinary?

15. Other

  a. Are there any events that occurred after the end of the fiscal period that have a significant effect on the financial statements?

  b. Have actions taken at stockholder, board of directors, or comparable meetings that affect the financial statements been reflected?

  c. Have there been any material transactions between related parties?

  d. Are there any material uncertainties? Is there any change in the status of material uncertainties previously disclosed?

.16 Illustrative Ratio Analysis Worksheet

Below you will find 34 financial ratios. These financial ratios include all of the key ratios included in Robert Morris Associates Annual Statement Studies [Published by Robert Morris Associates, Philadelphia, PA] and Dun and Bradstreet's Key Business Ratios [Published by Dun and Bradstreet Credit Services, Murray Hill, NJ].

	Ratio Name		Formula for Ratio		Calculations
1.	Current Ratio	=	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	=	
2.	Quick Ratio	=	$\frac{\text{Quick Assets}}{\text{Current Liabilities}}$	=	
3.	Days Sales in Accounts Receivable	=	$\frac{\text{Accounts Receivable (net)}}{\text{Net Sales/360}}$	=	
4.	Allowance for Bad Debts as a % of A/R	=	$\frac{\text{Allowance for Bad Debts}}{\text{Accounts Receivable}}$	=	
5.	Bad Debt Exp. as a Percentage of Net Sales	=	$\frac{\text{Bad Debt Expense}}{\text{Net Sales}}$	=	
6.	Inventory Turnover	=	$\frac{\text{Cost of Sales} \times \text{(Days/Year)}}{\text{Inventory} \times \text{(Days/Period)}}$	=	
7.	Net Sales to Inventory	=	$\frac{\text{Net Sales} \times \text{(Days/Year)}}{\text{Inventory} \times \text{(Days/Period)}}$	=	
8.	Days Inventory	=	$\frac{\text{Inventory} \times \text{(Days/Period)}}{\text{Cost of Sales}}$	=	
9.	Net Fixed Assets to Net Worth	=	$\frac{\text{Net Fixed Assets}}{\text{Net Worth}}$	=	
10.	Current Liabilities to Net Worth	=	$\frac{\text{Current Liabilities}}{\text{Net Worth}}$	=	
11.	Current Liabilities to Inventory	=	$\frac{\text{Current Liabilities}}{\text{Inventory}}$	=	
12.	Accounts Payable to Net Sales	=	$\frac{\text{Accts. Payable} \times \text{(Days/Period)}}{\text{Net Sales} \times \text{(Days/Year)}}$	=	
13.	Total Liabilities to Net Worth	=	$\frac{\text{Total Liabilities}}{\text{Net Worth}}$	=	

	Ratio Name		Formula for Ratio		Calculations
14.	Net Worth to Total Liabilities	=	$\frac{\text{Net Worth}}{\text{Total Liabilities}}$	=	
15.	Net Sales to Working Capital	=	$\frac{\text{Net Sales} \times \text{(Days/Year)}}{\text{Working Capital} \times \text{(Days/Per.)}}$	=	
16.	Total Assets to Net Sales	=	$\frac{\text{Total Assets} \times \text{(Days/Period)}}{\text{Net Sales} \times \text{(Days/Year)}}$	=	
17.	Return on Total Assets	=	$\frac{\text{Net Income} \times \text{(Days/Year)}}{\text{Total Assets} \times \text{(Days/Period)}}$	=	
18.	Return on Net Worth	=	$\frac{\text{Net Income} \times \text{(Days/Year)}}{\text{Net Worth} \times \text{(Days/Period)}}$	=	
19.	Return on Net Sales	=	$\frac{\text{Net Income}}{\text{Net Sales}}$	=	
20.	Net Sales to Accounts Receivable	=	$\frac{\text{Net Sales} \times \text{(Days/Year)}}{\text{A/R (net)} \times \text{(Days/Period)}}$	=	
21.	Net Sales to Net Fixed Assets	=	$\frac{\text{Net Sales} \times \text{(Days/Year)}}{\text{Fixed Assets} \times \text{(Days/Period)}}$	=	
22.	Net Sales to Total Assets	=	$\frac{\text{Net Sales} \times \text{(Days/Year)}}{\text{Total Assets} \times \text{(Days/Period)}}$	=	
23.	Net Sales to Net Worth	=	$\frac{\text{Net Sales} \times \text{(Days/Year)}}{\text{Net Worth} \times \text{(Days/Period)}}$	=	
24.	Days Payables in Cost of Sales	=	$\frac{\text{Accts. Payable} \times \text{(Days/Period)}}{\text{Cost of Sales}}$	=	
25.	Income Before Tax to Net Worth	=	$\frac{\text{Inc. Before Tax} \times \text{(Days/Year)}}{\text{Net Worth} \times \text{(Days/Period)}}$	=	
26.	Income Before Tax to Total Assets	=	$\frac{\text{Inc. Before Tax} \times \text{(Days/Year)}}{\text{Total Assets} \times \text{(Days/Period)}}$	=	
27.	Retained Earnings to Net Income	=	$\frac{\text{Ret. Earn.} \times \text{(Days/Period)}}{\text{Net Income} \times \text{(Days/Year)}}$	=	
28.	Gross Profit Percentage	=	$\frac{\text{Net Sales} - \text{Cost of Sales}}{\text{Net Sales}}$	=	
29.	Operating Expenses as a % of Net Sales	=	$\frac{\text{Operating Expenses}}{\text{Net Sales}}$	=	

	Ratio Name		Formula for Ratio		Calculations
30.	Times Interest Earned	=	Inc. Before Interest and Taxes / Interest Expense	=	
31.	Interest Expenses to Net Sales	=	Interest Expense / Net Sales	=	
32.	Amort/Deprec Expense to Net Sales	=	Amort. and Deprec. Expense / Net Sales	=	
33.	Officers Compensation to Net Sales	=	Officers Compensation / Net Sales	=	
34.	Altman Z Score	=	The Altman Z Score, developed by Edward I. Altman, is a composite formula that is widely used to measure the financial "health" of a company. The formula takes financial ratios and multiplies each by a specific constant. The amounts so computed are added together to obtain an overall score. This score is then compared to scores from other companies to rate relative financial health. The formulas are as follows:		

For private companies:
(four variable)

Working Capital / Total Assets	×	6.56	=	
Retained Earnings / Total Assets	×	3.26	=	
Income Before Interest and Taxes / Total Assets	×	6.72	=	
Net Worth / Total Liabilities	×	1.05	=	
		Altman Z Score		

For private companies:
(five variable)

Working Capital / Total Assets	×	.717	=	
Retained Earnings / Total Assets	×	.847	=	
Earnings Before Interest and Taxes / Total Assets	×	3.107	=	
Net Worth (Book Value) / Total Liabilities	×	.420	=	
Sales / Total Assets	×	.998	=	
		Altman Z Score		

For public companies:

Working Capital / Total Assets	×	.012	=	
Retained Earnings / Total Assets	×	.014	=	
Earnings Before Interest and Taxes / Total Assets	×	.033	=	
Market Value Equity / Book Value of Total Liabilities	×	.006	=	
Sales / Total Assets	×	.999	=	
		Altman Z Score		

Altman Z Score Source: Altman, Edward, Corporate Financial Distress, A Complete Guide to Predicting, Avoiding, and Dealing with Bankruptcy, 1983, John Wiley & Sons.

.17 Illustrative Analytical Procedures Comparative Report

Sample Services, Inc.

Analytical Procedures Comparative Report
For the period ended December 31, 19XX

Prepared by ______

Reviewed by ______

Account Name	Account #	Prior	Ending	Net Change	%
Cash—Operating	110				
Cash—Savings	115				
Petty Cash	118				
Accounts Receivable	120				
Prepaid Insurance	130				
Prepaid Dues	131				
Prepaid Interest	132				
Supplies Inventory	140				
Land	200				
Buildings	210				
Accum. Depr.—Buildings	215				
Equipment	220				
Accum. Depr.—Equipment	225				
Other Assets	250				
Notes Payable	310				
Accounts Payable	330				
Accrued Liabilities	340				
Long-term Debt	390				
Common Stock	400				
Paid-in Capital	410				
Retained Earnings	450				
Sales	510				
Interest Income	520				
Other Revenue	530				
Automobile	700				
Bad Debts	705				
Depreciation	710				
Donations	715				
Insurance	720				
Interest	725				
Licenses & Dues	730				
Medical Insurance	735				
Payroll Taxes	740				
Postage	745				
Professional Fees	750				
Profit Sharing	755				
Repairs & Maintenance	760				
Salaries—Employees	765				
Salaries—Officers	767				
Supplies	770				
Telephone	775				
Travel	780				
Utilities	785				
Miscellaneous	790				
	Net Balance				

.18 Review of Financial Statements—Illustrative Representation Letter

(Date of Accountant's Report)

(To the Accountant)

In connection with your review of the (identification of financial statements) of (name of client) as of (date) and for the (period of review) for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your review.

1. The financial statements referred to above present the financial position, results of operations, and cash flows of (name of client) in conformity with generally accepted accounting principles. In that connection, we specifically confirm that—

   a. The company's accounting principles, and the practices and methods followed in applying them, are as disclosed in the financial statements.

   b. There have been no changes during the (period reviewed) in the company's accounting principles and practices.

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

   d. There are no material transactions that have not been properly reflected in the financial statements.

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

   f. There are no 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, and there are no other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.

   g. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.

   h. There are no related party transactions or related amounts receivable or payable that have not been properly disclosed in the financial statements.

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

   j. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

2. We have advised you of all actions taken at meetings of stockholders, board of directors, and committees of the board of directors (or other similar bodies, as applicable) that may affect the financial statements.

3. We have responded fully to all inquiries made to us by you during your review.

____

(Name of Owner or Chief
Executive
Officer and Title)

____

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

.19 Short-Form Checklist for a Review Engagement

		AR Ref*	Initials
1.	Obtain an engagement letter or document an understanding of the engagement in a memorandum. (See section 3175.09 for a sample engagement memorandum.)	.08*	________
2.	Determine whether your firm is independent, if the firm is not, go to step 3. If the firm is, go to step 4.	.38	________
3.	Stop. Do not issue a review report. (However, it may be possible to issue a compilation report.)	.38	________
4.	Acquire the necessary knowledge of the client's industry accounting principles and practices.	.24	________
5.	Acquire a general understanding of the nature of the client's business, including (a) its operating characteristics and (b) the nature of its assets, liabilities, revenues, and expenses.	.26	________
6.	Apply appropriate inquiry and analytical procedures in order to obtain a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements.	.24 & .27	________
7.	Read the financial statements to determine whether, based on the information presented, they appear to conform to generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting. Obtain reports of other accountants for subsidiaries, investee, etc., if any. Indicate division of responsibility if reference is made to other accountants.	.27	________
8.	Perform additional procedures if information appears to be incorrect, incomplete, or otherwise unsatisfactory.	.30	________
9.	Document in your workpapers matters covered in steps 6 and 7 above. Also describe unusual matters that were considered and how they were resolved (step 8).	.31	________
10.	Determine whether the inquiry and analytical procedures considered necessary to achieve limited assurance are incomplete or restricted in any way. If they are, go to step 11; if not, go to step 12.	.36	________
11.	Consider whether a compilation report should be issued rather than a review report. (A review that is incomplete or restricted is not an adequate basis for issuing a review report.) If the client has refused to provide additional or revised information, the accountant should withdraw from the engagement.	.12 & .36	________
12.	Consider whether the financial statements contain known departures from GAAP or an other comprehensive basis of accounting, including disclosure departures. If they do, go to step 13. If they do not, go to step 14.	.39	________
13.	Get client to revise the financial statements. Failing that, consider modifying your report by adding a separate paragraph or paragraphs. If the impact of the departure has been determined by management or is known by you, disclose the dollar effects in your report. (However, uncertainties and inconsistencies should not cause the report to be modified if they are properly disclosed.) Withdraw from the engagement if the departures are designed to mislead financial statement users.	.39 & .40	________
14.	Obtain a representation letter from the client.	.28	________
15.	Determine whether the basic financial statements are accompanied by information presented for supplementary analysis purposes. If they are, go to step 16. If they are not, go to step 17.	.43	________
16.	Indicate the responsibility assumed for the supplementary information in your review report or in a separate report. The report should disclose whether (a) the supplemental information has been reviewed (as part of the basic financial statement review) and you are not aware of any needed material modification or (b) the supplemental information has not been reviewed but only compiled.	.43	________

* The abbreviation "AR Ref" in this checklist means AR section 100. All references in this checklist are to paragraphs in AR section 100.

	AR Ref*	Initials
17. Mark each page of the financial statements, including any supplemental data, "See accountant's review report."	.34	______
18. Date your report using the date the inquiry and analytical procedures were completed.	.33	______
19. Issue the financial statements and related review report.	.32	______
20. If subsequent to the date of the report, facts that would possibly cause the financial statements to be misleading are discovered (and were in existence at the report date), consult SAS No. 1, section 561 (AU section 561), Interpretation No. 4 of SSARS No. 1 (AR section 9100.13—.15), and your attorney.	.42*	______

Completed by ______________________ Date: ____

[The next page is 2401.]

* The abbreviation "AR Ref." in this checklist means AR section 100. All references in this checklist are to paragraphs in AR section 100.

AAM Section 2400

Form and Content of Financial Statements

Statements Prepared

.01 The basic financial statements for a company that presents its financial statements in accordance with generally accepted accounting principles (GAAP) are:

- Balance Sheet
- Income Statement
- Statement of Cash Flows (either direct or indirect method)
- Statement of Changes in Stockholders' Equity

Examples of financial statement presentations can be found in the AICPA Disclosure Checklist Series.

.02 The description of accounting policies and the notes to the financial statements are considered part of the basic financial statements.

.03 Each financial statement presented should include the name of the company, the applicable statement title, and the date or time period covered. SSARS 1, paragraph 16 (AR section 100.16), states that each page of financial statements compiled by the accountant should contain a reference such as "See Accountant's Compilation Report." Each page of reviewed financial statements should refer to the accountant's review report, as required by SSARS 1, paragraph 34 (AR section 100.34).

.04 When the financial statements are either compiled or reviewed, some accountants prefer to follow the statement title with the word "unaudited." SSARS 1 (AR section 100) does not require use of the word "unaudited" when associated with compiled or reviewed statements nor does it prohibit its use.

Comparative Financial Statements

.05 There is no requirement to prepare comparative financial statements. However, Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapter 2, paragraph 1, states that comparative statements in annual and other reports enhance the usefulness of such reports. ARB No. 43 also states that notes of the prior year should be repeated, or referred to, to the extent that they continue to be of significance.

.06 When comparative financial statements are presented, the accountant should issue an appropriate report for each period presented in accordance with SSARS 2 (AR section 200). Comparative financial statements may contain statements for which the level of service provided in each period is different. Often, times the level of service is indicated in the statement title as follows:

ABC COMPANY

BALANCE SHEETS

As of December 31, 19X2 (Reviewed) and 19X1 (Compiled)

.07 Illustrative reports on comparative financial statements can be found in AAM sections 2510.11–.16 and 2520.07–.12.

Notes to Financial Statements

.08 The notes to the financial statements, as a part of the basic statements, are the responsibility of management. The accountant should explain the statements and the notes to the client so that the client understands the statements in sufficient depth to take full responsibility for them. The practitioner who assists the client in preparing the financial statements or who totally prepares them must be careful in the wording of the notes. The accountant should avoid wording the notes in such a way as would imply that they are the responsibility of the accountant. For example, words such as "we," "our," and "the client," should be avoided. When referring to the client, some accountants prefer to use the terms "the Company" or "Management."

.09 All of the disclosures required by GAAP should be made either on the face of the financial statements or in the notes thereto. In a compilation engagement, the client may elect to omit substantially all disclosures; a more detailed discussion of this appears in AAM section 2500. For a list of required disclosures, the accountant and the client may wish to review the applicable AICPA disclosure checklists.

Supplementary Information

.10 The accountant's report on supplementary information is discussed in SSARS 1, paragraph 43 (AR section 100.43), which states that when the basic financial statements are accompanied by information presented for supplementary analysis purposes, the accountant should clearly indicate the degree of responsibility he is taking regarding the other information. The supplementary information is generally separated from the basic financial statements and many accountants believe it should be presented after the basic statements.

.11 When the accountant compiles both the basic financial statements and the other data presented for supplementary analysis purposes only, his or her compilation report should include the supplementary information.

.12 When the accountant has reviewed the basic financial statements, he may indicate the degree of responsibility he is taking with respect to the other information by an explanation in his review report or in a separate report on the other data, that the review has been made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements for them to be in conformity with GAAP, and either—

a. The other data accompanying the financial statements are presented for supplementary analysis purposes only and have been subjected to the inquiry and analytical procedures applied in the review of the financial statements, and the accountant did not become aware of any material modifications that should be made to such data, or

b. The other data accompanying the financial statements are presented for supplementary analysis purposes and have not been subjected to the inquiry and analytical procedures applied in the review of the financial statements, but were compiled from information that is the representation of management, without audit or review, and the accountant does not express an opinion or any other form of assurance on such data.

.13 Illustrative accountants' reports on supplementary information accompanying compiled and reviewed financial statements can be found in AAM sections 2510.17, 2520.13, and .14, respectively.

Subsequent Discovery of Facts

.14 Subsequent to the report date for compiled or reviewed financial statements the accountant may become aware of facts that may have existed at the report date which might have caused the accountant to believe that information supplied by the client was incorrect, incomplete, or otherwise unsatisfactory. SSARS 1, paragraph 42 (AR section 100.42), states that, in those circumstances, the accountant may wish to consider the guidance in SAS No. 1, section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AU section 561), in determining the proper course of action.

.15 Interpretation 4 of SSARS 1, "Discovery of Information After the Date of the Accountant's Report" (AR section 9100.13–.15), discusses two factors the accountant might consider when determining the appropriate course of action regarding the subsequent discovery. The two factors discussed are (1) the reliability of the information and (2) the existence of persons known to be relying on or likely to rely on the financial statements. If the accountant determines that the information is reliable and there are persons known to be relying on or likely to rely on the information, the accountant would ordinarily conclude that those individuals should be notified in an appropriate manner.

.16 Both SSARS 1, paragraph 42 (AR section 100.42) and Interpretation 4 (AR section 9100.13–.15) indicate that because of the legal implications involved in actions contemplated under SAS No. 1, section 561 (AU section 561) and Interpretation 4 discussed in paragraphs .14 and .15, the accountant should consider consulting an attorney.

[*The next page is 2501.*]

AAM Section 2500
Accountants' Reports

.01 The users of financial statements should be able to easily identify the degree of responsibility that an accountant is taking with respect to a specific set of financial statements. The usual method of conveying the amount of responsibility taken is the written accountant's report. Therefore, whenever an accountant reviews or compiles financial statements, a report should be prepared in accordance with the AICPA Statements on Standards for Accounting and Review Services (SSARS).

.02 According to SSARS 1, paragraph 6, as amended by SSARS 7 (AR section 100.06), an accountant should not consent to the use of his or her name in a document or written communication containing unaudited financial statements unless

a. the accountant has compiled or reviewed the financial statements and his (her) report accompanies them,
or

b. the financial statements are accompanied by an indication that the accountant has not compiled or reviewed the financial statements and that no responsibility is assumed for them.

.03 If an accountant becomes aware that his or her name has been improperly used in a client-prepared document containing unaudited financial statements, the client should be advised that use of his or her name is inappropriate. The accountant should consider what other courses of action need to be taken, including consulting with his or her attorney.

.04 An accountant should not submit unaudited financial statements to his or her client or third parties unless, as a minimum service, the financial statements have been compiled in accordance with SSARS.

.05 Submission of financial statements under SSARS is defined as presenting to a client or others financial statements that the accountant has—

a. Generated, either manually or through the use of computer software, or

b. Modified by materially changing account classification, amounts, or disclosures directly on client-prepared financial statements. (See AR section 100.07.)

.06 If the accountant has performed more than one service, the report issued should be appropriate for the highest level of service performed. For example, if an accountant performs both a compilation and an audit of financial statements, the appropriate report to issue would be the audit report.

Compilation Report

.07 SSARS 1, paragraph 14, as amended (AR section 100.14), states that financial statements compiled by an accountant should be accompanied by a report that states—

a. A compilation has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

b. A compilation is limited to presenting in the form of financial statements information that is the representation of management.

c. The financial statements have not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on them.

Any other procedures performed by the accountant either before or during the compilation engagement should not be described in the accountant's report. An example of the accountant's standard compilation report can be found in AAM section 2510.01.

.08 Each page of the financial statements compiled by the accountant should include a reference to the accountant's report, such as, "See Accountant's Compilation Report" (SSARS 1, paragraph 16 (AR section 100.16)).

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

.10 An accountant may be asked to issue a compilation report on only one financial statement and not on the other related financial statements, for example, reporting on the balance sheet, but not on the related statements of income, retained earnings, and cash flows. SSARS 1, as amended (AR section 100) does not prohibit the accountant from performing such a service.

.11 If an accountant is not independent, a compilation report may still be issued, provided that the accountant has followed the appropriate authoritative literature during his engagement. The accountant should disclose the lack of independence; however, the reason should not be described. The following statement should be included as the last paragraph of the report:

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

Review Report

.12 SSARS 1, paragraph 32, as amended (AR section 100.32), states that financial statements reviewed by an accountant should be accompanied by a report that states—

a. A review has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

b. All information included in the financial statements is the representation of management of the entity.

c. A review consists principally of inquiries of company personnel and analytical procedures applied to financial data.

d. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements taken as a whole and, accordingly, no such opinion is expressed.

e. 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 generally accepted accounting principles (GAAP), other than those modifications, if any, indicated in the report.

Any other procedures performed by the accountant either before or during the review engagement should not be described in the accountant's report. An example of the accountant's standard review report can be found in AAM section 2520.01.

.13 Each page of the financial statements reviewed by the accountant should include a reference to the accountant's report, such as, "See Accountant's Review Report" (SSARS 1, paragraph 34, as amended (AR section 100.34)).

.14 The date of the completion of the accountant's inquiry and analytical procedures should be used as the date of the accountant's report (SSARS 1, paragraph 33, as amended (AR section 100.33)).

.15 If an accountant is unable to perform the necessary inquiry and analytical procedures to achieve the limited assurance which is contemplated by a review, or the client does not provide the accountant with a representation letter, then the review is incomplete. Therefore, he or she would not have an adequate basis for issuing a review report. If this is the case, the accountant should consider whether in this situation the incomplete review also precludes the issuance of a compilation report on the financial statements. A change in the level of service is discussed in AAM section 2200.15 through .22.

.16 An accountant may be asked to issue a review report on only one financial statement and not on the other related financial statements, for example, reporting on the balance sheet, but not on the related statements of income, retained earnings, and cash flows. According to SSARS 1, paragraph 37, as amended (AR section 100.37), the accountant may do so as long as the scope of the analytical procedures has not been limited.

.17 SSARS 1, paragraph 38, as amended (AR section 100.38), precludes the accountant from issuing a review report for an entity with respect to which the accountant is not independent.

Modifications to Standard Report

Omission of Substantially All Disclosures

.18 SSARS 1, paragraphs 19 through 21, as amended (AR section 100.19–.21), discuss reporting on financial statements that omit substantially all disclosures. An accountant may compile financial statements that omit substantially all disclosures required by GAAP, provided that this omission is clearly indicated in the report, and is not, to the accountant's knowledge, undertaken with the intention to mislead users of the financial statements. Examples of the appropriate reports under these circumstances can be found in AAM section 2510.02.

.19 If the entity wants to include disclosures about only a few matters in the form of notes to the financial statements, then that information should be clearly labeled as selected information, i.e., "Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included."

.20 If the financial statements are compiled in accordance with a comprehensive basis of accounting other than GAAP and disclosure is not made of the basis used, then the basis should be disclosed in the accountant's report.

Omission of Statement of Cash Flows

.21 FASB Statement No. 95, *Statement of Cash Flows*, paragraph 3 (AC C25), requires that an entity that provides a set of financial statements that reports both financial position and results of operations should include a statement of cash flows for each period for which results of operations are reported. Therefore, omitting this statement is a departure from GAAP. A GAAP departure must be disclosed in a separate paragraph of the accountant's report. If the statement of cash flows is omitted, then the following paragraph should be added to the accountant's compilation or review report:

> A statement of cash flows for the year ended December 31, 19XX, has not been presented. Generally accepted accounting principles require that such a statement be presented when financial statements purport to present financial position and results of operation.

The first paragraph of the report should also be modified accordingly. Examples of the full accountant's reports, both compilation and review, can be found in AAM sections 2510 and 2520, respectively.

GAAP Departures

.22 An accountant who is engaged to compile or review financial statements may become aware of a GAAP departure that is material to the financial statements taken as a whole. The accountant should ask management to revise the financial statements. If management refuses to revise the financial statements, then the accountant should consider whether modification of the standard report is sufficient to disclose the departure.

.23 SSARS 1, paragraph 40, as amended (AR section 100.40), states that if the accountant decides that modification of the standard report is appropriate, then the departure should be disclosed in a separate paragraph of the report. This disclosure should include the effects of the departure on the financial statements if management has determined these effects or if the accountant has been able to determine the effects through other procedures performed during the engagement. The accountant is not required to determine the effects if management has not done so provided the accountant states in his report that such determination has not been made. Examples of both compilation and review reports can be found in AAM sections 2510.04, .05, and 2520.02–.04, respectively.

.24 If the accountant believes that modification of the standard compilation or review report is not sufficient to indicate the deficiencies of the financial statements taken as a whole, then according to SSARS 1, paragraph 41, as amended (AR section 100.41), the accountant should withdraw from the engagement and provide no further services with respect to that set of financial statements. The accountant may also want to contact his or her attorney.

Scope Limitations

.25 According to SSARS 1, paragraph 36, as amended (AR section 100.36), if an accountant is unable to perform the necessary inquiry and analytical procedures to achieve the limited assurance contemplated by a review or the client does not provide the accountant with a representation letter then the review is incomplete and the accountant would not have an adequate basis for issuing a review report. If this is the case, then the accountant should consider whether the incomplete review also precludes issuing a compilation report on the financial statements.

.26 In such a situation, the accountant should consider the matter discussed in SSARS 1, paragraphs 44–49, as amended (AR section 100.44–.49), in deciding whether it is appropriate to issue a compilation report on the financial statements.

Going-Concern Uncertainties

.27 In evaluating the adequacy of disclosure of going-concern uncertainties, the accountant should look to the guidance provided in SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, paragraphs 10 and 11, as amended by SAS No. 77 (AU section 341.10 and .11).

.28 Normally a going-concern uncertainty would not cause an accountant to modify the standard report provided the financial statements appropriately disclose such matters. If the accountant believes that the disclosure of an uncertainty is inadequate, he or she should consider the guidance provided in SSARS 1, paragraphs 39–41, as amended (AR section 100.39–.41).

.29 Although it is not required, an accountant may wish to add an explanatory paragraph to the compilation or review report to emphasize the existence of a going-concern uncertainty. An example of an explanatory paragraph follows:

> 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 to the financial statements that might be necessary should the Company be unable to continue as a going concern.

Examples of full compilation and review reports for this situation can be found in AAM sections 2510.18 and 2520.15, respectively.

[*The next page is 2515.*]

AAM Section 2510

Accountants' Reports on Compilation of Financial Statements of a Nonpublic Entity

.01 Accountant's Standard Report

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17).]

Notes: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity.

Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.02 Omission of Substantially All Disclosures

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, (and cash flows)* for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

Management has elected to omit substantially all of the disclosures (and the statement of cash flows) required by generally accepted accounting principles. If the omitted disclosures (and the statement of cash flows) 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.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 21, as amended by SSARS 7 (AR section 100.21).]

Notes: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity.

Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

This form of report is appropriate only for a compilation engagement, not for a review engagement.

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* If the statement of cash flows is omitted, the first and third paragraphs of the report should be modified accordingly.

.03 Accountant Not Independent

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

I am (We are) not independent with respect to XYZ Company.[1]

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17) and SSARS 1, paragraph 22 (AR section 100.22).]

Notes: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity.

Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

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[1] In making a judgment about whether he is independent, the accountant should be guided by the AICPA Code of Professional Conduct. For example, the accountant should be aware that interpretation 101-3 (ET section 101.05) under rule 101 (ET section 101.01) of the rules of conduct indicates that independence is not necessarily impaired when an accountant provides manual or automated bookkeeping or data processing services to a client.

.04 Departure From GAAP—Omission of Statement of Cash Flows

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income and retained earnings for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, I (we) did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.

A statement of cash flows for the year ended December 31, 19XX, has not been presented. Generally accepted accounting principles require that such a statement be presented when financial statements purport to present financial position and results of operations.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.05 Departure from GAAP—Accounting Principles Not Generally Accepted

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, I (we) did become aware of a departure (certain departures) from generally accepted accounting principles that is (are) described in the following paragraph(s).

As disclosed in note X to the financial statements, generally accepted accounting principles require that land be stated at cost. Management has informed me (us) that the company has stated its land at appraised value and that, if generally accepted accounting principles had been followed, the land account and stockholders' equity would have been decreased by $500,000.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.06 Cash Basis Statements*—Full Disclosure.

Addressee:

I (We) have compiled the accompanying statement of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19XX, and the related statement of revenue collected and expenses paid for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

[*Signature*]

[*Date*]

[Source: Accounting and Review Services Interpretation No. 12 of SSARS 1, as amended by SSARS 7 (AR section 9100.45).]

Notes: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

See the AICPA publication, *Preparing and Reporting on Cash- and Tax-Basis Financial Statements*, for further guidance on the unique recognition, measurement, and disclosure issues for OCBOA (other comprehensive basis of accounting) financial statements, including illustrative financial statements and notes.

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* When financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the notes ordinarily would state the basis of presentation and describe how that basis differs from generally accepted accounting principles. [Source: Accounting and Review Services Interpretation No. 12 of SSARS 1 (AR section 9100.45).]

.07 Cash Basis Statements—Omission of Substantially All Disclosures, With No Reference to Basis

Addressee:

I (We) have compiled the accompanying statement of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19XX, and the related statement of revenue collected and expenses paid for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The financial statements have been prepared on the cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

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

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

[*Signature*]

[*Date*]

[Source: Accounting and Review Services Interpretation No. 12 of SSARS 1, as amended by SSARS 7 (AR section 9100.45).]

Notes: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

See the AICPA publication, *Preparing and Reporting on Cash- and Tax-Basis Financial Statements*, for further guidance on the unique recognition, measurement, and disclosure issues for OCBOA (other comprehensive basis of accounting) financial statements, including illustrative financial statements and notes.

.08 **Income Tax Basis Statements*—Full Disclosure**

Addressee:

I (We) have compiled the accompanying statement of assets, liabilities, and capital—income tax basis of ABC Partnership as of December 31, 19XX, and the related statements of revenues and expenses—income tax basis and changes in partners' capital accounts—income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

[*Signature*]

[*Date*]

[Source: Accounting and Review Services Interpretation No. 12 of SSARS 1, as amended by SSARS 7 (AR section 9100.45).]

Notes: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

See the AICPA publication, *Preparing and Reporting on Cash- and Tax-Basis Financial Statements,* for further guidance on the unique recognition, measurement, and disclosure issues for OCBOA (other comprehensive basis of accounting) financial statements, including illustrative financial statements and notes.

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* When financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the notes ordinarily would state the basis of presentation and describe how that basis differs from generally accepted accounting principles.

.09 Income Tax Basis Statements—Omission of Substantially All Disclosures, With No Reference to Basis

Addressee:

I (We) have compiled the accompanying statement of assets, liabilities, and equity—income tax basis of XYZ Company as of December 31, 19XX, and the related statement of revenue and expenses—income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The financial statements have been prepared on the accounting basis used by the Company for Federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

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

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

[*Signature*]

[*Date*]

[Source: Accounting and Review Services Interpretation No. 12 of SSARS 1, as amended by SSARS 7 (AR section 9100.45).]

Notes: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

See the AICPA publication, *Preparing and Reporting on Cash- and Tax-Basis Financial Statements*, for further guidance on the unique recognition, measurement, and disclosure issues for OCBOA (other comprehensive basis of accounting) financial statements, including illustrative financial statements and notes.

.10 Continuing Accountant's Report on Comparative Statements—Both Periods Compiled

Addressee:

I (We) have compiled the accompanying balance sheets of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

[*Signature*]

[*Date*]

[Source: SSARS 2, paragraph 9, as amended by SSARS 7 (AR section 200.09).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.11 Continuing Accountant's Report on Comparative Statements—Current Period Compiled With Reference to Review Report on Prior-Period

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

The accompanying 19X1 financial statements of XYZ Company were previously reviewed by me (us) and my (our) report dated March 1, 19X2, stated that I was (we were) not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles. I (We) have not performed any procedures in connection with that review engagement after the date of my (our) report on the 19X1 financial statements.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 12 (AR section 200.12) and SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.12 Continuing Accountant's Report on Comparative Statements—Both Periods Compiled With Restatement of Prior-Period Financial Statements[1]

Addressee:

I (We) have compiled the accompanying balance sheets of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

In my (our) previous compilation report dated March 1, 19X2, on the 19X1 financial statements, I (we) referred to a departure from generally accepted accounting principles because the company carried its land at appraised values. However, as disclosed in Note X, the company has restated its 19X1 financial statements to reflect its land at cost in accordance with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SSARS 2, paragraphs 9 and 15, as amended by SSARS 7 (AR section 200.09 and .15).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

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[1] A changed reference to a departure from generally accepted accounting principles includes the removal of a prior reference or the inclusion of a new reference.

.13 Successor Accountant's Compilation Report on Current-Period Financial Statements That Refers to a Predecessor Accountant's Compilation Report on Prior-Period Financial Statements

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying 19X2 financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The 19X1 financial statements of XYZ Company were compiled by other accountants whose report dated February 1, 19X2, stated that they did not express an opinion or any other form of assurance on those statements.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 19 (AR section 200.19) and SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.14 Successor Accountant's Compilation Report on Current-Period Financial Statements That Refers to a Predecessor Accountant's Review Report on Prior-Period Financial Statements

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying 19X2 financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The 19X1 financial statements of XYZ Company were reviewed by other accountants whose report dated March 1, 19X2, stated that they were not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 18 (AR section 200.18) and SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.15 Continuing Accountant's Report on Comparative Statements—Current Period Compiled With Reference to Audit Report on Prior Period

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

The financial statements for the year ended December 31, 19X1, were audited by me (us) (other accountants) and I (we) (they) expressed an unqualified opinion on them in my (our) (their) report dated March 1, 19X2, but I (we) (they) have not performed any auditing procedures since that date.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 28 (AR section 200.28) and SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.16 Continuing Accountant's Compilation Report on Comparative Statements—Prior Period Financial Statements That Omit Substantially All Disclosures Have Been Compiled From Previously Compiled (Reviewed) Financial Statements for the Same Period

Addressee:

I (We) have compiled the accompanying balance sheets of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

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

The accompanying 19X1 financial statements were compiled by me (us) from financial statements that did not omit substantially all of the disclosures required by generally accepted accounting principles and that I (we) previously compiled (reviewed) as indicated in my (our) report dated March 1, 19X2.

[*Signature*]

[*Date*]

[Source: SSARS 2, paragraph 30, as amended by SSARS 7 (AR section 200.30).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.17 Compilation Report—Financial Statements Accompanied by Supplementary Information

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, and the accompanying supplementary information (*identify the supplementary information, for example, schedules of cost of goods sold and selling, general and administrative expenses*), which are presented only for supplementary analysis purposes, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 43, as amended by SSARS 7 (AR section 100.43).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.18 Compilation Report—Emphasis of a Going-Concern Uncertainty

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

As discussed in note 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 to the financial statements that might be necessary should the Company be unable to continue as a going concern.*

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40) and Accounting and Review Services Interpretation No. 11 of SSARS 1 (AR section 100.40 and AR section 9100.33–.40).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

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* The accountant is not required to modify his or her compilation report for a going-concern uncertainty that is appropriately disclosed in the financial statements. However, he or she may wish to draw attention to the going-concern uncertainty in an explanatory paragraph of his or her compilation report as shown above. [Source: Accounting and Review Services Interpretation No. 11 of SSARS 1 (AR section 9100.34–.38).]

.19 Interim Historical Financial Statements Accompanied by a Financial Forecast Labeled as a "Budget"

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the six months then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

The accompanying budgeted balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 19XX, and for the six months then ending, have not been compiled or examined by us and, accordingly, we do not express an opinion or any other form of assurance on them.

Management has (The owners have) elected to omit the summaries of significant assumptions and accounting policies required under established guidelines for presentation of prospective financial statements. If the omitted summaries were included in the budgeted information, they might influence the user's conclusions about the company's budgeted information. Accordingly, this budgeted information is not designed for those who are not informed about such matters.

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17), Statement on Standards for Attestation Engagements (SSAE) *Financial Forecasts and Projections,* paragraph 58 (AT section 200.58) and AICPA Audit and Accounting Guide *Guide for Prospective Financial Information,* paragraph 10.20.]

.20 Comparative Statements—Current Year Compiled and Prior Year Audited by a Different Accountant Who Has Ceased Operations

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X2 and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with the Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying 19X2 financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The financial statements for the year ended December 31, 19X1, were audited by other accountants who have ceased operations, and they expressed an unqualified opinion on them in their report dated March 1, 19X2, but they have not performed any auditing procedures since that date.

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17), SSARS 2, paragraph 28 (AR section 200.28) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations*, paragraph 8.*]

* This Notice to Practitioners was issued by the Auditing Standards Division and is intended to provide guidance to accountants in situations in which the predecessor accountant has ceased operations. The guidance in this Notice does not apply to situations in which a firm of independent accountants assumes responsibility for the work of another firm in conjunction with, for example, a merger with, or acquisition of, the other firm.

.21 Comparative Statements—Both Years Compiled; However, Prior Year by a Different Accountant Who Has Ceased Operations

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X2 and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with the Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

The 19X1 financial statements of XYZ Company were compiled by other accountants who have ceased operations and whose report dated February 1, 19X2, stated that they did not express an opinion or any other form of assurance on those statements.

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 17, as amended by SSARS 7 (AR section 100.17), SSARS 2, paragraph 19, (AR section 200.19) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations*, paragraph 8.*]

[*The next page is 2545.*]

* This Notice to Practitioners was issued by the Auditing Standards Division and is intended to provide guidance to accountants in situations in which the predecessor accountant has ceased operations. The guidance in this Notice does not apply to situations in which a firm of independent accountants assumes responsibility for the work of another firm in conjunction with, for example, a merger with, or acquisition of, the other firm.

AAM Section 2520

Accountants' Reports on Review of Financial Statements of a Nonpublic Entity

.01 Accountant's Standard Report

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 35, as amended by SSARS 7 (AR section 100.35).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.02 Departure From GAAP—Accounting Principle Not Generally Accepted

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, with the exception of the matter described in the following paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

As disclosed in note X to the financial statements, generally accepted accounting principles require 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 generally accepted accounting principles on financial position, results of operations, and cash flows have not been determined.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.03 Departure From GAAP—Change in Accounting Principle Without Reasonable Justification

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standard for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, with the exception of the matter described in the following paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

As disclosed in note X to the financial statements, 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 generally accepted accounting principles, the company does not appear to have reasonable justification for making a change as required by Opinion No. 20 of the Accounting Principles Board.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.04 Departure From GAAP—Omission of Statement of Cash Flows

Addressee:

I (we) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, and retained earnings, for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, with the exception of the matter described in the following paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

A statement of cash flows for the year ended December 31, 19XX, has not been presented. Generally accepted accounting principles require that such a statement be presented when financial statements purport to present financial position and results of operations.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.05 Cash Basis Statements*—Full Disclosure

Addressee:

I (We) have reviewed the accompanying statement of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19XX, and the related statement of revenue collected and expenses paid for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the cash basis of accounting, as described in note X.

[*Signature*]

[*Date*]

[Source: Accounting and Review Services Interpretation No. 12 of SSARS 1, as amended by SSARS 7 (AR section 9100.45).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

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* When financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the notes ordinarily would state the basis of presentation and describe how that basis differs from generally accepted accounting principles.

.06 Income Tax Basis Statements*—Full Disclosure

Addressee:

I (We) have reviewed the accompanying statement of assets, liabilities, and equity—income tax basis of XYZ Company as of December 31, 19XX, and the related statement of revenue and expenses—income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements if the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the income tax basis of accounting, as described in note X.

[*Signature*]

[*Date*]

[Source: Accounting and Review Services Interpretation No. 12 of SSARS 1, as amended by SSARS 7 (AR section 9100.41–.45).]

Notes: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

See the AICPA publication, *Preparing and Reporting on Cash- and Tax-Basis Financial Statements,* for further guidance on the unique recognition, measurement, and disclosure issues for OCBOA (other comprehensive basis of accounting) financial statements, including illustrative financial statements and notes.

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* When financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the notes ordinarily would state the basis of presentation and describe how that basis differs from generally accepted accounting principles.

.07 Continuing Accountant's Report on Comparative Statements—Both Periods Reviewed

Addressee:

I (We) have reviewed the accompanying balance sheets of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SSARS 2, paragraph 9, as amended by SSARS 7 (AR section 200.09).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.08 Continuing Accountant's Report on Comparative Statements—Current Period Reviewed and Prior Period Compiled

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the 19X2 financial statements in order for them to be in conformity with generally accepted accounting principles.

The accompanying 19X1 financial statements of XYZ Company were compiled by me (us). A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the 19X1 financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

[*Signature*]

[*Date*]

[Source: SSARS 2, paragraph 10, as amended by SSARS 7 (AR section 200.10).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.09 Continuing Accountant's Report on Comparative Statements—Both Periods Reviewed With Restatement of Prior-Period Financial Statements[1]

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2 and 19X1, the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

In my (our) previous review report dated March 1, 19X2, on the 19X1 financial statements, I (we) referred to a departure from generally accepted accounting principles because the company carried its land at appraised values. However, as disclosed in Note X, the company has restated its 19X1 financial statements to reflect its land at costs in accordance with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SSARS 2, paragraphs 10 and 15, as amended by SSARS 7 (AR section 200.10 and .15).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

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[1] A changed reference to a departure from generally accepted accounting principles includes the removal of a prior reference or the inclusion of a new reference.

.10 Successor Accountant's Review Report on Current-Period Financial Statements That Refers to a Predecessor Accountant's Review Report on Prior-Period Financial Statements

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying 19X2 financial statements in order for them to be in conformity with generally accepted accounting principles.

The 19X1 financial statements of XYZ Company were reviewed by other accountants whose report dated March 1, 19X2, stated that they were not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 18, as amended by SSARS 7 (AR section 200.18) and SSARS 1, paragraph 35, as amended by SSARS 7 (AR section 100.35).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.11 Successor Accountant's Review Report on Current-Period Financial Statements That Refers to a Predecessor Accountant's Compilation Report on Prior-Period Financial Statements

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

The 19X1 financial statements of XYZ Company were compiled by other accountants whose report dated February 1, 19X2, stated that they did not express an opinion or any other form of assurance on those statements.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 19, as amended by SSARS 7 (AR section 200.19) and SSARS 1, paragraph 35, as amended by SSARS 7 (AR section 100.35).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.12 Continuing Accountant's Report on Comparative Statements—Current Period Reviewed With Reference to Audit Report on Prior Period

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

The financial statements for the year ended December 31, 19X1, were audited by me (us) (other accountants) and I (we) (they) expressed an unqualified opinion on them in my (our) (their) report dated March 1, 19X2, but I (we) (they) have not performed any auditing procedures since that date.

[*Signature*]

[*Date*]

[Sources: SSARS 2, paragraph 28 (AR section 200.28) and SSARS 1, paragraph 35, as amended by SSARS 7 (AR section 100.35).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.13 Review Report—Supplementary Information Subjected to Review Procedures

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

My (our) review was conducted for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. The information included in the accompanying (identify the supplementary information, for example, schedules of cost of goods sold and selling, general, and administrative expenses) is presented only for supplementary analysis purposes. Such information has been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements and I am (we are) not aware of any material modifications that should be made thereto.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraphs 35 and 43, as amended by SSARS 7 (AR section 100.35 and .43).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.14 Review Report—Supplementary Information Not Subjected to Review Procedures

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

My (our) review was conducted for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. The information included in the accompanying (identify the supplementary information, for example, schedules of cost of goods sold and selling, general, and administrative expenses) is presented only for supplementary analysis purposes. Such information has not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, but was compiled from information that is the representation of management, without audit or review. Accordingly, I (we) do not express an opinion or any other form of assurance on the supplementary information.

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraphs 35 and 43, as amended by SSARS 7 (AR section 100.35 and .43).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

.15 Review Report—Emphasis of a Going Concern Uncertainty

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

As discussed in Note 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 to the financial statements that might be necessary should the Company be unable to continue as a going concern.*

[*Signature*]

[*Date*]

[Source: SSARS 1, paragraph 40, as amended by SSARS 7 (AR section 100.40) and Accounting and Review Services Interpretation No. 11 of SSARS 1 (AR section 9100.38).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4).

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* The accountant is not required to modify his or her review report for a going-concern uncertainty that is appropriately disclosed in the financial statements. However, he or she may wish to draw attention to the going-concern uncertainty in an explanatory paragraph of his or her review report as shown above. [Source: Accounting and Review Services Interpretation No. 11 of SSARS 1 (AR section 9100.34–.38).]

.16 Comparative Statements—Both Years Reviewed; However, Prior Year by a Different Accountant Who Has Ceased Operations

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

The 19X1 financial statements of XYZ Company were reviewed by other accountants who have ceased operations and whose report dated February 1, 19X2, stated that they were not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 35, as amended by SSARS 7 (AR section 100.35), SSARS 2, paragraph 18 (AR section 200.18) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations,* paragraph 8.*]

* This Notice to Practitioners was issued by the Auditing Standards Division and is intended to provide guidance to accountants in situations in which the predecessor accountant has ceased operations. The guidance in this Notice does not apply to situations in which a firm of independent accountants assumes responsibility for the work of another firm in conjunction with, for example, a merger with, or acquisition of, the other firm.

.17 Comparative Statements—Current Year Reviewed and Prior Year Audited by a Different Accountant Who Has Ceased Operations

Addressee:

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

The financial statements for the year ended December 31, 19X1, were audited by other accountants who have ceased operations, and they expressed an unqualified opinion on them in their report dated March 1, 19X2, but they have not performed any auditing procedures since that date.

[*Signature*]

[*Date*]

[Sources: SSARS 1, paragraph 35, as amended by SSARS 7 (AR section 100.35), SSARS 2, paragraph 18 (AR section 200.18) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations*, paragraph 8.*]

[*The next page is 2601.*]

* This Notice to Practitioners was issued by the Auditing Standards Division and is intended to provide guidance to accountants in situations in which the predecessor accountant has ceased operations. The guidance in this Notice does not apply to situations in which a firm of independent accountants assumes responsibility for the work of another firm in conjunction with, for example, a merger with, or acquisition of, the other firm.

AAM Section 2600
Special Areas

Prescribed Forms

.01 SSARS 3 (AR section 300) allows an accountant to issue a compilation report when a prescribed form calls for a departure from GAAP by using a measurement principle different from GAAP or by not requiring the disclosures required by GAAP. A prescribed form is defined in SSARS 3, paragraph 2 (AR section 300.02), as "any standard preprinted form designed or adopted by a 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."

.02 Generally, it is assumed that the information required by a prescribed form meets the needs of the body that required the form to be completed, and, therefore, it is not necessary for that body to be advised of departures from GAAP that are required by the form. An example of the compilation report to be issued when the unaudited financial statements of a nonpublic entity are included in a prescribed form that calls for departures from GAAP can be found in AAM section 2610.01.

.03 If, during the compilation engagement, the accountant becomes aware of a departure from GAAP not required by the prescribed form, he should follow the guidance discussed in AAM section 2500.21 through .23 on GAAP departures. If the accountant finds that there is a departure from the requirements of the prescribed form, he or she should consider the departure to be the same as a departure from GAAP in determining the effects on the report. An example of a compilation report for a departure from GAAP which was not called for by the prescribed form can be found in AAM section 2610.02.

.04 SSARS 3, paragraph 5 (AR section 300.05), states that if the accountant is asked to sign a preprinted form that does not conform with the guidance found in SSARS 3 (AR section 300) or SSARS 1 (AR section 100), he or she should not sign the form, but should add the appropriate report to the prescribed form.

.05 If your client applies for a bank loan, the bank loan officer may request financial statements in the format prescribed in the Robert Morris Associates' Business Credit Information Package (BCIP). Those financial statements are required to be in conformity with generally accepted accounting principles, however, they do not contain all disclosures required in complete GAAP presentations. AAM section 2610.03 contains a sample prescribed-form compilation report for a BCIP presentation.

Specified Elements

.06 SSARS 1 (AR section 100) provides guidance on the compilation and review of financial statements. Some accountants are asked to issue review reports on separate presentations of specified elements, accounts or items of financial statements. Because this type of presentation is not a financial statement, guidance for this type of engagement is not found in the SSARS. This type of engagement should follow the Attestation Standards. (See AAM section 2610.04 for an illustrative review report.) If the accountant is engaged to apply agreed-upon procedures to elements, accounts, or items of a financial statement, he or she should refer to SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622).

[*The next page is 2611.*]

AAM Section 2610

Accountants' Reports on Prescribed Forms, BCIP, and Specified Elements

.01 Financial Statements Included in Certain Prescribed Forms

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended included in the accompanying prescribed form, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

My (Our) compilation was limited to presenting in the form prescribed by ABC Bank information that is the representation of management (owners). I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

These financial statements (including related disclosures) are presented in accordance with the requirements of [*name of body*], which differ from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such differences.

[*Signature*]

[*Date*]

[Source; SSARS 3, paragraph 3, as amended by SSARS 7 (AR section 300.03).]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4). SSARS 3 (AR section 300), provides for an alternative form of standard compilation report when a prescribed form or related instructions call for departure from generally accepted accounting principles or another comprehensive basis of accounting.

.02 Financial Statements Included in Certain Prescribed Forms—Departure From GAAP Not Called for by the Prescribed Forms

Addressee:

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended included in the accompanying prescribed form, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

My (Our) compilation was limited to presenting in the form prescribed by ABC Trade Association information that is the representation of management (owners). I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them. However, I (we) did become aware of a departure from generally accepted accounting principles that is not called for by the prescribed form or related instructions, as described in the following paragraph.

As disclosed in note X to the financial statements, generally accepted accounting principles require that land be stated at cost. Management has informed me (us) that the company has stated its land at appraised value and that, if generally accepted accounting principles had been followed, the land account and stockholders' equity would have been decreased by $XXX,XXX.

These financial statements (including related disclosures) are otherwise presented in accordance with the requirements of [*name of body*], which also differ from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such differences.

[*Signature*]

[*Date*]

[Source: SSARS 3, paragraph 4, as amended by SSARS 7 (AR section 300.04.]

Note: Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. Statements on Standards for Accounting and Review Services (SSARS) provide guidance to the accountant who performs services in connection with unaudited financial statements or other unaudited financial information of a nonpublic entity. However, when a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARS as permitted by footnote 4 of SAS No. 26 (AU section 504.05, footnote 4). SSARS 3 (AR section 300), provides for an alternative form of standard compilation report when a prescribed form or related instructions call for departure from generally accepted accounting principles or another comprehensive basis of accounting.

.03 Prescribed-Form Compilation Report for BCIP, Accompanying Supplementary Information Has Been Compiled

____

____

____

I (We) have compiled the [*identify financial statements and supplementary schedules, including periods presented and name of client*] included in the accompanying Business Credit Information Package in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

My (Our) compilation was limited to presenting in the form designed by Robert Morris Associates (the "Business Credit Information Package") and requested by [*name of bank*] information that is the representation of management. I (We) have not audited or reviewed the financial statements or supplementary information referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

These financial statements (including related disclosures) and supplementary information are for the use of [*name of bank*] and are presented in accordance with the requirements of the Business Credit Information Package, which differ from generally accepted accounting principles. Accordingly, these financial statements and supplementary information are not designed for those who are not informed about such differences.

[*Firm's Signature*]

[*Report Date*]

[Sources: SSARS 3, paragraph 3, as amended by SSARS 7 (AR section 300.03) and Robert Morris Associates, Business Credit Information Package.]

.04 Review Report on Elements, Accounts, or Items of a Financial Statement Under the Attestation Standards*

____

____

____

I (We) have reviewed the accompanying __________ [*identify the presentation of assertions relating to schedule(s) of elements, accounts or items*] of ________ [*client name*] for the ________ [*period*] ended ________. My (Our) review was conducted in accordance with standards established by the American Institute of Certified Public Accountants.

A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the __________ [*identify the presentation of assertions relating to schedule(s) of elements, accounts or items*]. Accordingly, I (we) do not express such an opinion.[1]

Based on my (our) review, nothing came to my (our) attention that caused me (us) to believe that the accompanying __________ [*identify the presentation of assertions relating to schedule(s) of elements, accounts or items*] is (are) not presented in conformity with generally accepted accounting principles (or other identified basis of accounting).

[*Firm's Signature*]

[*Report Date*]

[Source: Accounting and Review Services Interpretation No. 8 of SSARS 1, as amended by SSARS 7 (AR section 9100.27 and .28) and SSAE No. 1, paragraph 58 (AT section 100.58).]

[*The next page is 3001.*]

* SSARS 1 (AR section 100) provides guidance concerning the standards and procedures applicable to compilations and reviews of financial statements. Presentations of specified elements, accounts, or items of a financial statement are not financial statements. SAS No. 62 (AU section 623) and Interpretations thereof (AU section 9623) provide guidance with respect to reporting on such presentations when the engagement is intended to result in the expression of an audit opinion. SAS No. 75 (AU section 622) provides guidance with respect to reporting on the results of applying agreed-upon procedures to specified elements, accounts, or items of a financial statement. SSAE No. 1 (AT section 100) provides guidance with respect to reporting on such presentations when the accountant is engaged to express moderate assurance in a review report.

[1] An additional explanatory paragraph may be added after the second paragraph to emphasize matters relating to the attest engagement or the presentation of assertions.

AAM Section 3000

Engagement Planning and Administration

Sections 3165, 3170, and 3175 include illustrative audit assignment control forms, engagement letters, and an illustrative planning checklist that can be used by an accountant in the planning phase of an audit engagement.

Various formats of audit assignment controls, engagement letters, and planning checklists are in use; nevertheless, inclusion of the formats in this section in no way means that they are preferable. Readers are urged to refer directly to authoritative pronouncements when appropriate.

Illustrative formats of audit assignment controls, engagement letters, and planning checklists are often helpful in developing a consistent style within a firm. However, no set of illustrative formats can cover all the situations that are likely to be encountered in practice because the circumstances of engagements vary widely.

Readers should consider other sources of illustrative presentations, such as those in authoritative pronouncements and AICPA audit and accounting guides.

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AAM Section 3100
Planning the Engagement

.01 The planning phase is an important part of every engagement. During this phase, the partner and the staff review the client's business and the industry in which the client operates, then develop an overall strategy for the expected conduct and scope of the engagement.

.02 The need for planning is highlighted in Rule 201, General Standards (ET section 201.01), AICPA Code of Professional Conduct, which states: "A member shall adequately plan and supervise an engagement."

.03 The first standard of fieldwork of generally accepted auditing standards states: "The work is to be adequately planned and assistants, if any, are to be properly supervised." Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), provides authoritative interpretive guidance on the first standard of fieldwork.

.04 Proper planning also enhances the productivity of engagement personnel and should result in a more profitable engagement.

.05 The planning memo and the planning checklist are two commonly used planning documents. The style and complexity of these documents will depend on engagement needs and firm preference. The same memo or checklist may be referred to in the review process to ensure that the items highlighted in the planning phase are given adequate attention during the engagement.

.06 The steps in audit planning are as follows:

a. Understand the scope of services and the nature of reports expected to be rendered.

b. Decide whether or not to accept the engagement.

c. Assign personnel to the engagement and prepare a preliminary time budget.

d. Assess independence of firm and audit team.

e. Understand the entity's business and the industry in which it operates.

f. Assess the auditability of the entity by—

1. Gaining an adequate understanding of the internal control structure.
2. Evaluating management integrity.

g. Establish an agreement with the client, preferably with an engagement letter.

h. Assess control risks.

i. Make a preliminary judgment about materiality levels for audit purposes.

j. Estimate the level of audit risk and consider its interactive components.

k. Consider how components of audit risk relate to one another for each cycle or major account.

l. Consider cost-effectiveness of different audit strategies.

m. Write the audit program and finalize a time budget.

[The next page is 3121.]

AAM Section 3105
Understanding the Assignment

.01 The auditor should (*a*) meet with the client to understand the type, scope, and timing of the engagement; (*b*) understand if reports on compliance, internal control structure, or segments of the entity are required; (*c*) understand the client's expectations, both stated and implied; and (*d*) review the expectations of both the owners and managers. A sample checklist is located in AAM section 3165.

.02 To obtain an adequate understanding of any assignment, the auditor should be familiar with generally accepted accounting principles (GAAP), which includes specialized industry guides as well as Emerging Issues Task Force (EITF) consensuses.

.03 Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* sets forth the GAAP hierarchy. Statement on Standards for Accounting and Review Services 7 *Omnibus Statement on Standards for Accounting and Review Services—1992,* indicates that the GAAP hierarchy set forth in SAS No. 69 also applies to compilation and review engagements.

.04 SAS No. 69:

a. Presents two separate but parallel hierarchies—one for state and local governments and another for nongovernmental entities, and

b. Establishes a true GAAP hierarchy—each successive category in the hierarchy is a different level of authority.

.05 The table below summarizes the pronouncements that are included in each of the five categories of GAAP for nongovernmental entities and for state and local governments.

.06 GAAP Hierarchy Summary *

	Nongovernmental Entities	State and Local Governments
Established Accounting Principles	10a. FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins	12a. GASB Statements and Interpretations, plus AICPA and FASB pronouncements if made applicable to state and local governments by a GASB Statement or Interpretation
	10b. FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position	12b. GASB Technical Bulletins, and the following pronouncements if specifically made applicable to state and local governments by the AICPA: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position
	10c. Consensus positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins	12c. Consensus positions of the GASB Emerging Issues Task Force ‡ and AICPA Practice Bulletins if specifically made applicable to state and local governments by the AICPA
	10d. AICPA accounting interpretations, "Qs and As" published by the FASB staff, as well as industry practices widely recognized and prevalent	12d. "Qs and As" published by the GASB staff, as well as industry practices widely recognized and prevalent
Other Accounting Literature †	11. Other accounting literature, including FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; GASB Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids;* and accounting textbooks, handbooks, and articles	13. Other accounting literature, including GASB Concepts Statements; pronouncements in categories (*a*) through (*d*) of the hierarchy for nongovernmental entities when not specifically made applicable to state and local governments; FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids;* and accounting textbooks, handbooks, and articles

[The next page is 3141.]

* Paragraph references correspond to the paragraphs of SAS No. 69 (AU section 411) that describe the categories of the GAAP hierarchy.

† In the absence of established accounting principles, the auditor may consider other accounting literature, depending on its relevance in the circumstances.

‡ As of the date of this Manual, the GASB had not organized such a group.

AAM Section 3110
Assigning Personnel to the Engagement

General Comments

.01 Engagement planning should include procedures for assigning personnel to the engagement. The procedures established should provide the firm with reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances. Generally, the more able and experienced the personnel assigned to a particular engagement, the less need for direct supervision.

.02 Some procedures regarding assignment of personnel to the engagement are discussed in this section. The specific procedures adopted by a firm would not necessarily include all the procedures or be limited to those discussed. Overall firm requirements for assigning personnel to engagements are addressed in the *Quality Control Policies and Procedures for CPA Firms,* "Establishing Quality Control Policies and Procedures," (QC section 90), paragraphs .11—.12. (See AAM section 11,500.03—.06 for examples of quality control forms which can be helpful in assigning personnel to engagements.)

Engagement Planning Procedures

.03 A time budget for the engagement should generally be prepared to determine manpower requirements and to schedule field work. The engagement partner should approve the time budget prior to the beginning of field work. A time budget should have columns for budgeted time (in hours) for preliminary and final field work. Time budget forms differ depending upon firm preference and needs. Some firms use separate forms for the time budget report and the job progress report or analysis (see AAM section 3170.01 for "Audit Time Budget—Sample A"), whereas others combine these reports into one form (see AAM section 3170.02 for "Audit Time Budget—Sample B").

.04 Other alternatives include longer, more detailed sets of forms. These forms combine the features of a time budget, a source document for staff scheduling, and a job progress report that compares each assigned person's actual daily hours against the budget. Some firms use a shorter, less detailed form for jobs of less than a predetermined number of staff hours (for example, one hundred hours; see AAM section 3170.03 for "Audit Time Analysis—Short Form") and a longer form for jobs requiring more time (see AAM section 3170.04 for "Audit Time Analysis—Long Form"). Some firms use a weekly (or daily) progress report (see AAM section 3170.05, for example). This report, submitted by the accountant in charge, shows the time actually spent in relation to the estimate, the estimated additional time required, and the estimated variance from the original estimate.

.05 When the combined time budget and progress report form (sample B) is used, it must be kept current as the assignment progresses. This form is carried in the working papers file and is filled in daily by the accountant in charge, for all persons applying time on the engagement. This procedure is vital to identify and control time as it is applied so that it can be compared to the budgeted time for that phase of the engagement.

.06 The following factors should be considered in achieving a balance of engagement manpower requirements, personnel skills, individual development, and utilization:

a. Engagement size and complexity

b. Personnel availability

c. Special expertise

d. Timing of the work to be performed

e. Continuity and periodic rotation of personnel *f.* Opportunities for on-the-job training

.07 The scheduling and staffing of the engagement should be approved by the partner with final responsibility for the engagement so that the partner can consider the qualifications, experience, and training of personnel to be assigned. The experience and training of the engagement personnel should be considered in relation to the complexity or other requirements of the engagement and the extent of supervision to be provided.

.08 It is recommended that all procedures discussed in this section be documented in the accountant's work papers. A sample checklist documenting the procedures listed in this section is located in AAM section 3165.

[The next page is 3161.]

AAM Section 3115
Independence

General Comments

.01 Engagement planning should include procedures to provide the firm with reasonable assurance that persons at all organizational levels maintain independence to the extent required by the AICPA Code of Professional Conduct. Interpretation 101-1 of rule 101 of the rules of conduct (ET section 101.02), contains examples of instances wherein a firm's independence will be considered to be impaired.

.02 The procedures employed at the engagement level should be designed to ascertain whether the firm and its partners and employees have complied with all applicable independence rules, with emphasis on those related to financial interest, performance of accounting services for the client, and unpaid fees. Overall firm requirements for independence are addressed in the *Quality Control Policies and Procedures for CPA Firms,* "Establishing Quality Control Policies and Procedures," (QC section 90), paragraphs .09—.10. (See AAM section 11,500.01—.02 for independence checklists for employees and other auditors.)

.03 Some procedures regarding independence which a firm may employ in the planning phase of an engagement are discussed in this section. The specific procedures adopted by a firm would not necessarily include all these procedures or be limited to those discussed.

Engagement Planning Procedures

.04 Annual independence questionnaires should be reviewed for all engagement personnel by the engagement partner to assure that those individuals assigned to the engagement are independent.

.05 Accounts receivable from the client should be reviewed to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

.06 According to SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors* (AU section 543), the firm, when acting as principal auditor, should obtain confirmation of the independence of another firm engaged to perform segments of the audit. Written confirmation enables the principal auditor to document his assessment of the other auditor's independence in his audit work papers.

.07 In situations in which the accountant is not independent, the type of opinion to be issued should be discussed in the planning stage. A disclaimer of opinion should be issued as discussed in SAS No. 26, *Association With Financial Statements,* paragraphs 8—10 (AU section 504.08—.10), or the engagement should be turned into a compilation.

.08 It is recommended that all procedures discussed in this section be documented in the auditor's work papers. A sample checklist documenting the procedures listed in this section is located in AAM section 3165.

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AAM Section 3120
Knowledge of the Entity's Business

.01 The accountant should obtain a level of knowledge of the entity's business that will enable the accountant to plan and perform the audit in accordance with generally accepted auditing standards. That level of knowledge should enable the accountant to obtain an understanding of the events, and may have a significant effect on the financial statements. The level of knowledge customarily possessed by management relating to managing the entity's business is substantially greater than that which is obtained by the accountant in performing the audit. Knowledge of the entity's business helps the accountant in—

a. Identifying areas that may need special consideration.

b. Assessing conditions under which accounting data are produced, processed, reviewed, and accumulated within the operation.

c. Evaluating the reasonableness of estimates, such as valuation of inventories, depreciation, allowances for doubtful accounts, and percentage-of-completion of long-term contracts.

d. Evaluating the reasonableness of management representations.

e. Making judgments about the appropriateness of the accounting principles applied and the adequacy of disclosures.[1]

Engagement Planning Procedures

.02 The accountant should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics. Such matters include, for example, the type of business, types of products and services, capital structure, related parties, locations and production, distribution, and compensation methods. The accountant should also consider matters affecting the industry in which the entity operates—such as economic conditions, government regulations, and changes in technology—as they relate to his audit. Other matters, such as accounting practices common to the industry, competitive conditions, and, if available, financial trends and ratios, should also be considered by the accountant.

.03 Knowledge of an entity's business is obtained through performing analytical procedures, prior experience with the entity or its industry, and inquiry of the entity's personnel. Working papers from prior years may contain useful information about the nature of the business, organizational structure, operating characteristics, and transactions that may require special consideration. Other sources an accountant may consult include AICPA audit and accounting guides, industry publications, financial statements of other entities in the industry, textbooks, periodicals, and individuals knowledgeable about the industry.

.04 The accountant should give thought to whether specialized skills are needed to consider the effect of computer processing on the audit, to understand the nature of internal control structure policies and procedures, or to design and perform audit procedures. If specialized skills are needed, the accountant should seek assistance from a professional who may be either on or outside the accountant's staff. If the use of such a professional is planned, the accountant should have sufficient computer-related knowledge to communicate the objectives of the other professional's work, to evaluate whether the specified procedures will meet the accountant's objectives, and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned

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[1] See SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* paragraphs 4 and 6 (AU section 411.04 and .06).

audit procedures. The accountant's responsibilities for using such a professional are equivalent to those for using assistants.[2]

.05 The accountant should consider the methods the entity uses to process accounting information in planning the audit because such methods influence the design of the accounting system and the nature of control procedures. The extent to which computer processing is used in significant accounting applications, as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures. Accordingly, when evaluating the effect of an entity's computer processing on an audit of financial statements, the accountant should consider matters such as—

a. The extent to which the computer is used in each significant accounting application.

b. The complexity of the entity's computer operations, including the use of an outside service center.[3]

c. The organizational structure of the computer processing activities.

d. The availability of data. Documents that are used to enter information into the computer for processing certain computer fields, and other evidential matter that may be required by the accountant, may exist only for a short period or only in computer-readable form. In some computer systems, input documents may not exist at all because information is entered directly into the system. An entity's data retention policies may require the accountant to request retention of some information for the review or to perform audit procedures at a time when the information is available.

e. The use of computer-assisted audit techniques to increase the efficiency of performing audit procedures.[4] Using computer-assisted audit techniques may also provide the accountant with an opportunity to apply certain procedures to an entire population of accounts or transactions. In addition, in some accounting systems, it may be difficult or impossible for the auditor to analyze certain data or test specific control procedures without computer assistance.

In addition, certain information generated by the computer for management's internal purposes may be useful in performing substantive tests (particularly analytical procedures).[5]

.06 It is recommended that all procedures discussed in this section be documented in the accountant's work papers. A sample checklist for documenting the procedures listed in this section is located in AAM section 3165.

[The next page is 3201.]

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[2] Since the use of a specialist who is effectively functioning as a member of the audit team is not covered by SAS No. 11, *Using the Work of a Specialist* (AU section 336), a computer audit specialist requires the same supervision and review as any assistant.

[3] See SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), and the related AICPA Audit and Accounting Guide, *Audits of Service-Center-Produced Records,* for guidance concerning the use of a service center for computer processing of significant accounting applications.

[4] See the AICPA Audit and Accounting Guide, *Computer-Assisted Audit Techniques,* for guidance relating to this specialized area.

[5] SAS No. 56, *Analytical Procedures* (AU section 329), describes the usefulness of and guidance pertaining to such procedures.

AAM Section 3125
Consideration of Internal Control

Introduction

.01 Internal control is broadly defined as a process designed to provide reasonable assurance regarding the achievement of entity objectives. Internal control is accomplished by an entity's board of directors, management, and other personnel.

.02 The above definition reflects certain fundamental concepts:

- *A process.* Internal control is a process. It is not one event or circumstance, but a series of actions that permeate an entity's activities. These actions are pervasive, and are inherent in the way management runs the business.
- *People.* Internal control is effected by people. It is not accomplished by policy manuals and forms, but the people of an organization, what they do and say. People must know their responsibilities and limits of authority.
- *Reasonable assurance.* Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's objectives.
- *Achievement of objectives.* Internal control is geared to the achievement of entity objectives. The definition of these objectives provides auditors with a useful framework for understanding and analyzing internal controls.

.03 Auditors are required to consider their client's internal control during the planning phase of every audit. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AU section 319), states the following:

> A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

.04 As a practical matter, the above requirement raises the following questions.

- What constitutes a "sufficient understanding"? That is, what should an auditor know about the client's internal control?
- How should an auditor obtain this understanding?
- Once an auditor understands the client's internal control, how is that information used to plan the audit?

.05 This section provides answers to each of the above three questions.

What Auditors Should Understand About Internal Control

.06 A "sufficient" understanding of internal control means:

- An auditor should understand how controls have been designed and whether they have been placed in operation.

- This understanding is generally limited to controls that pertain to the entity's objective of preparing reliable financial statements for external purposes.
- That one objective can be broken into five components, and an auditor should obtain an understanding of each of the five components.

.07 Whether a control has been "placed in operation" is different from its "operating effectiveness." In obtaining knowledge about whether controls have been placed in operation, the auditor determines whether the entity is using them. Operating effectiveness, on the other hand, is concerned with how the control was applied, the consistency with which it was applied, and by whom.

.08 *The Jones family owns and operates several neighborhood grocery stores in Anytown. On a monthly basis, the controller of Jones Grocery performs bank reconciliations for all the bank accounts. For planning purposes, the auditor of Jones Grocery needs to understand whether the controller performs the reconciliations. Not testing, but identifying controls are a key part of audit planning.*

.09 SAS No. 55 (AU section 319), as amended, provides a framework to help auditors obtain their understanding of internal control. That framework is built on two basic concepts: objectives and components.

.10 Internal control is a process designed to provide reasonable assurance regarding the achievement of entity *objectives*. Entities generally have the following three objectives:

- *Financial reporting.* This objective relates to the preparation of reliable published financial statements.
- *Operations.* This objective relates to effective and efficient use of the entity's resources.
- *Compliance.* This objective relates to the entity's compliance with applicable laws and regulations.

.11 *The bank reconciliation performed by the Jones Grocery controller is an example of a control that relates primarily to the* ***financial reporting*** *objective. Jones also has an inventory tracking and management system that allows each store manager to track inventory levels and order new items before they stock-out. This control activity is part of the* ***operations*** *objective. Each store also has a small deli that prepares sandwiches and hot entrees. These food preparation activities must comply with state health laws and regulations, and Jones has policies in place to help ensure that those laws and regulations are met. Those policies are directed at the entity's* ***compliance*** *objective.*

.12 Generally, relevant controls for an audit relate to the financial reporting objective. Controls relating to operations and compliance objectives that are not relevant to an audit need not be considered.

.13 *The controls having to do with the ordering of inventory or compliance with state health laws and regulations are important to Jones Grocery, but ordinarily will not relate to the audit of the company's financial statement. The auditor of Jones may wish to inquire and document these controls for client service or other purposes, but since these controls are not relevant to the audit, he or she is not required to do so.*

.14 However, if controls relating to operations and compliance objectives pertain to data the auditor evaluates or uses in applying auditing procedures, then they may be relevant to the audit.

.15 For example, the financial reporting system may produce a sales report by inventory stock number for each sales region. If the auditor decided to use information from this report when auditing the proper valuation of inventory, he or she should consider obtaining an understanding of the following:

- Which transactions or classes of transactions are included in the report.
- How significant accounting data about those transactions are entered into and flow through the financial reporting system.
- The files that are processed.

- The nature of processing involved in producing the report.

.16 Controls pertaining to detecting noncompliance with laws and regulations that may have a direct and material effect on the financial statements, such as controls over compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

.17 Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. For example, use of a lockbox system for collecting cash or passwords for limiting access to accounts receivable data files may be relevant to a financial statement audit. Conversely, controls to prevent the excess use of materials in production generally are not relevant to a financial statement audit. An auditor's responsibility to understand internal control is generally limited to those controls relevant to the reliability of financial reporting.

.18 An objective is what an entity strives to achieve. But what is needed to achieve that objective?

.19 SAS No. 55 (AU section 319), as amended, provides a framework that separates each financial reporting objective into five components. These components represent what is needed to achieve the entity's objectives. The components of internal control are briefly described as follows:

- *Control environment.* The core of any business is its people—their individual attributes, including integrity, ethical values, and competence—and the environment in which they operate. They are the engine that drives the entity and the foundation on which everything rests.
- *Risk assessment.* The entity must be aware of and deal with the risks it faces. It must set objectives, integrated with the sales, production, marketing, financial, and other activities so that the organization is operating in concert. It also must establish mechanisms to identify, analyze, and manage the related risks.
- *Control activities.* Control policies and procedures must be established and executed to help ensure the actions identified by management as necessary to address risks to achievement of the entity's objectives are effectively carried out.
- *Information and communication.* Surrounding the control activities are information and communication systems, including the financial reporting information system. These systems enable the entity's people to capture and exchange the information needed to conduct, manage, and control its operations.
- *Monitoring.* The entire process must be monitored, and modifications made as necessary. In this way, the system can react dynamically, changing as conditions warrant.

.20 Some control components, for example the control environment, will have a pervasive effect on the entity's activities. Other components, for example control activities, will be directed primarily toward the achievement of one or more of the three objectives described in AAM section 3125.10. Auditors are generally interested only in those components of internal control that have a pervasive effect on the entity and those that are directly related to the reliability of financial reporting.

.21 This internal control framework, the relationship between an entity's objectives and internal control components, is discussed in more detail in AAM section 4200.

.22 The internal control framework described here and in AAM section 4200 is only a means to help auditors consider the impact of an entity's internal control in an audit. An auditor's primary concern is *not* the classification of a specific control into any particular component and related objective. Rather, an auditor's primary concern is whether a specific control affects financial statement assertions.

.23 *Andrea Auditor audits Jones Grocery. As on all audits, she is required to obtain an understanding of internal control sufficient to plan the audit. To achieve this, she organizes her inquiries and other procedures to understand each* *of the five components of internal control that relate to the financial reporting objective. As a result of performing her procedures, she discovers the client's bank reconciliation procedures. Should a bank reconciliation be considered a "control procedure"? What about the fact that someone follows up and investigates old or unusual reconciling items. Is that considered a "monitoring" activity?*

.24 *The issue of how to classify a particular control is irrelevant for Andrea's purposes. As an auditor, her primary consideration is to understand how the bank reconciliations affect financial statement assertions relating to cash.*

How an Auditor Obtains an Understanding of Internal Control

.25 An auditor often obtains an understanding of internal control through previous experience with the entity and the following:

- Inquiries of appropriate management, supervisory, and staff personnel.
- Inspection of entity documents and records.
- Observation of entity activities and operations.

.26 Auditors should consider the types of misstatements that occurred in prior audits, for example, whether they were associated with accounting estimates, whether they were routine errors that resulted from a lack of control consciousness, or whether they resulted from lack of sufficient personnel. This knowledge of prior misstatements can help an auditor focus his or her inquiries on those areas and whether changes have been made to internal control to prevent those misstatements in the future.

.27 In a continuing audit, the auditor may already have significant experience with and documentation of internal control. In these situations, this knowledge from previous audits allows the auditor to focus on system changes.

.28 *Jones Grocery purchased a commercially available software package for independent grocers. During 19X1, Jones installed the general ledger system and the cash receipts/disbursements and accounts payable modules. As part of performing her 19X1 audit, Andrea Auditor obtained an understanding of the software package and the modules that were installed. For her 19X2 audit, Andrea should focus on changes made to the system since 19X1. For example, she might inquire about the installation of other modules (such as inventory) or updated versions of the software package.*

.29 Some controls are documented in policy and procedure manuals, flowcharts, source documents, journals, and ledgers. In these cases, inspection of the documentation and inquiries of entity personnel may provide a sufficient understanding to plan the audit.

.30 *When Jones Grocery receives a bill, it is input directly into the accounts payable module of their software package. The computer generates an accounts payable aging and a cash requirements report that indicates when each bill should be paid. The accounts payable module interfaces with the general ledger system to automatically post and update the appropriate general ledger account whenever bills are received or paid. To obtain her understanding of the accounts payable system, Andrea performed a "walk-through." She made inquiries of Jones personnel and obtained copies of bills and the reports generated by the computer. She "walked through" the example bills to see how they were included in the computer reports and how totals from those reports were posted to the general ledger. She also made inquiries related to the completeness assertion, that is, how does Jones ensure that* ***all*** *bills are entered into the system? Andrea observed the Jones employee performing those control procedures.*

.31 Documentation may not be available for some controls. For example, the understanding of certain aspects of the control environment, such as management integrity, may be obtained through previous experience updated by inquiries of management and observation of their actions. Although documentation may not be available, the auditor is still responsible for documenting his or her understanding of the components of internal control.

.32 In obtaining an understanding of the design of computer programmed control activities and whether they have been placed in operation, the auditor may make inquiries of appropriate entity personnel and inspect relevant systems documentation to understand control activities design. The auditor may also inspect exception reports generated as a result of such control activities to determine that they have been placed in operation. In actuality, as discussed in AAM section 3125.30, it is possible that the auditor will test controls when obtaining their understanding of internal control.

.33 The auditor's assessment of inherent risk and judgments about materiality for various account balances and transaction classes also affect the nature and extent of the procedure performed to obtain the understanding. For example, the auditor may conclude that planning the audit of the prepaid insurance account does not require specific procedures to obtain an understanding of internal control.

.34 AAM sections 4300 and 4400 contain a series of forms and questionnaires to help auditors perform the procedures to obtain an understanding of internal control.

Using Internal Control Information to Plan the Audit

.35 Effective audit planning requires the auditor to know what can go wrong in the financial statements. That is, the auditor should identify the types of material misstatements that could occur and assess the risk that they will occur. Understanding the design of internal control and whether it has been placed in operation provides important information about the types and risks of potential material misstatement that could occur in financial statements.

.36 *The controller of Jones Grocery performs monthly bank reconciliations, but suppose the controller is not required to follow up on old or unusual reconciling items and that the reconciliation itself is not subject to supervisory review. This is a flaw in the design of internal controls which affects the risk of misstatements occurring in the cash accounts going undetected and increases the risk that a misstatement may not be identified timely.*

.37 Knowledge of internal control is also a primary source of information about the specific processes, methods, records, and reports used in preparing the entity's financial statements. The auditor uses this information to design substantive audit tests.

.38 *In obtaining an understanding of internal control at Jones Grocery, Andrea Auditor determines that the accounting system generates an accounts payable trial balance of all unpaid invoices. This information is useful for Andrea to plan her search for unrecorded liabilities—that is, post-balance sheet disbursements and unpaid invoices will be traced to that report to determine if they have been properly accrued at year end.*

.39 The understanding of internal control is also used by auditors to plan an overall audit *strategy*. There are generally two types of audit strategies:

- A primarily substantive approach, where control risk is assessed at or slightly below the maximum, or
- An approach where control risk is assessed below the maximum.

.40 When control risk is assessed as below the maximum and it has been determined that reliance on the controls is possible, auditors can modify the nature, timing, and extent of substantive procedures, for example, sample sizes may be reduced or substantive testwork can be performed in advance of the balance sheet date.

.41 The choice of an audit strategy is done at the *assertion* level and is not a global strategy for the entire audit. For some assertions, the auditor may choose a primarily substantive approach, and for other assertions, the auditor may plan to assess control risk below the maximum.

.42 *Andrea Auditor has been the auditor of Jones Grocery for several years. During that time she has helped Jones design and implement the procedures used for the annual inventory count. The count itself is performed by an outside inventory count company that specializes in taking inventory at grocery stores. The outside company is supervised by Jones Grocery employees. Based on this knowledge of the internal controls for the physical inventory count, Andrea plans to assess internal control risk below the maximum for the existence assertion related to inventory.*

.43 In the above example, the audit strategy was determined at the assertion level. The physical count of inventory is a control directly related to the existence assertion. It has little relevance to the valuation assertion and no relevance to the completeness assertion. Thus, the auditor is able to modify tests related to the existence assertion, for example, reducing the number of test counts or stores where inventory is observed. Substantive audit procedures related to other assertions (for example, proper pricing) should not be modified.

Choosing an Audit Strategy

.44 As described in AAM section 3125.06, on all audits, an auditor is required to understand how controls are designed and whether they have been placed in operation. This understanding is sufficient to plan a primarily substantive approach.

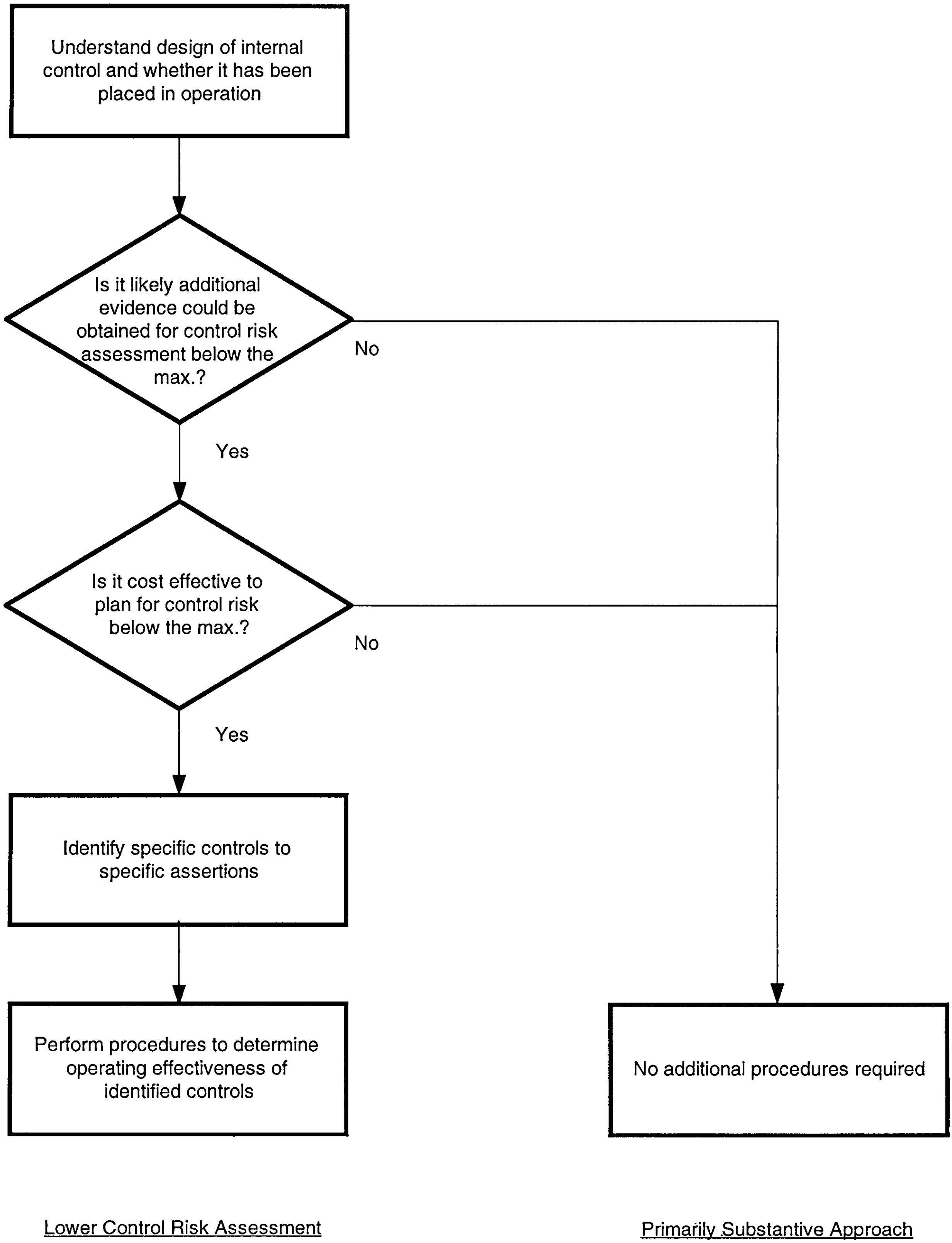
.45 In order to assess control risk below the maximum, the auditor must also:

- Identify specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions, and
- Perform tests of controls to evaluate the effectiveness of such controls.

.46 AAM section 4600 describes in more detail the steps an auditor should take in order to assess control risk below the maximum.

.47 The decision of which audit strategy to pursue is primarily one of audit efficiency. Assessing control risk below the maximum requires the auditor to perform additional procedures to evaluate the effectiveness of controls. However, as a result of assessing control risk below the maximum, the auditor is able to modify his or her substantive tests. In planning the audit, auditors should consider whether the benefits of modifying substantive tests are greater than the costs of performing additional procedures to gauge the effectiveness of controls.

.48 The following diagram illustrates how an auditor chooses an audit approach.



[*The next page is 3221.*]

AAM Section 3130
Preparing an Engagement Letter

.01 Adequate engagement planning includes establishing an understanding with the client regarding the nature of the firm's services, timing of field work, report deadlines, responsibilities of the client, and methods of fee determination and payment. The engagement partner should annually confirm an understanding of the nature of the engagement and the extent of the reporting responsibilities before beginning field work. Such understanding will normally include an appropriate engagement letter and a pre-engagement client conference. If an engagement letter is not used, the understanding should be documented in the working papers.

.02 Currently there are no authoritative pronouncements requiring a written engagement letter for an audit, although most firms regard their completion as good business practice. An engagement letter helps to prevent misunderstandings between the client and the auditor regarding the services to be provided, including the limitations. The engagement letter also sets forth the responsibilities of the client, and in most states it becomes a legally binding contract on both parties. There are other good reasons to obtain an engagement letter, including the following:

- *Reduce the risk of litigation and avoid misunderstandings with the client.* In today's litigious environment an engagement letter is needed for both old and new clients. To avoid misunderstandings, the engagement letter should describe in detail the services to be rendered, the fee, and other terms and conditions of the engagement. Oral agreements may result in differences of recollection or understanding between the accountant and the client.
- *Avoid misunderstandings by the staff.* The members of the staff working on the engagement must have a complete understanding of what is required of them. A copy of the engagement letter in the working papers provides them with an authoritative reference to supplement their oral instructions.

.03 Often, entities that have never been audited resist signing a client representation letter. To avoid client resistance at the end of the audit, many firms notify the client in the engagement letter that they will be asked to sign a client representation letter.

.04 If the auditor has reason to believe the client may publish all or a portion of an audit report, he should advise the client (preferably in the engagement letter) that firm policy is to read printer's proofs of the report and any other accompanying material. This precaution will protect both the client and accountant against condensation of financial statements, omission of footnotes, erroneous layout, and other errors such as misstatement of figures used in a president's letter, other narrative, or statistics.

.05 The letter should be prepared by the in-charge before any significant work takes place on the engagement. The partner should personally present the letter to the client to ensure that a complete understanding has been achieved. The signed copy should be filed with the current engagement's working papers.

Practice Tip

Be careful when using a proposal or preliminary engagement letter for a client. If the letter describes additional services that are not finally agreed upon, it may be used in litigation as an indication of inadequate performance by you on the engagement. You should always make sure that a final engagement letter is issued in such circumstances.

.06 Should the nature of an engagement change during its progress, or should the firm be engaged for additional services during the year, a new engagement letter should be prepared. A step-down to a compilation or review engagement, or a special engagement for preparing a forecast, are examples of changes that would require a new engagement letter. Such changes should be made by the engagement partner after careful consideration of the reasons justifying the change. For example, the reasons justifying a step-down from an audit to a compilation or review may prevent the firm from reporting on the lower level of service.

Special Considerations

.07 The following matters should be considered while preparing an engagement letter:

a. Whether the circumstances preclude an unqualified opinion, as in these examples:

- The auditor is retained after the beginning of the client's fiscal year, did not observe inventories or confirm receivables at the beginning of the year and was unable to gain satisfaction through application of alternative procedures.
- The client imposes restrictions on the scope of the audit. (SAS No. 58, *Reports on Audited Financial Statements*, paragraph 42 [AU section 508.42]).
- Significant litigation or other matters exist which may affect the opinion.

b. Whether fee should be stated as a range, in hourly rates, as standard per diem charges for the engagement, or as a maximum or flat fee

c. The person or persons to whom reports should be addressed

d. The number of copies needed of the report and the people to whom they are to be distributed

e. Deadlines for reports or analyses

f. Out-of-pocket costs

g. Additional work not contemplated in the original engagement

h. The condition of records or circumstances other than those contemplated in the engagement letter (for example, deficient internal controls)

i. A retainer

j. One-time engagements

k. Start-up costs when the client changes accountants

l. Underwriters' requirements in connection with public offerings

m. The part of the work to be done by other accountants

Contents of Engagement Letters

.08 The content of the engagement letter should include the following:

- Addressee

  The letter should be addressed to the board of directors, chief executive, or to whomever retained the firm. The client should be requested to return a copy of the letter indicating approval by the appropriate person.

- Nature of the engagement

  A description of the primary service and illustrative report wording should be included for all standard and modified reports. Circumstances causing modification of the standard report, subsequent to signing the engagement letter, should be discussed with the client by the partner.

- Additional services

  All additional services such as income tax return preparation or consulting services should be described in the letter.

- Unexpected circumstances

  Client notification, in the event of unforeseen circumstances, should be mentioned.

- Client's responsibilities

  Client assistance such as schedules, financial statements and tax return preparation, and other clerical assistance should be included. It often is detailed in a separate attachment to the engagement letter (see AAM section 3130.09 below).

- Fraud, irregularities, and illegal acts

  A statement that although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed and cannot be relied upon to disclose all fraud, defalcations or other irregularities. However, the auditors will inform the client of any material errors, and all irregularities or illegal acts, unless they are clearly inconsequential, that come to their attention.

- Fee determination and billing methods

  The anticipated fee or fee range may be included. Estimates of fees should be based on conservative, carefully prepared estimates. The expected billing methods and payment periods should be described.

- Signatures

  The engagement partner should sign the letter on behalf of the firm. The client representative responsible for the engagement should sign the letter indicating agreement with the contract.

- Regulator's access to working papers

.09 Presented below is a list of analyses, schedules and other items that are often requested from the client prior to the start of an audit engagement. The client assistance schedule should be tailored to each specific engagement.

- The general ledger.
- A reconciliation for each bank account.
- A trade accounts receivable aging.
- Accounts receivable confirmation letters, using drafts to be provided by the accountant.
- A schedule of accounts receivable from officers and employees.
- A schedule of bad debts written off during the year.
- A schedule of notes receivable. The notes should be available for inspection.
- A schedule of transactions with affiliated enterprises.
- An inventory listing.
- An analysis of transactions affecting marketable securities.
- An insurance schedule. The policies should be available for inspection.
- A schedule of property and equipment additions and retirements.

- A depreciation schedule.
- A schedule of life insurance for officers.
- A schedule of accounts payable. The creditor's regular monthly statements for [*date*] should be retained and made available.
- A schedule of notes payable.
- The corporate stock book and minutes should be up to date and available for inspection.
- A schedule of all transactions to partners' capital and drawing accounts.
- A copy of the partnership agreement or corporate charter should be available for inspection.
- Copies of all leases, including equipment rental contracts, should be available for inspection.
- Copies of employment contracts with salesmen or executives should be available for inspection
- Copies of pension, profit-sharing, deferred compensation, and stock option agreements, and letters of acceptance from the Treasury Department, should be available for inspection.
- A schedule of repairs in excess of $ ________ .
- A schedule of each officer's salary and expense account payments.
- A schedule of contributions.
- A schedule of tax expense.
- A schedule of professional fees.

.10 An engagement letter may optionally include—

a. A description of a particular audit procedure, if requested by the client or deemed necessary for the protection of the auditor. (The detailed audit program should not be made available to client personnel, orally or otherwise.)

b. The extent and timing interim auditing.

c. The name of the client's personnel to be contacted during engagement.

d. A study and evaluation of internal control and a report thereon. (This would be a special engagement, not a part of the normal audit routine.)

e. Interim contact and cooperation with the internal auditor.

f. A list of services specifically excluded.

g. Acknowledgment by the client of its responsibility for the financial statements. (Because auditors of smaller, non-public entities often may maintain accounting records, prepare financial statements, and advise management about appropriate accounting principles, such an acknowledgment may be particularly appropriate for such clients.)

h. A statement that the client will be informed of any reportable conditions in internal control that come to the auditor's attention during the audit of financial statements. (Such a communication, either orally or in writing, is required by SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* [AU section 325].)

.11 Following is a list of common engagement letter deficiencies:

a. Reference in the letter to audit of the books and records rather than to audit of financial statements *b.* Adverse comments about other firms

c. Failure to specify *in detail* the services to be rendered when a maximum fee is quoted

d. Inclusion of a review of internal control as one of the services when what is really intended is a consideration of internal control as required by auditing standards

e. Failure to identify accounting or other problems that may have an effect on the opinion

f. Failure to change, in writing, the terms of the engagement when conditions are found to be different (such as the inability to express an opinion without extensive additional auditing because internal control was found deficient)

g. Failure to include fee basis and payment terms

h. Failure to identify subsidiaries

i. Failure to identify specific tax returns to be prepared

Investigatory Procedures for Individuals

.12 When credit information is requested about individuals who are new clients, the investigative procedures are subject to the Fair Credit Reporting Act of 1971.

.13 An individual should be informed in writing that an investigative consumer report, including information about the individual's character, general reputation, personal characteristics, and mode of living is being made. The individual should also be advised, within three days of the time the report is requested, that he may within a reasonable time, by written request, be furnished disclosure of the nature and scope of the investigation.

Filing of Engagement Letters

.14 The signed engagement letter is a contract and should be filed in the client's permanent file. A copy may also be filed with the current working papers, if desired, because of the possible overlapping of billing and collecting as compared to the term of the actual engagement. This also permits easy access when reference to the previous year's letter is needed to prepare the letter for the following year's engagement.

.15 A sample checklist documenting procedures listed in this section is located in AAM section 3165.

.16 See AAM section 3175 for sample engagement letters.

[*The next page is 3271.*]

AAM Section 3140

Assessing Audit Risk and Materiality

.01 In rendering an unqualified opinion that states "In our opinion, the financial statements present fairly in all material respects . . . in conformity with generally accepted accounting principles . . .," the auditor is giving implicit recognition to the concepts of audit risk and materiality. The existence of audit risk is implicit in the phrase "in our opinion." Materiality is explicit in the phrase "presents fairly in all material respects in conformity with generally accepted accounting principles."

Audit Risk

.02 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312), defines audit risk as "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated." In other words, audit risk is the risk that the auditor will give an unqualified opinion on financial statements that are materially incorrect.

.03 In addition to audit risk, the auditor is also exposed to business risk in every audit engagement. Business risk is the risk that the auditor's professional practice will suffer loss or injury from litigation or adverse publicity in connection with an audit of financial statements. Business risk is present even though the auditor conducts the audit in accordance with generally accepted auditing standards. For example, the auditor may conduct a proper audit and yet be sued by a disgruntled party without cause. Even though the auditor may win the lawsuit in such circumstances, the auditor's professional reputation may be damaged. This type of risk differs from audit risk. Business risk cannot be used to reduce audit risk under generally accepted auditing standards.

Risk Components

.04 SAS No. 47, states that audit risk consists of three components:

a. *Inherent risk* is the susceptibility of an assertion to a material misstatement, assuming that there are no related internal control structure policies or procedures. The risk of such misstatement is greater for some assertions and related balances or classes than for others. For example, complex calculations are more likely to be misstated than simple calculations. Cash is more susceptible to theft than is an inventory of coal. Accounts consisting of amounts derived from accounting estimates pose greater risks than do accounts consisting of relatively routine, factual data. External factors also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.

b. *Control risk* is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control structure policies or procedures. That risk is a function of the effectiveness of the design and operation of the internal control structure policies or procedures. Some control risk will always exist because of the inherent limitations of any internal control structure.

c. *Detection risk* is the risk that the auditor will not detect a material misstatement that exists in an assertion. Detection risk is a function of the effectiveness of an auditing procedure and of its application by the auditor. It arises partly from uncertainties that exist when the auditor does not examine 100 percent of an account balance or class of transactions and partly because of other uncertainties that exist even if he were to examine 100 percent of the balance or class. Such other uncertainties arise because an auditor might select an inappropriate auditing procedure, misapply an appropriate procedure, or misinterpret the audit results. These other uncertainties can be reduced to a negligible level through adequate planning and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards.

.05 Inherent risk and control risk differ from detection risk in that they exist independently of the audit of the financial statements. Inherent risk and control risk are functions of the client and its environment, regardless of whether an audit is conducted. Detection risk, on the other hand, relates to the auditor's procedures and can be changed at the auditor's discretion. The assessment of the potential for material misstatements occurs when the auditor considers inherent risk.

.06 The client may establish internal control structure policies and procedures to detect material misstatements and remove them from the accounting system. Ideally, the control structure should detect all material misstatements before they enter the financial statements, but sometimes the control structure may not detect a material misstatement even though it went through the control structure. For example, there may be a weakness or breakdown in the client's structure that allows a misstatement to remain undetected.

.07 Even when a client has effective internal control structure policies and procedures, certain misstatements can bypass the structure because of special circumstances. For example, if a client had an unusual exchange of nonmonetary assets, no internal control structure policies and procedures may have been established to detect a misstatement in this special circumstance.

.08 If the client's internal control structure does not detect and remove misstatements, they will flow through and be included in the financial statements. The auditor's responsibility is to design audit procedures that provide reasonable assurance that material misstatements do not remain in financial statements.

.09 The auditor will never have absolute assurance that no material misstatements exist in the financial statements. From a cost-benefit perspective, an audit providing absolute assurance that no material misstatements exist in the financial statements is impractical. Thus, the auditor designs audit tests to provide *reasonable assurance* that there are no material misstatements in the financial statements. There is always some risk that (*a*) material misstatements will exist; (*b*) they will not be detected by the client's internal control structure; (*c*) they will not be detected by the auditor; or (*d*) they will affect the financial statements. The auditor's responsibility is to reduce audit risk to an acceptably low level. Both the tests of details (tests of balances and tests of transactions) and analytical procedures are means by which the auditor detects material misstatements.

Risk Assessment and Planning

.10 In planning the audit engagement, the auditor should assess inherent risk and control risk to determine how much detection risk can be accepted while still restricting audit risk to an acceptably low level. As the auditor's assessment of inherent risk and control risk decreases, the acceptable level of detection risk increases. The auditor should not rely on the assessments of inherent risk and control risk to the exclusion of performing substantive tests. In fact, for a small business with limited segregation of duties, the auditor often assesses inherent risk and control risk at their maximum and relies completely on substantive tests to reduce audit risk to an acceptably low level.

Quantifying Risk

.11 The auditor's assessments of audit risk and its components of inherent risk, control risk, and detection risk are matters of *professional judgment*. Although the auditor may use quantitative tools such as decision tables and structured aids such as questionnaires to assist in assessing risk components, the ultimate assessment of audit risk is based on professional judgment.

.12 Some auditors confuse audit risk with risk associated with statistical sampling and thus erroneously assume that all audit risk can be quantified. Statistical sampling can be used to quantify the risk of misstatement in determining the extent of audit testing; that is, by using statistical sampling techniques, the auditor can quantify the risk of relying on the results of applying a procedure to a sample, rather than to 100 percent of the items in an account balance or class of transaction. However, quantitative assessment of risk using statistical sampling techniques is only one element of audit risk. As noted previously, audit risk is composed of control risk, detection risk, and inherent risk. Detection risk, which relates to audit procedures, is a function of the nature and timing of audit procedures as well as of the extent of their application.

.13 Generally accepted auditing standards do not require the auditor to quantify risk or to perform any additional analyses of risk. Those standards simply require the auditor to plan the audit so that there is a low level of risk that an unqualified opinion will be expressed when, in fact, the financial statements are materially misstated.

Materiality

.14 SAS No. 47 states that audit risk is "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are *materially* misstated." As SAS No. 47 observes, audit risk and materiality should be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

.15 Materiality is the criterion used by accountants and auditors to distinguish between unimportant and important matters. Obviously, some misstatements could be included in the financial statements without precluding the auditor from expressing an opinion that the financial statements are fairly presented in all material respects in conformity with generally accepted accounting principles. The auditor's consideration of materiality is a matter of professional judgment and is influenced by a perception of the needs of the users of the financial statements. In determining the materiality of an item, the auditor should consider the nature and amount of the item in relation to the financial statements being audited.

In Planning

.16 In planning the audit, materiality should be viewed as an allowance for likely and potential undetected misstatements. Of course, in planning, the auditor cannot anticipate all the factors that will ultimately influence judgment about materiality in the evaluation of audit findings at the completion of the audit. Thus, materiality in planning may differ from materiality used in evaluating results at the conclusion of the audit. If the materiality amount used in evaluating audit findings is reduced significantly from the amount used in planning, the auditor should reevaluate—on the basis of planning materiality—the sufficiency of the auditing procedures that were performed. For example, an auditor may propose audit adjustments that significantly lower revenues. As a result of these adjustments, the auditor's assessment of materiality at the conclusion of the audit may be reduced (for example, from $1,000 to $500). In view of the lower threshold of materiality, the auditor should evaluate whether the audit evidence obtained is sufficient.

Quantifying Materiality

.17 Professional standards require auditors to make a preliminary judgment about materiality in the planning stage of an audit (SAS No. 47, paragraph 3 [AU section 312.03]). Although no authoritative body has established specific guidelines for materiality, some auditors believe that there are certain rules of thumb that can be used in making a preliminary assessment of materiality.

.18 Generally, auditors agree that materiality guidelines should be relative rather than absolute. In other words, materiality is usually set as a percentage rather than as an absolute amount. For example, an absolute amount such as $100,000 may be immaterial to a large, multinational corporation but very material to a small, closely held company. To apply percentage guidelines, auditors must determine what base to use. Generally, auditors select a base that is relatively stable and predictable. Bases commonly used include net income before taxes, revenues, and total assets. Because financial statements are interrelated, and also for reasons of efficiency, auditors normally consider materiality in terms of the smallest amount that would be material to the financial statements. Generally, misstatements become material to income before they become material to the balance sheet. As a consequence, net income before taxes is often selected as the base.

.19 In small business audits, auditors sometimes make a number of significant audit adjustments. Thus, income before taxes may vary too much to be useful as a base. When net income before taxes is not used as a base, auditors sometimes use either total revenue or an average of net income for several prior periods.

Example

.20 A common rule of thumb for materiality is 5 to 10 percent of pretax income. Some auditors apply this rule of thumb so that items less than 5 percent of normal pretax income are considered immaterial, whereas items that are more than 10 percent are material. For items between 5 and 10 percent, judgment is applied. For example, when unusual factors exist (perhaps the company is about to be sold for a multiple of audited earnings) auditors would tend to classify items between 5 and 10 percent as material. Others use 1 or 1.5 percent of the larger of total assets or revenues. (See Exhibit 1 for a sample planning materiality worksheet.)

Exhibit 1

	Initials	Date
Done	______	______
Reviewed	______	______

Client Name
Planning Materiality Worksheet
Balance Sheet Date

1. Unaudited total assets at balance sheet date ______
2. Unaudited total revenues at balance sheet date ______
3. Select the larger of *1* or *2* ______
4. Select a multiplier if audit risk is normal, or, if better than normal, select .01 ______
5. Multiply *3* times *4* ______
6. Unaudited pretax income (or equivalent if not a for-profit entity) ______
7. Select a multiplier if audit risk is normal, or, if better than normal, select .1 ______
8. Multiply *6* times *7* ______
9. Evaluate *5* and *8* along with other relevant factors and determine materiality for audit planning purposes ______

.21 Consideration of which base to use should include such factors as income variability and the nature of the client's business and industry. For a nonprofit organization, for example, the auditor would probably use total assets or revenues as a base, since pretax income is not meaningful.

.22 A sample checklist documenting procedures listed in this section is located in AAM section 3165.

[The next page is 3291.]

AAM Section 3145
Errors and Irregularities

General Comments

.01 The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to financial statements.

.02 The auditor should exercise:

a. Due care in planning, performing, and evaluating the results of audit procedures.

b. The proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected.

Consideration of Audit Risk at the Financial Statement Level

.03 An assessment of the risk of material misstatements should be made during planning. The auditor's understanding of the internal control structure should either heighten or mitigate the auditor's concern about the risk of material misstatements.

.04 Factors such as those listed below may be considered:

a. Management characteristics (e.g., management's attitude toward reporting is unduly aggressive).

b. Operating and industry characteristics (e.g., profitability of an entity relative to its industry is inadequate or inconsistent).

c. Engagement characteristics (e.g., significant and unusual related party transactions not in the ordinary course of business are present).

.05 The size, complexity, and ownership characteristics of the entity have a significant influence on the risk factors considered to be important.

.06 The auditor should assess risk of management misrepresentation by reviewing information obtained about risk factors and the internal control structure. Matters such as the following may be considered:

a. Are there known circumstances that may indicate a management predisposition to distort financial statements, such as frequent disputes about aggressive application of accounting principles that increase earnings?

b. Are there indications that management has failed to establish policies and procedures that provide reasonable assurance of reliable accounting estimates, such as personnel who develop estimates appearing to lack necessary knowledge and experience?

c. Are there conditions that indicate lack of control of activities, such as constant crisis conditions in operating or accounting areas?

d. Are there indications of a lack of control over computer processing, such as a lack of control over access to applications that initiate or control the movement of assets (e.g., a demand-deposit application in a bank)?

e. Are there indications that management has not developed or communicated adequate policies and procedures for security of data or assets, such as not investigating employees in key positions before hiring?

The Auditor's Response to Risk at the Financial Statement Level

.07 The auditor's overall judgment about the level of risk in an engagement may affect engagement staffing, extent of supervision, overall strategy for expected conduct and scope of audit, and degree of professional skepticism applied.

.08 Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and conduct of the engagement.

.09 Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of the balance sheet date, or modify the nature of procedures.

Consideration of Audit Risk at the Balance or Class Level

.10 Examples of factors that may influence the auditor's consideration of risk of material misstatement at balance or class level are:

a. Complexity and contentiousness of accounting issues affecting balance or class.

b. Nature, cause, and amount of known and likely misstatements detected in the balance or class in the prior audit.

c. Susceptibility of related assets to misappropriation.

d. Extent of judgment involved in determining the total balance or class.

Professional Skepticism

.11 An audit should be planned and performed with an attitude of professional skepticism. The auditor neither assumes that management is dishonest nor assumes unquestioned honesty.

.12 When approaching difficult-to-substantiate assertions, the auditor should recognize the increased importance of factors that bear on management integrity. A presumption of management dishonesty, however, would be contrary to the accumulated experience of auditors. Moreover, if dishonesty were presumed the auditor would potentially need to question the genuineness of all records and documents obtained from the client and would require conclusive rather than persuasive evidence to corroborate all management representations. An audit conducted on these terms would be unreasonably costly and impractical.

Professional Skepticism in Audit Planning

.13 Whenever the auditor has reached a conclusion that there is significant risk of material misstatement, the auditor reacts in one or more ways.

.14 The auditor should consider this assessment in determining the nature, timing or extent of procedures, assigning staff, or requiring appropriate levels of supervision.

.15 The auditor may identify specific transactions involving senior management and confirm the details with appropriate external parties and review in detail all material accounting entries prepared or approved by senior management.

.16 The auditor should consider whether accounting policies are acceptable in circumstances. Increased risk of intentional distortion of the financial statements should cause greater concern about whether accounting principles that are otherwise generally accepted are being used in inappropriate circumstances to create a distortion of earnings.

.17 When evaluation at the financial statement level indicates significant risk, the auditor requires more or different evidence to support material transactions than would be the case in the absence of such risk. For example, the auditor may perform additional procedures to determine that sales are properly recorded, giving consideration to the possibility that the buyer has a right to return the product. Transactions that are both large and unusual, particularly at year-end, should be selected for testing.

.18 A sample checklist documenting procedures listed in this section is located in AAM section 3165.

[The next page is 3301.]

AAM Section 3150
Illegal Acts

General Comments

.01 The term "illegal acts" refers to violations of laws or governmental regulations. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.

.02 Whether an act is illegal is a determination that is normally beyond the auditor's professional competence. The auditor's training and experience may provide a basis for recognition that some client acts coming to his attention may be illegal.

Direct and Material Effect Illegal Acts

.03 The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts (except disclosure of contingencies). For example, tax laws affect accruals and the amount recognized as expense in the accounting period; applicable laws and regulations may affect the amount of revenue accrued under government contracts.

.04 The auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality *per se.*

.05 The auditor's responsibility to detect and report misstatement resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for material errors and irregularities as described in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU section 316).

Other Illegal Acts

.06 Entities may be affected by many other laws or regulations, including those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. Generally, these laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects and their financial statement effect is indirect.

.07 An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality.

Engagement Planning Procedures

.08 The auditor should assess the risks that the entity has not complied with laws and regulations which have a direct and material effect on the determination of financial statement amounts (except disclosure of contingencies) in the planning phase of the audit.

.09 Matters that may influence the auditor's assessment include:

a. Management's understanding of the requirements of laws and regulations pertinent to audit objectives.

b. The nature and extent of noncompliance noted in prior audits.

c. Changes in requirements since the last audit.

d. Internal control structure elements designed to give management reasonable assurance that the entity complies with those laws and regulations.

e. The client's policy relative to the prevention of illegal acts.

.10 Normally, there is no need to include audit procedures specifically designed to detect illegal acts.

.11 A sample checklist documenting the procedures listed in this section is located in AAM section 3165.

[The next page is 3331.]

AAM Section 3155
Analytical Procedures

General Comments

.01 Understanding financial relationships is essential in planning and evaluating the results of analytical procedures and generally requires knowledge of the client and the industry or industries in which the client operates. An understanding of the purposes of analytical procedures and the limitations of those procedures is also important. Accordingly, the identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared to expectations, requires judgment by the auditor.

.02 Analytical procedures are used for the following purposes:

a. To assist the auditor in planning the nature, timing, and extent of other auditing procedures.

b. As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.

c. As an overall review of the financial information in the final review stage of the audit.

Analytical procedures should be applied to some extent for the purposes referred to in (*a*) and (*c*) above for all audits of financial statements made in accordance with generally accepted auditing standards. In addition, in some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

.03 Analytical procedures involve comparisons of recorded amounts or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:

a. Financial information for comparable prior period(s) giving consideration to known changes.

b. Anticipated results—for example, budgets or forecasts including extrapolations from interim or annual data.

c. Relationships among elements of financial information within the period.

d. Information regarding the industry in which the client operates—for example, gross margin information.

e. Relationships of financial information with relevant nonfinancial information.

Engagement Planning Procedures

.04 The purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain evidential matter for specific account balances or classes of transactions. To accomplish this, the analytical procedures used in planning the audit should focus on (*a*) enhancing the auditor's understanding of the clients' business and the transactions and events that have occurred since the last audit date, and (*b*) identifying areas that may represent specific risks relevant to the audit. Thus, the objective of the procedures is to identify such things as the existence of unusual transactions and events, and amounts, ratios and trends that might indicate matters that have financial statement and audit planning ramifications.

.05 Analytical procedures used in planning the audit generally use data aggregated at a high level. Furthermore, the sophistication, extent and timing of the procedures, which are based on the auditor's judgment, may vary widely depending on the size and complexity of the client. For some entities, the procedures may consist of reviewing changes in account balances from the prior to the current year using the general ledger or the auditor's preliminary or unadjusted working trial balance. In contrast, for other entities, the procedures might involve an extensive analysis of quarterly financial statements. In both cases, the analytical procedures, combined with the auditor's knowledge of the business, serve as a basis for additional inquiries and effective planning.

.06 Although analytical procedures used in planning the audit often use only financial data, sometimes relevant non-financial information is considered as well. For example, number of employees, square footage of selling space, volume of goods produced, and similar information may contribute to accomplishing the purpose of the procedures.

.07 A sample checklist documenting procedures listed in this section is located in AAM section 3165.

[*The next page is 3361.*]

AAM Section 3165

Illustrative Planning Checklist

	Done by	Date
.01 A. Understanding the Assignment		
1. Have engagement personnel considered the following matters in planning the engagement:		
a. The entity's accounting policies and procedures	______	______
b. Financial statement items likely to require adjustment	______	______
c. The nature of reports expected to be rendered (for example, a report on consolidated or consolidating financial statements, reports on financial statements filed with the SEC, or special reports such as those on compliance with contractual provisions)	______	______
2. In planning the audit, have engagement personnel—		
a. Discussed the type, scope, and timing of the audit with the entity's management, board of directors, or audit committee?	______	______
b. Considered the effects of applicable accounting and auditing pronouncements, particularly new ones?	______	______
c. Coordinated the assistance of entity personnel in data preparation?	______	______
d. Determined the extent of involvement, if any, of consultants, other independent auditors, specialists, and internal auditors?	______	______
.02 B. Assigning Personnel to the Engagement		
1. Has a time budget for the engagement been prepared to determine manpower requirements and to schedule fieldwork?	______	______
2. Has the engagement partner approved the time budget prior to the beginning of fieldwork?	______	______
3. Have the following factors been considered in achieving a balance of engagement manpower requirements, personnel skills, individual development, and utilization:		
a. Engagement size and complexity?	______	______
b. Personnel availability?	______	______
c. Special expertise required?	______	______
d. Timing of the work performed?	______	______
e. Continuity and periodic rotation of personnel?	______	______
f. Opportunities for on-the-job training?	______	______
4. Has the scheduling and staffing of the engagement been approved by the partner with final responsibility for the engagement, so that the partner can consider the qualifications, experience, and training of personnel to be assigned?	______	______
.03 C. Independence		
1. If acting as principal auditor, has written confirmation of the independence of other firms engaged to perform segments of the audit been obtained?	______	______
2. Have annual independence questionnaires been reviewed for all engagement personnel to assure that those individuals assigned to the engagement are independent?	______	______
3. Have accounts receivable from the client been reviewed to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence?	______	______

	Done by	Date
4. In situations in which the firm is not independent, has the issuance of a disclaimer of opinion been discussed in accordance with Statement on Auditing Standards (SAS) No. 26, *Association With Financial Statements,* paragraphs 8—10 (AU section 504.08—.10)?	____	____

.04 D. **Knowledge of the Entity's Business**

	Done by	Date
1. Has an initial, overall understanding of the clients' operations been obtained by—		
a. Reviewing the prior years' working papers, permanent file, auditors' report, and statements?	____	____
b. Reviewing any interim financial statements or reports for the current year, including filings with regulatory agencies; or, if such statements or reports have not been prepared, by scanning the general ledger (or trial balance) to determine whether the amounts and relationships appear reasonable in comparison with the prior years?	____	____
c. Reviewing most recent management letters?	____	____
d. Reviewing the client correspondence file?	____	____
e. Obtaining copies of the minutes of meetings of stockholders and the board of directors?	____	____
f. Considering possible impact of nonaudit services rendered to client on the audit?	____	____
2. Have engagement personnel obtained a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics such as the following:		
a. The type of business?	____	____
b. Types of products and services?	____	____
c. Capital structure?	____	____
d. Related parties?	____	____
e. Locations?	____	____
f. Production?	____	____
g. Distribution methods?	____	____
h. Compensation methods?	____	____
3. Have engagement personnel obtained a knowledge of matters affecting the industry in which the entity operates, such as the following:		
a. Economic conditions?	____	____
b. Government regulations?	____	____
c. Changes in technology?	____	____
d. Accounting practices common to the industry?	____	____
e. Competitive conditions?	____	____
f. Financial trends and ratios?	____	____
4. Have engagement personnel consulted other sources of information that relate to the entity's business, such as the following:		
a. AICPA audit and accounting guides?	____	____
b. Industry publications?	____	____
c. Financial statements of other entities in the industry?	____	____
d. Textbooks, periodicals, and individuals knowledgeable about the industry?	____	____
5. Have methods the entity uses to process accounting information been considered in planning the audit?	____	____
6. Have the following matters been considered in evaluating the effect of the entity's computer processing on the audit of financial statements:		

	Done by	Date
a. The extent to which the computer is used in each significant accounting application?	_____	_____
b. The complexity of the entity's computer operations, including the use of an outside service center?	_____	_____
c. The organizational structure of the computer processing activities?	_____	_____
d. The availability of data?	_____	_____
e. The use of computer-assisted audit techniques to increase the efficiency of performing audit procedures?	_____	_____
7. Have engagement personnel considered whether specialized skills are needed to consider the effect of computer processing on the audit?	_____	_____
.05 E. Assessing Auditability		
1. Has the adequacy of the accounting records been assessed for the following factors:		
a. Are transactions described in sufficient detail to permit appropriate classification in financial statements?	_____	_____
b. Are transactions described in a manner that permits the recording of monetary value in the financial statements?	_____	_____
c. Do accounting records include the period in which the transactions occurred to permit the recording of transactions in the appropriate accounting period?	_____	_____
2. Has an understanding of the design of the relevant policies, procedures, and records, pertaining to the control environment, accounting system, and control procedures of the internal control structure and whether they have been placed in operation been obtained through:		
a. Previous experience with the entity?	_____	_____
b. Inquiries of appropriate management, supervisory, and staff personnel?	_____	_____
c. Inspection of entity documents and records?	_____	_____
d. Observation of entity activities and operations?	_____	_____
3. Has the understanding of the entity's internal control structure elements obtained to plan the audit been documented?	_____	_____
4. Have the following procedures been performed regarding the integrity of management:		
a. Inquiries of local attorneys, bankers, and other business leaders as to the client's standing in the business community?	_____	_____
b. A check of the client's credit rating?	_____	_____
.06 F. Engagement Letter		
1. Have the following items been included in the engagement letter:		
a. Name of entity (and subsidiaries, if any) and its year end?	_____	_____
b. Statement(s) to be audited, compiled, or reviewed?	_____	_____
c. Scope of services, as detailed as necessary—including limitations imposed by the client?	_____	_____
d. Type of report(s) to be rendered?	_____	_____
e. Disclaimer of responsibility for detecting fraud (see AAM section 3175)?	_____	_____
f. Obligations of the client's staff to prepare schedule and statements?	_____	_____
g. Requirement that accountant read all printed material in which his report appears?	_____	_____
h. Responsibility for preparation or review of tax returns and subsequent tax examinations?	_____	_____
i. Fee or method of determining fee?	_____	_____
j. Frequency of billing and client's obligations for payment, including retainer, if applicable?	_____	_____
k. Provision for client's acceptance signature and date?	_____	_____
l. Expression of thanks for being selected as auditors or to perform other services?	_____	_____

	Done by	Date
m. That, in new engagements, the client should take the responsibility for getting the cooperation of the prior auditor and the successor auditor to communicate with the predecessor auditor prior to accepting the engagement?	______	______
2. Have the following optional items been included in the engagement letter:		
a. Description of particular audit procedure, if requested by client or deemed necessary for protection of the auditor (The detailed audit program should not be made available to client personnel, orally or otherwise)?	______	______
b. Extent and timing of interim auditing?	______	______
c. Name of client's personnel to be contacted during engagement?	______	______
d. Study and evaluation of internal control and report thereon (This would be a special engagement, not part of the normal audit routine)?	______	______
e. Interim contact and cooperation with internal auditor?	______	______
f. List of services specifically excluded?	______	______
g. Acknowledgment by the client of its responsibility for the financial statements (Because auditors of smaller, nonpublic entities often may maintain accounting records, prepare financial statements, and advise management about appropriate accounting principles, such an acknowledgment may be particularly appropriate for such clients.)?	______	______
h. A statement that the client will be informed of any reportable conditions in the internal control structure that come to the auditor's attention during his audit of financial statements (Such a communication, either orally or in writing, is required by SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* [AU section 325].)?	______	______
.07 G. **Assessing Audit Risk and Materiality**		
1. Have inherent and control risk been assessed to determine how much detection risk can be accepted while still restricting audit risk to an acceptably low level?	______	______
2. Has a preliminary judgment about the dollar amount of misstatement that would be material to the financial statements been determined?	______	______
3. Has that amount been related to tolerable error for specific account balances in planning audit procedures?	______	______
.08 H. **Assessment of Control Risk**		
1. If control risk is assessed at the maximum level for some or all financial statement assertions, has that conclusion been documented?	______	______
2. Have the following procedures been performed in assessing control risk at below the maximum level for some or all financial statement assertions:		
a. Identifying specific internal control structure policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions?	______	______
b. Performing tests of controls to evaluate the effectiveness of the design and operation of such policies and procedures?	______	______

	Done by	Date
3. If a further reduction in the assessed level of control risk is desired for some financial statement assertions, have additional tests of relevant controls been performed?	____	____
4. Has the basis for the conclusion that control risk is assessed at below maximum level for some or all financial statement assertions been documented?	____	____
.09 I. Errors and Irregularities		
1. Have the following factors been considered in assessing the risk of material misstatement at the financial statement level:		
a. Management characteristics (e.g., management's attitude toward financial reporting is unduly aggressive)?	____	____
b. Operating and industry characteristics (e.g., profitability of entity relative to its industry is inadequate or inconsistent)?	____	____
c. Engagement characteristics (e.g., significant and unusual related party transactions not in the ordinary course of business are present)?	____	____
2. Have the following factors been considered in assessing the risks of management misrepresentation at the financial statement level:		
a. Are there known circumstances that may indicate a management predisposition to distort financial statements, such as frequent disputes about aggressive application of accounting principles that increase earnings?	____	____
b. Are there indications that management has failed to establish policies and procedures that provide reasonable assurance of reliable accounting estimates, such as personnel who develop estimates appearing to lack necessary knowledge and experience?	____	____
c. Are there conditions that indicate a lack of control of activities, such as constant crisis conditions in operating or accounting areas?	____	____
d. Are there indications of a lack of control over computer processing, such as a lack of controls over access to applications that initiate or control the movement of assets (e.g., a demand-deposit application in a bank)?	____	____
e. Are there indications that management has not developed or communicated adequate policies and procedures for security of data or assets, such as not investigating employees in key positions before hiring?	____	____
3. Have the following factors been considered in assessing the risk of material misstatement at the balance or class level:		
a. Complexity and contentiousness of accounting issues affecting balance or class?	____	____
b. Nature, cause, and amount of known and likely misstatements detected in the balance or class in the prior audit?	____	____
c. Susceptibility of related assets to misappropriation?	____	____
d. Extent of judgment involved in determining the total balance or class?	____	____
4. Has the assessment of risk of material misstatement been considered in determining:		
a. The nature, timing or extent of audit procedures?	____	____
b. Assigning staff?	____	____
c. Requiring appropriate levels of supervision?	____	____
5. If it is determined that significant risk of material misstatement exists:		
a. Have the details of specific transactions involving senior management been identified and confirmed with the appropriate external parties?	____	____

	Done by	Date
b. Have the details of all material accounting entries prepared or approved by senior management been reviewed?	____	____
c. Has it been considered whether accounting policies are acceptable in the circumstances?	____	____

.10 J. **Illegal Acts**

	Done by	Date
1. Have the following matters been considered in the assessment of risk that the entity has not complied with laws and regulations that have a direct and material effect on the determination of financial statement amounts:		
a. The client's policy, if any, relative to the prevention of illegal acts?	____	____
b. Management's understanding of the requirements of laws and regulations pertinent to audit objectives?	____	____
c. The nature and extent of noncompliance noted in prior audits?	____	____
d. Internal control structure elements designed to give management reasonable assurance that the entity complies with those laws and regulations?	____	____

.11 K. **Analytical Procedures**

	Done by	Date
1. Have analytical procedures been used which focus on:		
a. Enhancing the auditor's understanding of the client's business and the transactions and events that have accrued since the last audit date?	____	____
b. Identifying areas that may represent specific risks relevant to the audit?	____	____

.12 L. **Audit Strategies and the Audit Program**

	Done by	Date
1. Has the proposed audit program been developed for the engagement?	____	____
2. Has the final audit program been approved by the engagement partner?	____	____

[The next page is 3381.]

AAM Section 3170
Audit Assignment Controls

.01

Audit Time Budget – Sample A

Client ______________________ **Audit date** ______________________

Prepared by ______________________

Approved
Supervisor __________ Date ______ Partner __________ Date ______

Preliminary work
Start __________ End __________

Final work
Start __________ End __________

	Budget (in hours)	
	May to Nov	Dec to April
Cash		
Receivables		
Confirmation of balances		
Review ledgers etc		
Inventories		
Observation of physical counts		
Price tests etc		
Securities and investments		
Property plant, and equipment		
Accumulated depreciation and amortization		
Other assets		
Notes and accounts payable		
Tax accruals		
Other liabilities		
Capital stock		
Retained earnings		
Other equity accounts		
Income accounts		
Costs and expense accounts		
Current provision for taxes		
Other income and expense accounts		
Minutes, agreements, etc		
Conferences with client		
General supervision and planning		
Review computer programs and auditability		
Review of internal control		
Review and update permanent files		
Travel		
Report and statement review		
Other matters		
Total budgeted hours *(Excludes tax and report departments time)*		

.02

Audit Time Budget — Sample B

Date	Total hours (Accountant's initials color coded)				General											Review in-house computer programs	Audit of with computer	General ledger and journal entries	Cash		Notes accts rec and allowance for losses	Inventories				Prepaid expenses	Other current assets	Fixed assets and depreciation	Investments	Other assets	Notes payable and long-term debt	Accounts payable	Other current liabilities	Other long-term liabilities and deferred income	Stockholders' equity	Contingent liabilities	Sales and revenue	Payroll	Other expense and income tests and analyses	Preparation of tax returns	Other (describe)		
	Total	Supervisor or manager	Senior	Assistant	Audit program	Prior period reports working papers etc.	Trial balance and adjusting entries	Permanent file	Financial statement comparison	Transactions since balance sheet date	Preparation of reports	Internal control quest. and mgmt. letter	Tax summary	Supervision	Correspondence and conferences				In banks and on hand	Receipts and disbursements		Observation	Comparison of quantities	Valuation	Clerical accuracy and analytical review																		
Budget																																											
Actual																																											

.03

Audit Time Analysis *(Short Form)*

Client ______ Year ended ______

	Prior years		Budgeted hours											Actual daily hours																					Next year's budget
			Total	Week beginning																														Total	
Administration																																			
Accounting systems review																																			
Confirmations																																			
Permanent file																																			
Client advisory comments																																			
Report preparation																																			
Tax returns																																			
Initial review																																			
Overall review																																			
Detailed review																																			
Tax accrual review																																			
Trial balance																																			
Cash																																			
Receivables																																			
Inventories																																			
Other assets																																			
Liabilities																																			
Equity																																			
Operating accounts																																			
Totals																																			
Accountants In Charge																																			
Totals																																			

.04

Audit Time Analysis (Long Form)

Client ______________ Year ended ______________

	Prior Years		Budgeted Hours Total	Week beginning										Actual Daily Hours																				Total	Next year's budget
Administration																																			
Client conferences																																			
Planning and scheduling																																			
Staff supervision																																			
Accounting systems review																																			
Internal control																																			
EDP installation																																			
General ledger																																			
Cash																																			
Sales																																			
Voucher register																																			
Payroll																																			
Journal entries																																			
Confirmations																																			
Permanent file																																			
Client advisory comments																																			
Report preparation																																			
Financial statements																																			
Footnotes																																			
Tax return preparation																																			
Review																																			
Initial review																																			
Overall review																																			
Detailed review																																			
Tax accrual review																																			
Subtotal to next page																																			

Audit Time Analysis (Long Form) (Continued)

Client ______ Year ended ______

	Prior Years		Budgeted Hours											Actual Daily Hours																				Next year's budget
				Week beginning																														
			Total																														Total	
Year end verification																																		
Trial balance																																		
Cash																																		
Notes receivable																																		
Accounts receivable																																		
Inventories																																		
Prepaid expenses																																		
Intercompany accounts																																		
Securities and investments																																		
Fixed assets																																		
Other assets																																		
Notes payable																																		
Accounts payable																																		
Tax grouping and accrual																																		
Accrued liabilities																																		
Deferred credits																																		
Contingencies and commitments																																		
Equity																																		
Audit of/with computer																																		
Operating accounts																																		
Subtotal from previous page																																		
Totals																																		
Accountants																																		
Manager																																		
In charge																																		
Totals																																		

.05

Weekly Progress Report

Date ____________

Supervisor ____________ In-charge accountant ____________

Client ____________ Case ____________

	Staff days—seven hours				
	Original Estimate	Used to date	Unused	Est to complete	Variance
In-charge accountant					
Assistants *(list)*					
Total assistants					
Grand total					

[The next page is 3401.]

AAM Section 3175
Sample Engagement Letters

.01 Following are illustrative engagement letters (and one engagement memorandum). They may be used as guides in the design of specific letters, tailored to satisfy the terms of a particular engagement.

.02 Audit Engagement Leading to Opinion

LACKO, LYNCH, BROWN & COMPANY Certified Public Accountants

[*Date*]
Mr. Matt Decker, President
Anonymous Company, Inc.
Route 32
Heartland, Kansas 10000

Dear Mr. Decker:

This will confirm our understanding of the arrangements for our audit of the financial statements of Anonymous Company, Inc., for the year ending December 31, 19XX.

We will audit the Company's balance sheet as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and matters related thereto.

Although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed and cannot be relied upon to disclose all fraud, defalcations, or other irregularities. However, we will inform you of any material errors, and all irregularities or illegal acts, unless they are clearly inconsequential, that come to our attention.[1]

---

[1] Some practitioners prefer to include in an engagement letter a clause that would indemnify them against knowing management misrepresentations in jurisdictions where such clauses are permitted. Ruling No. 94 under AICPA Rule of Conduct 101 [ET section 191.188 and .189] states that the following indemnification clause in an engagement letter would not impair a CPA's independence: "The client agrees to release, indemnify, and hold me (us) (and my (our) partners and our heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management." Auditors of publicly held entities also should consider the applicable Securities and Exchange Commission rules on independence before including an indemnification clause in an engagement letter.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

As part of our engagement for the year ending December 31, 19XX, we will review the federal and state income tax returns for Anonymous Company, Inc.

Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, is described in a separate attachment. Timely completion of this work will facilitate the completion of our audit.

Our fees will be billed as work progresses and are based on the amount of time required plus 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, which will range from $XX,XXX to $XX,XXX.

The working papers for this engagement are the property of ______________________ [*name of auditor*] and constitute confidential information. However, we may be requested to make certain working papers available to ____________________ [*name of regulator*] pursuant to authority given to it by law or regulation. If requested, access to such working papers will be provided under the supervision of ____________________ [*name of auditor*] personnel. Furthermore, upon request, we may provide photocopies of selected working papers to ______________________________ [*name of regulator*]. The ____________________ [*name of regulator*] may intend, or decide, to distribute the photocopies or information contained therein to others, including governmental agencies.[2]

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

We appreciate the opportunity to serve you and trust that our association will be a long and pleasant one.

Sincerely,

LACKO, LYNCH, BROWN & COMPANY

____

[Engagement Partner's Signature]

Accepted and agreed to:

____

[Client Representative's Signature]

____

[Title]

____

[Date]

[2] This paragraph is optional depending upon the nature of the engagement.

.03 SEC Engagement: Form 10-K and Annual Report to Shareholders

JOSHUA SNYDER & ASSOCIATES Certified Public Accountants

[Date]
Mr. Ron Tracy, President
Yang Tool Co., Inc.
473 Canyon Road
Turnston, NJ 07000

Dear Mr. Tracy:

This letter confirms our arrangements with Yang Tool Co., Inc. for the year ended December 31, 19XX.

We will audit the Corporation's balance sheet as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards. 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 also will audit the financial information necessary for the schedules required by Regulation S-X of the SEC. We believe that our audit will provide a reasonable basis for our opinion.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and matters related thereto.

Although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed and cannot be relied upon to disclose all fraud, defalcations, or other irregularities. However, we will inform you of any material errors, and all irregularities or illegal acts, unless they are clearly inconsequential, that come to our attention.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

Assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, is described in a separate attachment. Timely completion of this work will facilitate the completion of our audit.

As part of our engagement for the year ending December 31, 19XX, we will review the federal and state income tax returns for Yang Tool Co., Inc.

Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Our fees will be billed as work progresses and are based on the amount of time required plus 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, which will range from $XX,XXX to $XX,XXX.

The working papers for this engagement are the property of ______________________ [*name of auditor*] and constitute confidential information. However, we may be requested to make certain working papers available to ____________________ [*name of regulator*] pursuant to authority given to it by law or regulation. If requested, access to such working papers will be provided under the supervision of ____________________ [*name of auditor*] personnel. Furthermore, upon request, we may provide photocopies of selected working papers to ______________________________ [*name of regulator*]. The ____________________ [*name of regulator*] may intend, or decide, to distribute the photocopies or information contained therein to others, including governmental agencies.[1]

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

We appreciate the opportunity to serve you and trust that our association will be a long and pleasant one.

Sincerely,

JOSHUA SNYDER & ASSOCIATES

____

[Engagement Partner's Signature]

Accepted and agreed to:

____

[Client Representative's Signature]

____

[Title]

____

[Date]

[1] This paragraph is optional depending upon the nature of the engagement.

.04 Change in Circumstances From Those Contemplated in Original Engagement Letter

ROTYINGER & O'CONNOR, CPA'S Certified Public Accountants

[Date]
Mr. James Melakon, Treasurer
Nimbus Country Club
64 Eagle Road
Bethel, Ohio 10000

Dear Mr. Melakon: ,

As we agreed in our original engagement letter dated *[date]* we are notifying you that our audit of your December 31, 19XX financial statements requires additional procedures.

We have found that certain guest checks are held for only three months after they are paid. Thus, a substantial number of guest checks are not available for examination. Fortunately, your internal controls allow us to use alternative procedures to satisfy ourselves on this part of the audit. However, this will require substantially more time than examining guest checks.

The fee for these additional services will be billed at our standard per diem rates and added to the fees quoted in our previous letter.

The situation has been discussed with your controller, who assured us that in the future all guest checks will be kept for two years.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Very truly yours,

ROTYINGER & O'CONNOR, CPA'S

____

[Engagement Partner's Signature]

Accepted and agreed to:

____

[Client Representative's Signature]

____

[Title]

____

[Date]

.05 Conditions Encountered Which Do Not Permit Expression of Opinion as Anticipated in Original Engagement Letter

GEROW, COLLINS & RATCH Certified Public Accountants

[*Date*]
Mrs. Helene Daestrom, President
Cohrane Manufacturing, Inc.
1234 West Street
Cedar Hill, Tennessee 10000

Dear Mrs. Daestrom:

Our March 15, 19XX letter described our present engagement as an audit for the purpose of expressing an opinion on the financial statements based on our audit. This letter is to inform you that because of the circumstances described below, we will be required to qualify our opinion on these statements.

As you know, the Internal Revenue Service has proposed total income tax assessments of approximately $XXX,XXX for the three fiscal years ended December 31, 19XX. Your tax counsel has advised us that although you have a defensible position and will protest the assessments, counsel cannot offer an opinion as to your ultimate liability. No provision for this assessment or any portion of it is included in your December 31, 19XX financial statements, nor do you feel any is necessary.

Due to an inability to obtain sufficient evidential matter to support your assertions regarding the tax assessment situation described above, we will be unable to express an unqualified opinion. Our report will state the reasons for the qualification of our opinion.

You and your tax counsel have advised that you will inform us of any new developments in the proposed assessment before our report is issued so that we may consider their effect on your financial statements and on our report.

Sincerely,

GEROW, COLLINS & RATCH

____

[Engagement Partner's Signature]

____

Note: The client is not asked to sign this letter. Its purpose is to inform the client of the altered circumstances and the effect on the opinion. There is no change in the terms of the engagement. However, it might be desirable to have the client acknowledge receipt of this letter by signing a copy and returning it where—for example—it is a problem, or when there has been a history of misunderstandings.

.06 SEC Engagement: Initial Registration, Form S-1

BELLARMINE, PERRICONE & COMPANY Certified Public Accountants

[*Date*]
Mr. James Flood, President
Special Eyeglasses Company, Inc.
3 Bay Drive
La Mancha, California 99999

Dear Mr. Flood:

This letter confirms the arrangements for our services in connection with the registration statement Special Eyeglasses Company will file with the Securities and Exchange Commission.

We will audit the consolidated balance sheets of Special Eyeglasses Company, Inc., as of December 31, 19X1 and 19X0, and the related statements of income, retained earnings, and cash flows for the three years then ended, which will be included in a Form S-1,* registration statement. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards. 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 also will audit the financial information included in the schedules required by Regulation S-X of the SEC. We believe that our audit will provide a reasonable basis for our opinion.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and matters related thereto.

If during our audit we find that we are unable to express an unqualified opinion on the financial statements or that we are otherwise unable to comply with the requirements of Form S-1, we will notify you of the problems encountered.

We will also fulfill the portion of the underwriter's agreement directed to the independent accountants, provided the requirements are within the purview of Statement on Auditing Standards No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (as amended by Statement on Auditing Standards No. 76), issued by the American Institute of Certified Public Accountants, and provided the material can properly be reported on by accountants pursuant to that Statement. In this regard, we require a copy of the tentative underwriting contract as soon as it is available.

Subsequent to issuance of our auditor's report, we will perform certain procedures required by Statement on Auditing Standards No. 37, *Filings Under Federal Securities Statutes*, issued by the American Institute of Certified Public Accountants, regarding execution of consent letters required for certain SEC filings. In connection therewith, all printer's proofs of reports to be filed with the Securities and Exchange Commission are to be submitted to us for review. This requirement extends to the entire registration statement and all other material that accompanies the financial statements.

Although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed and cannot be relied upon to disclose all fraud, de-

* This should be modified to agree with the particular form to be filed.

falcations, or other irregularities. However, we will inform you of any material errors, and all irregularities or illegal acts, unless they are clearly inconsequential, that come to our attention.

As part of our engagement for the years ending December 31, 19X0 and 19X1, we will review the federal and state income tax returns for Special Eyeglasses Company, Inc.

Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Our fees will be billed as work progresses and are based on the amount of time required plus 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, which will range from $XX,XXX to $XX,XXX.

The working papers for this engagement are the property of ____________________ [*name of auditor*] and constitute confidential information. However, we may be requested to make certain working papers available to __________________ [*name of regulator*] pursuant to authority given to it by law or regulation. If requested, access to such working papers will be provided under the supervision of ________________ [*name of auditor*] personnel. Furthermore, upon request, we may provide photocopies of selected working papers to ___________________________ [*name of regulator*]. The _________________ [*name of regulator*] may intend, or decide, to distribute the photocopies or information contained therein to others, including governmental agencies.[1]

Assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, is described in a separate attachment. Timely completion of this work will facilitate the completion of our audit.

We appreciate the opportunity to serve you and trust that our association will be a long and pleasant one.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Sincerely,

BELLARMINE, PERRICONE & COMPANY

____

[Engagement Partner's Signature]

Accepted and agreed to:

____

[Client Representative's Signature]

____

[Title]

____

[Date]

[1] This paragraph is optional depending upon the nature of the engagement.

.07 Sample Engagement Memorandum (When No Formal Engagement Letter Is Sent)

Engagement Memorandum

[*Date*]

Client	Kramden Bowling, Inc.
Address	213 Oak Street, Creekwood, Florida 20000
Phone	(201) 555-8900
Final arrangements made with	Ralph Marshall, President
Date final arrangements made	February 15, 19XX at a meeting in the ABC offices
Client's personnel responsible for accounting matters	John Sandoval, Treasurer
	Bob Wesley, Controller
Responsibilities of client's personnel in preparation for engagement	Trial balance of G/L and completion of schedules, a list of which we will submit two weeks before beginning of engagement
Reports to be addressed to	Board of Directors (twelve copies)
Financial statements to be audited	Balance sheet at March 31, 19XX and statements of income, retained earnings, shareholders' equity and cash flows for year ended March 31, 19XX
Nature of engagement	Opinion audit and review of federal and state income tax returns for year ended March 31, 19XX
Date audit to commence	Approximately April 24, 19XX (check with controller about April 10)
Estimated time required	About three weeks
Staff requirements	Manager, supervisor, an in-charge senior, and two staff assistants
Billing arrangements	Every two weeks, at standard plus out-of-pocket costs; invoices to attention of Bob Wesley; payable on presentation
Special accounting problems	Client was involved in a substantial sale and lease-back transaction during the year
	Imputed interest may be required on long-term liabilities resulting from purchase of business
Other comments	Client is presently negotiating with machinists union

.08 Audit of Personal Financial Statements

[Firm's Letterhead]

[Date]

____

____

____

This letter will confirm my (our) understanding of the terms and objectives of my (our) engagement and the nature and limitations of the services we will provide.

We will perform the following services:

- I (We) will audit the statement of financial condition of ____________ *[client's name]* as of *[statement of financial condition date]*, (and the related statement of changes in net worth for the ____________ *[period]* then ended) for the purpose of expressing an opinion on them. The financial statements are the responsibility of ____________ *[client's name]*. My (Our) responsibility is to express an opinion on the financial statements based on our audit.
- I (We) will conduct our audit in accordance with generally accepted accounting standards. Those standards require that (I) we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures included in the financial statements. It also includes assessing the accounting principles used and significant estimates made by ____________ *[client's name]*, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion.
- Although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed and cannot be relied upon to disclose all fraud, defalcations, or other irregularities. However, I (we) will inform you of any material errors, and all irregularities or illegal acts, unless they are clearly inconsequential, that come to my (our) attention.[1]
- Our report on the financial statements is presently expected to read as follows:

  [Standard Audit Report]
- As part of my (our) engagement for the year ending ____________ *[statement of financial condition date]*, I (we) also will prepare the federal and state income tax returns for ____________ *[client's name]*.
- If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.
- My (Our) fees will be billed as work progresses and are based on the amount of time required plus out-of-pocket expenses. Invoices are payable upon presentation. I (We) will notify you immediately of any circumstances I (we) encounter that could significantly affect my (our) initial estimate of total fees, which will range from $XX,XXX to $XX,XXX.

---

[1] Some practitioners prefer to include in an engagement letter a clause that would indemnify them against knowing management misrepresentations in jurisdictions where such clauses are permitted. Ruling No. 94 under AICPA Rule of Conduct 101 [ET section 191.188 and .189] states that the following indemnification clause in an engagement letter would not impair a CPA's independence: "The client agrees to release, indemnify, and holds me (us) (and my (our) partners and our heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management." Auditors of publicly held entities also should consider the applicable Securities and Exchange Commission rules on independence before including an indemnification clause in an engagement letter.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

I (We) appreciate the opportunity to serve you and trust that my (our) association will be a long and pleasant one.

Sincerely,

____

[Engagement Partner's Signature]

Accepted and agreed to:

____

[Client Representative's Signature]

____

[Title]

____

[Date]

[*The next page is 4001.*]

AAM Section 4000
Internal Control

The material included in these sections on internal control is presented for illustrative purposes only. The comments and illustrations are neither all inclusive nor are they prescribed minimums. They are intended as conveniences for users of this manual who may want assistance when developing materials to meet their individual needs.

This manual is a nonauthoritative kit of practice aids and, accordingly, these sections on internal control do not include extensive explanation or discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate.

TABLE OF CONTENTS

[The next page is 4101.]

AAM Section 4100
Introduction

Overview

.01 On every audit, the auditor is required to obtain an understanding of internal control sufficient to plan the audit. A "sufficient" understanding means you should determine how internal controls are designed and whether they have been placed in operation.

.02 Statement on Auditing Standards (SAS) No. 55 (AU section 319), as amended, provides a framework to help you obtain your understanding of internal control. This framework breaks internal control into five components as identified in AAM section 4200.03, which in turn are linked to entity objectives. When planning the audit, you should obtain an understanding of each of the five internal control components that relate to objectives relevant to the audit.

.03 Your understanding of internal control is used to—

- Identify types of potential misstatement.
- Consider factors that affect the risk of material misstatement.
- Design substantive tests.

.04 Your understanding of a client's internal control should be based on your previous experience with the client and the following:

- Inquiries of appropriate management, supervisory, and staff personnel
- Inspection of documents and records.
- Observation of the entity's activities and operations.

.05 Once you obtain an understanding of the design of controls and whether it has been placed in operation, you should develop an overall audit strategy at the assertion level that is generally based on one of the following planned control risk assessments:

- *Control risk at or slightly below the maximum.* This will result in a primarily substantive approach to auditing the assertion.
- *Control risk below the maximum.* This will require additional tests to determine the operating effectiveness of specified controls, but in return, you will be able to modify the nature, timing, and extent of substantive audit procedures.

.06 AAM section 3125 provides a more detailed description of how to consider internal control at the planning phase of an audit.

.07 The following sections provide additional guidance on how you should consider internal control.

- *AAM section 4200—Internal Control Framework.* This section provides more detail on the internal control framework described in SAS No. 55 (AU section 319), as amended.
- *AAM section 4300—Illustrative Internal Control Forms—Small Business.* The forms in this section serve two purposes: (1) to help you perform the procedures necessary to understand internal control, and (2) to document that understanding. This section is to be used for small business entities.

- *AAM section 4400—Illustrative Internal Control Forms—Medium to Large Business.* These forms are similar to the ones provided in AAM section 4300, except geared to medium to large businesses.
- *AAM section 4500—Flowcharting.* This section provides examples of how you might document your understanding of internal control using flowcharting techniques.
- *AAM section 4600—Assessing Control Risk Below the Maximum.* This section provides guidance on the procedures to be performed when you plan a control risk assessment below the maximum for a specific assertion.

[*The next page is 4201.*]

AAM Section 4200
Internal Control Framework

Introduction

.01 As described in AAM section 3125, Statement on Auditing Standards (SAS) No. 55 (AU section 319), as amended, provides a framework to help you obtain an understanding of internal control. That framework is built on two concepts: objectives and components.

.02 An *objective* is what the entity is trying to achieve. Generally, an entity tries to achieve objectives in the following three categories:

- Reliability of financial reporting
- Effectiveness and efficiency of operations
- Compliance with applicable laws and regulations

.03 For each of these objectives, internal control consists of the following five interrelated components:

- *Control environment,* which sets the tone of an organization and influences the control consciousness of its people. It is the foundation for all other components of internal control and provides discipline and structure.
- *Risk assessment,* which is the entity's identification and analysis of relevant risks to achievement of its objectives. It forms a basis for determining how the risks should be managed.
- *Control activities,* which are the policies and procedures that help ensure management directives are carried out.
- *Information and communication,* which are the identification, capture, and exchange of information in a form and time frame that enables people to carry out their responsibilities.
- *Monitoring,* which is a process that assesses the quality of internal control performance over time.

.04 Although an entity's internal control addresses objectives referred to in AAM section 4200.02, not all of these objectives and related controls are relevant to the audit of an entity's financial statements. Generally, controls that are relevant to an audit pertain to the entity's objective of preparing reliable financial statements for external purposes. An entity may have controls that relate to operations and compliance with laws and regulations that are not relevant to an audit and therefore need not be considered.

.05 *The Jones family owns and operates several neighborhood grocery stores in Anytown. The bank reconciliation performed by the Jones Grocery controller is an example of a control that relates primarily to the* ***financial reporting*** *objective. Jones also has an inventory tracking and management system that allows each store manager to track inventory levels and order new items before they stock-out. This control activity is part of the* ***operations*** *objective. Each store has a small deli that prepares sandwiches and some hot foods. These food preparation activities must comply with state health laws and regulations, and Jones has policies in place to help ensure that those laws and regulations are met. Those policies are directed at the* ***compliance*** *objective of the entity.*

.06 *The controls having to do with the ordering of inventory or compliance with state health laws and regulations are important to Jones Grocery, but ordinarily will not relate to the audit of the company's financial statement. If you* *were the auditor of Jones Grocery, you may wish to ask about and document these controls for client service or other purposes, but since these controls are not relevant to the audit, you are not required to do so.*

.07 However, if controls relating to operations and compliance objectives pertain to data you evaluate or use in applying auditing procedures, then they may be relevant to the audit.

.08 For example, the financial reporting system may produce a sales report by inventory stock number for each sales region. If the auditor decided to use information from this report when auditing the proper valuation of inventory, he or she should obtain an understanding of the following:

- Which transactions or classes of transactions are included in the report
- How significant accounting data about those transactions are entered into and flow through the financial reporting system
- The files that are processed
- The nature of processing involved in producing the report

.09 Controls pertaining to detecting noncompliance with laws and regulations that may have a direct and material effect on the financial statements, such as controls over compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

.10 Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. For example, use of a lockbox system for collecting cash or passwords for limiting access to accounts receivable data files may be relevant to a financial statement audit. Conversely, controls to prevent the excess use of materials in production generally are not relevant to a financial statement audit. Your responsibility to understand internal control is generally limited to those controls relevant to the reliability of financial reporting.

.11 The internal control framework described in SAS No. 55 (AU section 319), as amended, is only a means to help you consider the impact of an entity's internal control in an audit. Your primary concern is *not* the classification of a specific control into any particular component and related objective. Rather, your primary concern is whether a specific control affects financial statement assertions.

.12 *Suppose you are the auditor of Jones Grocery. As on all audits, you are required to obtain an understanding of internal control sufficient to plan the audit. To achieve this, you organize your inquiries and other procedures to understand each of the five components of internal control that relate to the financial reporting objectives. As a result of performing your procedures, you discover the client's bank reconciliation procedures. Should a bank reconciliation be considered a "control procedure"? What about the fact that someone follows up and investigates old or unusual reconciling items? Is that considered a "monitoring" activity?*

.13 *These questions are rhetorical since the issue of how to classify a particular control is irrelevant for your purposes. As an auditor, your primary consideration is to understand how the bank reconciliations affect financial statement assertions relating to cash.*

.14 The purpose of this section is to provide guidance on each of the five components that comprise the internal control framework. This guidance should help you perform procedures to obtain an understanding of internal control. These procedures generally require the following steps:

- Understand internal control components that have a pervasive effect on the organization.
- Understand how computers are used to process significant accounting information.
- Understand control activities for significant account balances or transaction cycles.
- Assess the risk of management override and lack of segregation of duties.

Focus on the Small Business Entity

.15 This section emphasizes the audit of a small business entity. Small business entities are typically characterized by—

- A single owner or a small group of owners who manage the business on a day-to-day basis.
- A small number of employees involved in the accounting function.
- No outside board of directors or internal audit function.
- The use of off-the-shelf, unmodified computer software or the use of an outside computer service organization to process significant accounting information.

.16 This section provides some guidance for the audits of medium to large businesses. Additional guidance is provided in the Audit Guide *Consideration of Internal Control in a Financial Statement Audit.*

Controls With a Pervasive Effect on the Organization

.17 Your client's control components consist of controls that either have a pervasive effect on the organization or are designed to address specific account balances and classes of transactions or activities. Initially, you should focus on the policies and procedures that have a pervasive effect on the organization.

Understanding the Control Environment

.18 The control environment sets the tone of an organization. It influences the control consciousness of its people and is the foundation for all other components of internal control. In obtaining an understanding of your client's control environment, you should try to understand the owner-manager's attitude, awareness, and actions concerning the control environment. The following paragraphs describe some factors you should consider when evaluating your client's control environment.

.19 ***Integrity and Ethical Values.*** The effectiveness of internal control cannot rise above the integrity and ethical values of the owner-manager. Integrity and ethical values are essential elements of the control environment because they affect the design, administration, and monitoring of other internal control components.

.20 Management may *tell you* a great deal about their integrity and ethical values. They may even commit their *words* to a *written document*. Responses to inquiries and written policies are good, but as an auditor you should focus on management's *actions* and how these actions affect the entity on a day-to-day basis.

.21 In order for management's integrity and ethical values to have a positive impact on the entity, the following must exist.

- The business owner and management must personally have high ethical and behavioral standards.
- These standards must be communicated to company personnel. In a small business, this communication is often informal.
- The standards must be reinforced.

.22 When observing and evaluating management's *actions* be alert for the following:

- *Segregation of personal from business funds and activities.* Many small business owners intermingle their personal and business activities, for example, the company may pay the owner's credit card bills even if they contain non-business expenditures. You should consider the owner's attitude and the care with which he or she separates the personal from the business activities. It's not unusual for a business to pay the owner's credit card bills, but the more important question is "does the owner reimburse the company?" Owners who treat company assets as if they were personal assets set a bad example for employees who may be encouraged to do the same.

- *Dealing with signs of problems.* Consider how management deals with signs that problems exist, particularly when the cost of identifying and solving the problem could be high. For example, suppose your client became aware of a possible environmental contamination on their premises. How would they react? Would they try to hide it, deny its existence, or act evasively if asked about it, or would they actively seek out your advice or the advice of their attorney?

- *Removal or reduction of incentives and temptations.* Individuals may engage in dishonest, illegal or unethical acts simply because the owner-manager gives them strong incentives or temptations to do so. Removing or reducing these incentives and temptations can go a long way toward diminishing undesirable behavior.

  The emphasis on results, particularly in the short term, fosters an environment in which the price of failure becomes very high. *Incentives* for engaging in fraudulent or questionable financial reporting practices include—

  — Pressure to meet unrealistic performance targets, particularly for short-term results.

  — High performance-dependent rewards.

  — Upper and lower cutoffs on bonus plans.

  Temptations for employees to engage in improper practices include—

  — Nonexistent or ineffective controls, such as poor segregation of duties in sensitive areas, that offer temptations to steal or conceal questionable financial reporting practices.

  — Owner-managers who are unaware of actions taken by employees.

  — Penalties for improper behavior that are insignificant or unpublicized and thus lose their value as deterrents.

- *Management intervention.* There are certain situations where it is appropriate for management to intervene and overrule prescribed policies or procedures for legitimate purposes. For example, management intervention is usually necessary to deal with non-recurring and non-standard transactions or events that otherwise might be handled by the financial reporting information system. You should consider whether management has provided guidance on the situations and frequency with which intervention of established controls is appropriate. Management intervention should be documented and explained.

.23 ***Commitment to Competence.*** Competence should reflect the knowledge and skills necessary to accomplish tasks that define an individual's job. Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

.24 *Mrs. Jones has always kept the books for Jones Grocery. She is "self-taught," with no formal training in accounting or bookkeeping. There are no plans to replace Mrs. Jones with someone more "qualified." As the auditor of Jones Grocery you recognized the risk of having an untrained bookkeeper and design your audit approach to address such concerns by—*

- *"Training" Mr. and Mrs. Jones to call you whenever they have a transaction out of the ordinary.*

- *Strongly encouraging Mrs. Jones to take training classes on her accounting software package. (She has.)*

- *Explaining to Mrs. Jones the importance of key accounting records such as the accounts payable subledger and inventory reports.*

- *Teaching Mrs. Jones important basic control functions such as bank reconciliations.*

.25 ***Management's Philosophy and Operating Style.*** Management's philosophy and operating style encompass a broad range of characteristics. Such characteristics may include—

- The owner-manager's approach to taking and monitoring business risks.
- Attitudes and actions toward financial reporting and tax matters.
- Emphasis on meeting budget, profit, and other financial and operating goals.

.26 Management's philosophy and operating style have a significant influence on the control environment, particularly in a small business where the owner-manager dominates the organization, regardless of the consideration given to the other control environment factors. For example, you may be concerned about your client's unduly aggressive attitude toward financial reporting. Not only might this cause you to assess control risk at the maximum for some or all assertions, but it may heighten concerns about irregularities affecting certain assertions.

.27 However, a dominant owner-manager does not necessarily cause you to assess control risk at the maximum.

.28 *Mr. Jones dominates the management of Jones Grocery. He demonstrates a positive attitude toward the control environment and a moderate to conservative attitude toward accepting business risk such as expansion. He is more concerned about taxes than financial reporting. Mr. Jones uses information generated by the financial reporting information system to monitor the financial results of the company and compare it to prior periods. His review of the accounting reports encourages Mrs. Jones and others who help with the accounting to work with greater care. Mr. Jones also performs many control activities himself, such as the review and supervision of the physical inventory counts. Although Mr. Jones is concerned about his income tax liability, you might not view the possible bias to misstate income as a significant risk because of the otherwise positive control environment.*

.29 ***Organizational Structure.*** Your client's organizational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and monitored.

.30 Significant aspects of establishing an organizational structure include considering key areas of authority and responsibility and appropriate lines of reporting. Small business entities usually have fairly simple organizational structures. A highly structured organization with formal reporting lines and responsibilities may be appropriate for large entities, but for a small business, this type of structure may impede the necessary flow of information.

.31 ***Assignment of Authority and Responsibility.*** The assignment of authority and responsibility includes the following:

- The establishment of reporting relationships and authorization procedures
- The degree to which individuals and groups are encouraged to use initiative in addressing issues and solving problems
- The establishment of limits of authority
- Policies describing appropriate business practices
- Resources provided for carrying out duties

.32 Alignment of authority and accountability often is designed to encourage individual initiatives, within limits. Delegation of authority means surrendering central control of certain business decisions to lower echelons, to the people who are closest to everyday business transactions.

.33 A critical challenge is to delegate only to the extent required to achieve objectives. This requires ensuring that risk acceptance is based on sound practices for identifying and minimizing risk, including sizing risks and weighing potential losses versus gains in arriving at good business decisions.

.34 Another challenge is ensuring that all personnel understand the entity's objectives. It is essential that each individual knows how his or her actions interrelate and contribute to achievement of the objectives.

.35 *Mr. Jones had to decide how to delegate authority and responsibility when he expanded Jones Grocery from the one, original store to its present eight-store chain spread out over Greater Anytown and the surrounding suburbs. One area that proved problematic was setting prices. Mr. Jones assumed that he would be able to set the prices at all the stores, just like he did for his original store. He felt this was a good procedure because it allowed him some control over profit margins. Problems arose because the competitive pressures were different in different areas of the city. A competitor in the North Suburb ran specials or lowered prices on certain items, while a competitor in the Western Suburb ran specials on different items. It became too difficult for Mr. Jones to keep up with the constantly changing price battles at eight different stores. He eventually delegated this responsibility to the individual store managers. He set a limit on how much a store manager could discount prices without his prior approval, but other than that, the store managers had the freedom to set prices to respond to the changing competitive environment.*

.36 *The responsibility for accounting information was also affected by Jones Grocery's expansion. Mr. Jones' original thought was that each store would be run as a separate business, with separate financial reporting information systems that would be "consolidated" together at the main store. Problems soon developed in several areas, most notably accounts payable. The store managers were responsible for entering vendor invoices into the computer system. But it seemed that no matter how much Mr. Jones threatened, cajoled, and begged his store managers to enter the invoices on a timely basis, they just couldn't do it consistently. The procedure had to be changed. Now, the store managers only have the responsibility to check incoming goods for quantity and condition. Vendor invoices are sent directly to Mrs. Jones at the main store, and she is responsible for maintaining the accounts payable for all the stores.*

.37 The control environment is greatly influenced by the extent to which individuals recognize that they will be held accountable. This holds true all the way to the owner-manager, who has the ultimate responsibility for all activities within the organization, including internal control.

.38 ***Human Resource Policies and Practices.*** Human resource policies and practices affect an entity's ability to employ sufficient competent personnel to accomplish its goals and objectives. Human resource policies and practices include an entity's policies and procedures for hiring, orienting, training, evaluating, counseling, promoting, compensating, and taking remedial action. In many small businesses, the policies may not be formalized but they should nevertheless exist and be communicated. The owner-manager can orally make explicit his or her expectations about the type of person to be hired to fill a particular job, and may even be active in the hiring process. Formal documentation is not always necessary for a policy to be in place and operating effectively.

.39 *When Mr. and Mrs. Jones added a second store, the hiring of a store manager was easy—they hired their daughter. Adding a third store proved to be more problematic, since the other Jones children had no interest in the family business. Mr. and Mrs. Jones talked at length about the type of person they would hire as a store manager. They finally decided it was more important to hire someone they could trust, someone they felt comfortable with on a personal level rather than someone with an extensive background in the grocery business. They felt they could teach someone the grocery business but not how to be trustworthy. That hiring policy worked, and they've been following it ever since.*

.40 Standards for hiring the most qualified individuals, with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior, demonstrate an entity's commitment to competent and trustworthy people. Hiring practices that include formal, in-depth employment interviews and informative and insightful presentations on the company's history, culture, and operating style send a message that the company is committed to its people.

.41 Personnel policies that communicate prospective roles and responsibilities and that provide training opportunities indicate expected levels of performance and behavior. Rotation of personnel and promotions driven by periodic performance appraisals demonstrate the entity's commitment to advancement of qualified personnel to higher levels of responsibility. Competitive compensation programs that include bonus incentives serve to motivate and reinforce outstanding performance. Disciplinary actions send a message that violations of expected behavior will not be tolerated.

Other Control Components With a Pervasive Effect on the Organization

.42 Elements of other control components may have a pervasive effect on the organization. These are discussed in the following paragraphs.

.43 *Risk Assessment.* An entity should identify, analyze, and manage risks relevant to the preparation of reliable financial statements. For example, risk assessment may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.

.44 Risks relevant to financial reporting include events and circumstances that may adversely affect the company's ability to record, process, summarize, and report financial data. Once risks are identified, management considers their significance, the likelihood of their occurrence, and how they should be managed. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations.

.45 Risks can arise or change due to circumstances such as the following:

- *Changes in the operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- *New personnel.* New personnel may have a different focus on or understanding of internal control. When people change jobs or leave the company, management should consider the control activities they performed and who will perform them going forward. Steps should be taken to ensure new personnel understand their tasks.
- *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control. When these systems are changed, management should assess how the changes will impact control activities. Are the existing activities appropriate or even possible with the new systems? Personnel should be adequately trained when information systems are changed or replaced.
- *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls. Management should consider whether accounting and information systems are adequate to handle increases in volume.
- *New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- *New lines, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- *Accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

.46 Your procedures to assess whether a risk assessment process is placed in operation are generally of an inquiry nature. For example, you may ask accounting personnel what accounts they believe are the most difficult to become satisfied with as they prepare the financial statements. You may also consider asking the same questions of personnel outside the accounting department.

.47 *Control Activities.* Control activities are policies and procedures that help ensure necessary actions are taken to address risks to achieve the entity's objectives. Control activities have various objectives and are applied at various organizational and functional levels.

.48 At the entity-wide level, control activities may be categorized as policies and procedures that pertain to the following.

- *Performance reviews.* These control activities include reviews of actual performance versus budgets, forecasts, and prior-period performance. They may also involve relating different sets of data (for example, operating or financial) to one another, together with analyses of the relationships, investigating unusual relationships and taking corrective action. Performance reviews may also include a review of functional or activity performance.

- *Information processing.* A variety of controls are performed to check accuracy, completeness, and authorization of transactions. The two broad groupings of information systems control activities are general controls and application controls. General controls commonly include controls over data center operations, system software acquisition and maintenance, and access security. Application controls apply to the processing of individual applications and help ensure that transactions are valid, properly authorized, and completely and accurately processed. These controls are discussed in more detail in AAM section 4200.64–.79.

- *Physical controls.* These activities encompass the physical security of assets, including adequate safeguards over access to assets and records such as secured facilities and authorization for access to computer programs and data files and periodic counting and comparison with amounts shown on control records. The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on the circumstances such as when assets are highly susceptible to misappropriation. For example, these controls would ordinarily not be relevant when inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, the physical security controls would be relevant to the audit.

- *Segregation of duties.* Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his or her duties. Segregation of duties is often a problem for small business entities. See AAM section 4200.106–.114 for further discussion and guidance.

.49 Ordinarily, audit planning does not require you to understand the control activities related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to them. Your understanding of control activities is sufficient when you can identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests.

.50 ***Information and Communication.*** The information system relevant to financial reporting objectives—which includes the financial reporting information system—consists of the methods and records established to record, process, summarize, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets and liabilities.

.51 The quality of system-generated information affects management's ability to make appropriate decisions in controlling the entity's activities and to prepare reliable financial statements. Thus, it is important that management receives the information they need to carry out their responsibilities and that the information is provided at the right level of detail.

.52 An information system encompasses methods and records that—

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording of their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

.53 The financial reporting information system is an integral part of an entity's information and communication system. Your consideration of the system should be made at the individual account and classes of transaction level. See AAM section 4200.89–.105 for additional guidance.

.54 *Monitoring.* Monitoring is a process that assesses the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions.

.55 Examples of ongoing monitoring activities include the following:

- Communications from external parties corroborate internally generated information or indicate problems. Customers implicitly corroborate billing data by paying their invoices. Conversely, customer complaints about billings could indicate system deficiencies in the processing of sales transactions. Similarly, bankers, regulators or other outside parties may communicate with the company on matters of accounting significance.
- External auditors regularly provide recommendations on the way internal control can be strengthened. Auditors may identify potential weaknesses and make recommendations to management for corrective action.
- Employees may be required to "sign off" to evidence the performance of critical control functions. The sign-off allows management to monitor the performance of these control functions.

Application to Medium and Large Businesses

.56 The control environments of medium to large businesses may differ from those of small business entities in the following ways:

- The presence of a Board of Directors or audit committee
- The presence of an internal audit function
- More formalized policies and procedures

Board of Directors or Audit Committee

.57 The control consciousness of a medium or large business is influenced significantly by the entity's board of directors and audit committee. In general, the board of directors should have an appropriate degree of management, technical, and other expertise. It should also have the necessary stature and mind-set so that it can adequately perform the necessary governance, guidance, and oversight responsibilities.

.58 Factors that influence the effectiveness of the board or audit committee include—

- Its independence from management.

- The experience and stature of its members.
- The extent of its involvement and scrutiny of activities.
- The appropriateness of its actions.
- The degree to which difficult questions are raised and pursued with management.
- Its interaction with internal and external auditors.

.59 The board of directors must be prepared to question and scrutinize management's activities, present alternative views and have the courage to act in the face of obvious wrongdoing. Because of this it is necessary that the board contain at least a critical mass of outside directors. The number should suit the entity's circumstances, but more than one outside director normally would be needed for a board to have the requisite balance.

Internal Audit Function

.60 The internal audit function is established within an entity to monitor and evaluate the adequacy and effectiveness of internal control. For entities with an internal audit function, you ordinarily should make inquiries of appropriate management and internal audit personnel about the internal auditors'—

- Organizational status within the entity.
- Application of professional standards.
- Audit plan, including the nature, timing, and extent of audit work.
- Access to records and any limitations on the scope of their activities.

.61 After obtaining an understanding of the internal audit function you may either—

- Conclude that the internal auditors' activities are not relevant to the financial statement audit and give no further consideration to the internal audit function,.
- Identify relevant internal auditor activities, but conclude that it would not be efficient to consider further the work of the internal auditors, or
- Decide that it would be efficient to consider how the internal auditors' work might affect the nature, timing, and extent of the audit. In this case, you should assess the competence and objectivity of the internal audit function as outlined in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AU section 322).

.62 You may also request direct assistance from the internal auditors. If so, you should follow the guidance in paragraph 27 of SAS No. 65 (AU section 322.27).

Formal Policies

.63 Medium and large businesses may communicate their policies in formal, written documents. For example, they may have a written code of conduct or human resource policies. The existence of formal policy documents is good, but as an auditor, your primary consideration is how the policies are implemented.

Computer Applications

.64 Small business entities are typically characterized by the use of off-the-shelf, unmodified computer software or the use of an outside computer service organization to process significant accounting information.

.65 *Jones Grocery has a stand-alone, state-of-the-art PC at its main store. One other store has a computer—an Apple Macintosh Mr. and Mrs. Jones' daughter used at college. The PC at the main store is used to run the accounting software, which is an off-the-shelf product developed specifically for independent grocers. The payroll is processed by an outside payroll service.*

.66 In gaining an understanding of how computers are used in the business, you should consider the following:

- The acquisition of hardware and software
- Physical access
- Logical access
- User controls over outsider service bureau applications

Acquisition of Hardware and Software

.67 Companies should take steps to ensure they have compatible hardware and software. The use of compatible software reduces the risk of error, since there will be no need to transfer data from one format into another. Even small businesses should have a coherent plan for the purchase of computer hardware and software. If the business is growing, management should plan for the upgrade of the processor, RAM, or hard-disk storage.

.68 *Mr. and Mrs. Jones did not plan for the purchase of their computers. For several years, Mrs. Jones processed the accounting applications on an old 286 PC with limited RAM and hard-disk storage. When the Jones' daughter opened the second store, she brought with her the Apple Macintosh she had in college. At first, she tried to transfer data from her store to the main store, but the software had problems converting from the Apple format, so the procedure was abandoned. At a trade show, Mr. Jones discovered a computer software program specifically designed for independent grocers. He was impressed with the program and decided that it fit his needs perfectly. However, his hardware was out of date, and so in order to run the software, he upgraded his hardware. The new software supposedly is able to handle Apple-formatted data, and the company has plans to transfer data from the second store electronically. There are no plans to install computers at the other stores.*

.69 *As the auditor of Jones Grocery, you should use this understanding of the company computer system to help plan the audit. For example, they plan to transfer data from the Apple to the PC. What sort of errors might occur in the transfer? What steps has the client taken to prevent or detect those errors? You also know that stores three through eight are on a manual system. What types of errors might occur in a manual system? What is the risk that those errors will occur?*

.70 Entities should also establish policies and procedures to mitigate the risk of computer viruses being introduced into their systems. Viruses can cause the loss of data and programs. A virus has the ability to attach itself to a program and infect other programs and systems. Although some viruses merely write messages across the screen, others can cause serious damage to disk files or shut down a network by replicating millions of times and filling all available memory or disk storage.

.71 Methods to prevent the introduction of viruses and to recover from a virus attack include the following:

- Obtain recognized software from reputable sources and only accept delivery of the software in the manufacturer's sealed package.
- Make multiple generations of backups. A virus that is not detected initially may be copied onto more recent backup copies, while the older versions may not be infected.
- Prohibit the use of unauthorized programs introduced by employees.

- Prohibit downloading of untested software from sources such as dial-up bulletin boards.
- Use virus protection software to screen for virus infections.

Physical Security

.72 Physical security—primarily backup and contingency planning—often is ignored by small businesses in a microcomputer environment. Poor backup procedures can result in the loss of important data that are very difficult, time-consuming and costly to recreate, if they can be recreated at all.

.73 Your clients should have established procedures for the periodic backup of data files and applications. Critical applications and files should be stored off-site with corresponding documentation in the event that on-site files become unavailable.

Logical Access

.74 Logical access to computer applications and data files may not be formally or rigorously controlled in a small business. This leaves the company exposed to the risk that files could be inappropriately manipulated or unauthorized transactions entered into the system. For example, without logical access controls a user may be able to enter any or all sections of a general ledger or other financial module and perform file maintenance such as changing the address of an accounts receivable customer or data used to calculate payroll.

.75 Management should identify confidential and sensitive data for which access should be restricted. Mechanisms such as password control or the use of menus should be used to limit the access to that data.

.76 In a microcomputer environment, password control may be installed over the operating system using a shell program to prevent the user from accessing menu options of a program. Even if such a restriction exists, a sophisticated user can often bypass the shell by using a utility. Therefore, the use of utility programs should be controlled or monitored carefully.

User Controls Over Computer Service Organization Applications

.77 Entities may use an outside computer service organization to process significant accounting information. Guidance on auditing entities that use computer service organizations is contained in SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324).

.78 When using an outside computer service organization, most small businesses typically retain the responsibility for authorizing transactions and maintaining the related accountability. The computer service organization merely records user transactions and processes the related data. In these circumstances, the user (the small business) should maintain controls over the input and output to prevent or detect material misstatement.

.79 *Jones Grocery uses an outside computer service to process payroll. Time cards are gathered for each store and reviewed by the store manager before being sent to the main store. Mrs. Jones reviews the time cards for the store managers and checks to make sure all personnel have submitted time cards for the pay period. All other payroll transactions such as pay rates, withholdings, etc. are sent directly to Mrs. Jones. She forwards all information to the payroll service, which prepares the checks and produces a payroll register. Mrs. Jones reviews the register and checks for any obvious misstatements, before she distributes the checks.*

Application to Medium or Large Businesses

.80 Medium and large businesses typically have more complicated computer processing systems than small businesses. They also tend to use the computer for a greater amount of processing. For example, a small business may prepare customer invoices manually by looking up prices on a master price list. A medium size business may maintain master price information on a computer file and use the computer to generate packing slips, sales invoices, and reports of unmatched documents.

.81 Medium and large businesses are also typically characterized by a separate management information services (MIS) department with formally defined job descriptions and responsibilities.

.82 Instead of using off-the-shelf, unmodified software, the medium or large business will modify standard software or develop their own applications. Their software may be more complicated than that used by the small business; for example, they may use a database management system or telecommunications software.

.83 Medium and large businesses often use a mainframe computer in conjunction with microcomputers or a local area microcomputer network. Information is frequently transferred between the mainframe and microcomputers that may be located on-site or at a remote location.

.84 Control activities in a computerized environment generally comprise a combination of the following:

- User control activities
- Programmed control activities and manual follow-up
- Computer general control activities

.85 *User Controls.* User control activities are manual checks of the completeness and accuracy of computer output against source documents or other input. For example, an entity may have programmed procedures in a billing system that calculate sales invoice amounts from shipping data and master-price files. The entity may also have a procedure to manually check the completeness and accuracy of the invoices. In many systems, user controls relate only to the completeness of records and not to the accuracy of processing.

.86 *Programmed Control Activities and Manual Follow-up Activities.* Programmed control activities are those that are built into the computer processing program; for example, the generation of an exception report. However, an exception report is useless unless the client follows up on the items listed. Thus, in addition to understanding the nature of the programmed control activities, you also need to understand the related manual follow-up procedures.

.87 *Computer General Control Activities.* If computer general control activities operate effectively, there is greater assurance that programmed control activities are properly designed and function consistently throughout the period. You may plan to understand computer general control activities to provide evidence that—

- Programs are properly designed and tested in development.
- Changes to programs are properly made.
- Computer operations ensure the proper use of application programs and data files.
- Adequate access controls reduce the risk of unauthorized changes to the program and data files.

.88 The following table summarizes computer general control activities.

Area	*Control Objectives*	*Example Controls*
Program Development	• Controls ensure that new applications systems are suitably authorized, designed, and tested	• Users are involved in the design and approval of systems • Checkpoints where users review the completion of various phases of the application • Development of test data and testing of the program • User involvement in the review of tests of the program • Adequate procedures to transfer programs from development to production libraries
Program Changes	• Controls over changes to existing programs and systems ensure that modifications to application programs are suitably approved, designed, tested, and implemented	• Same as systems development • User involvement • Adequate testing • Adequate transfer activities • Segregation of duties between programmers and production libraries
Computer Operations	• Controls ensure that application programs are used properly and that proper data files are used during processing	• Review of lists of regular and unscheduled batch jobs by operations management • Use of menu-driven job control instruction sets • Jobs executed only from the operator's terminal • Adequate procedures for managing and backing up data and program files
Access	• Controls should prevent or detect unauthorized changes to programs and to data files supporting the financial statements	• Programmers have limited access to production programs, live data files, and job control language • Operators have limited access to source code and individual elements of data files • Users have access only to defined programs and data files

Obtaining an Understanding of Significant Account Balances and Transaction Cycles

.89 You should obtain an understanding of the classes of transactions in your client's operations that are significant to the financial statements. For less significant classes of transactions or account balances, an understanding of controls that have a pervasive effect on the organization is usually sufficient.

.90 For significant transactions and account balances you should obtain an understanding of—

- How those transactions are initiated.
- The records, supporting documents, computer media, and specific accounts in the financial statements involved in the processing and reporting of transactions.
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.

- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

.91 ***Initiating Transactions.*** You should understand how transactions are initiated. Some transactions may be initiated by customers or others outside the entity. Other transactions may be initiated from inside the organization by the use of a computer program; for example, calculating depreciation expense.

.92 *At Jones Grocery, sales are initiated by customers and recorded in the cash register. At the end of the day the cash register totals are reconciled to the cash on hand, and a deposit is prepared for the day's receipts. On a weekly basis, the daily cash register tapes are batched for each store, forwarded to Mrs. Jones, and entered into the computer. The computer generates a sales register, a sales analysis report, and posts the sales totals to the general ledger.*

.93 ***Accounting Records, Supporting Documents, Computer Media, and Specific Accounts.*** In general you will want to identify the following for your client's significant accounts and transactions:

- Source documents
- The conversion of documents to computer media
- The nature of computer files that are further processed in the flow of information to the general ledger and the financial statements
- Accounts (subsidiary or general ledger master files) affected by the transaction
- Relevant accounting reports, journals, and ledgers produced in the flow of information to the general ledger and the financial statements

.94 Your client's accounting systems may create many documents, files, and reports that are useful for managing the organization, but you need to understand only those aspects that are relevant to the financial statements.

.95 *At Jones Grocery, the sales analysis report described in AAM section 4200.92 is used for management information and analysis. The documents and reports relevant to the financial statements are the daily cash register tapes and the computer-generated sales register.*

.96 ***Accounting Processing.*** You should obtain an understanding of how your client processes accounting information—from the initiation of the transaction to its inclusion in the financial statements. This understanding should include how the computer is used to process data. Your understanding involves knowledge of the ways in which transactions are valued, classified, and summarized in data files, journals, or ledgers. For some transactions, there may be several significant processing activities and accounting records, including the use of computer programs. Other transactions may involve only limited processing activities performed manually.

.97 *At Jones Grocery, the processing of inventory transactions (receipt of goods, sales, spoilage, etc.) involves several processing activities that are linked in the inventory module of the software package. On the other hand, recording depreciation expense is fairly simple. Fixed assets and the related depreciation are maintained on a computer spreadsheet, and each month, Mrs. Jones prepares a journal entry to record depreciation.*

.98 Understanding the accounting processing also involves understanding the information used for processing and when processing occurs. For example, when considering the completeness assertion, you normally should understand whether transactions entered into the computer system are processed immediately or in batches and how frequently batches are processed.

.99 The processing of accounting information may involve "end user computing." End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person.

.100 *Mrs. Jones developed and maintains the fixed asset spreadsheet that serves as the source document for her monthly depreciation expense journal entry.*

.101 In general, the product of end user computing may be used to—

- Process significant accounting information outside of the off-the-shelf accounting software package. For example, the fixed-asset spreadsheet is separate from the Jones Grocery general ledger software package.
- Make significant accounting decisions. For example, a spreadsheet application may be used to generate information used to write down inventory.
- Accumulate footnote information. For example, a spreadsheet may be used to calculate the five-year debt maturity disclosure.

.102 Generally, end users have no training in the formal computer application development process. Accordingly, applications developed by end users are often inadequately tested, and the development process is often not documented. This situation can cause significant difficulties for an organization if the end user computing application is critical to making business or financial decisions.

.103 The access to end user computing applications may also be an audit concern. Many computer applications used in end user computing come with on-line systems that are capable of restricting users to specific applications, specific departments, or even specific fields. Often, however, these access restrictions facilities are not implemented.

.104 To address these concerns and to ensure the end user applications process data completely and accurately, you should generally look for control policies and procedures that—

- Require all significant end user applications to be adequately tested before use.
- Prescribe documentation standards for significant end user applications.
- Provide for adequate access controls to data.
- Provide a mechanism to prevent or detect the use of incorrect versions of data files.
- Provide for appropriate applications controls, for example, edit checks, range tests, or reasonableness checks.
- Support meaningful user reconciliations.

.105 *Financial Reporting Process.* When gaining an understanding of the financial reporting process, you may determine the extent of client procedures to prepare accounting estimates (when significant accounting estimates are called for) and information for significant disclosures. You also should understand the way in which general ledger information is summarized to determine how the amounts and disclosures are reported in the financial statements.

Segregation of Duties and Management Override

.106 Small businesses are typically characterized by—

- A dominant owner-manager.
- A lack of segregation of duties.

.107 If your client has these characteristics, you should be sure to address the risks they pose to the entity.

.108 In general, duties should be divided, or segregated, among different people to reduce the risk of error or inappropriate actions. For instance, responsibilities for authorizing transactions, recording them, and handling the related assets should be divided.

.109 Even small businesses with only a few employees can usually parcel out responsibilities to achieve the necessary checks and balances. If that is not possible—as may occasionally be the case—direct oversight of the incompatible activities by the owner-manager can provide the necessary control. Thus, a dominant owner-manager may be a positive element in the design of internal controls.

.110 A dominant owner-manager may be a negative element in the design of internal control when he or she is able to override established policies and procedures.

.111 Management *override* should be distinguished from management *intervention*. Management *intervention* is discussed in AAM section 4200.22 and is described as the overrule of internal control for legitimate purposes. For example, management intervention is usually necessary to deal with non-recurring and non-standard transactions or events that otherwise might be handled by the system.

.112 In contrast, management *override* is the overrule of internal control for *illegitimate* purposes with the intent of personal gain or enhanced presentation of an entity's financial condition or compliance status.

.113 An owner-manager might override the control system for many reasons: to increase reported revenue, to boost market value of the entity prior to sale, to meet sales or earnings projections, to bolster bonus pay-outs tied to performance, to appear to cover violations of debt covenant agreements, or to hide lack of compliance with legal requirements. Override practices include deliberate misrepresentations to bankers, lawyers, accountants, and vendors, and intentionally issuing false documents such as sales invoices.

.114 When gaining an understanding of internal control, you should assess the risk of management override.

Assessing Internal Control Strengths and Weaknesses

.115 When obtaining your understanding of internal control, you should consider the *collective* effect of strengths and weaknesses in various control environment factors. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, owner-manager controls may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by top management to overstate earnings.

.116 Internal control strengths may indicate account balances, transaction classes or assertions where you can assess control risk below the maximum. See additional guidance in AAM section 4600. Internal control weaknesses usually indicate areas where a primarily substantive audit approach is required.

.117 In rare circumstances, your understanding of internal control may raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause you to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity's records may cause you to conclude it is unlikely that sufficient competent evidential matter will be available to support an opinion on the financial statements.

.118 If you determine the entity is unauditable, you should consider withdrawing from the engagement.

[*The next page is 4301.*]

AAM Section 4300

Illustrative Internal Control Forms—Small Business

.01 The following are illustrative internal control forms you might use to document your understanding of internal control sufficient to plan an audit. The illustrative questions are numbered merely for organizational purposes. The numbers are in no way intended to infer completeness or a preferred sequence. These forms may require modifications to meet the needs, preferences and circumstances of individual firms and their clients. Whenever you use standardized forms, checklists, or questionnaires, you should recognize that important matters in a particular set of circumstances may not be covered.

Instructions

.02 The forms in AAM sections 4310 and 4320 may be used on all small business audit engagements. Small businesses are typically characterized by—

- A single owner or a small group of owners who manage the business on a day-to-day basis.
- A small number of employees involved in the accounting function.
- No outside board of directors or internal audit function.
- The use of off-the-shelf, unmodified computer software or the use of an outside computer service organization to process significant accounting information.

.03 If your client does not have the characteristics of a small business, you should consider completing the internal control forms for medium to large businesses located in AAM section 4400.

.04 In every audit, you should obtain an understanding of each of the components of internal control sufficient to plan the audit. These forms should be used as a tool in documenting your understanding of internal control, how internal controls for your client are designed, and whether they have been placed in operation.

.05 These forms should be used in conjunction with other forms in certain circumstances:

- *Control Environment Checklist—Small Business Computer Applications* [AAM section 4310]. To be used whenever the client uses microcomputers or outside service organizations to process significant accounting information.
- *Financial Reporting Information Systems and Controls Checklist* [AAM section 4320]. To be used for each significant account and transactions cycle.

.06 These forms are appropriate whenever you plan a primarily substantive audit approach. That is, their completion generally results in control risk being assessed at or slightly below the maximum for all assertions related to account balances and transactions.

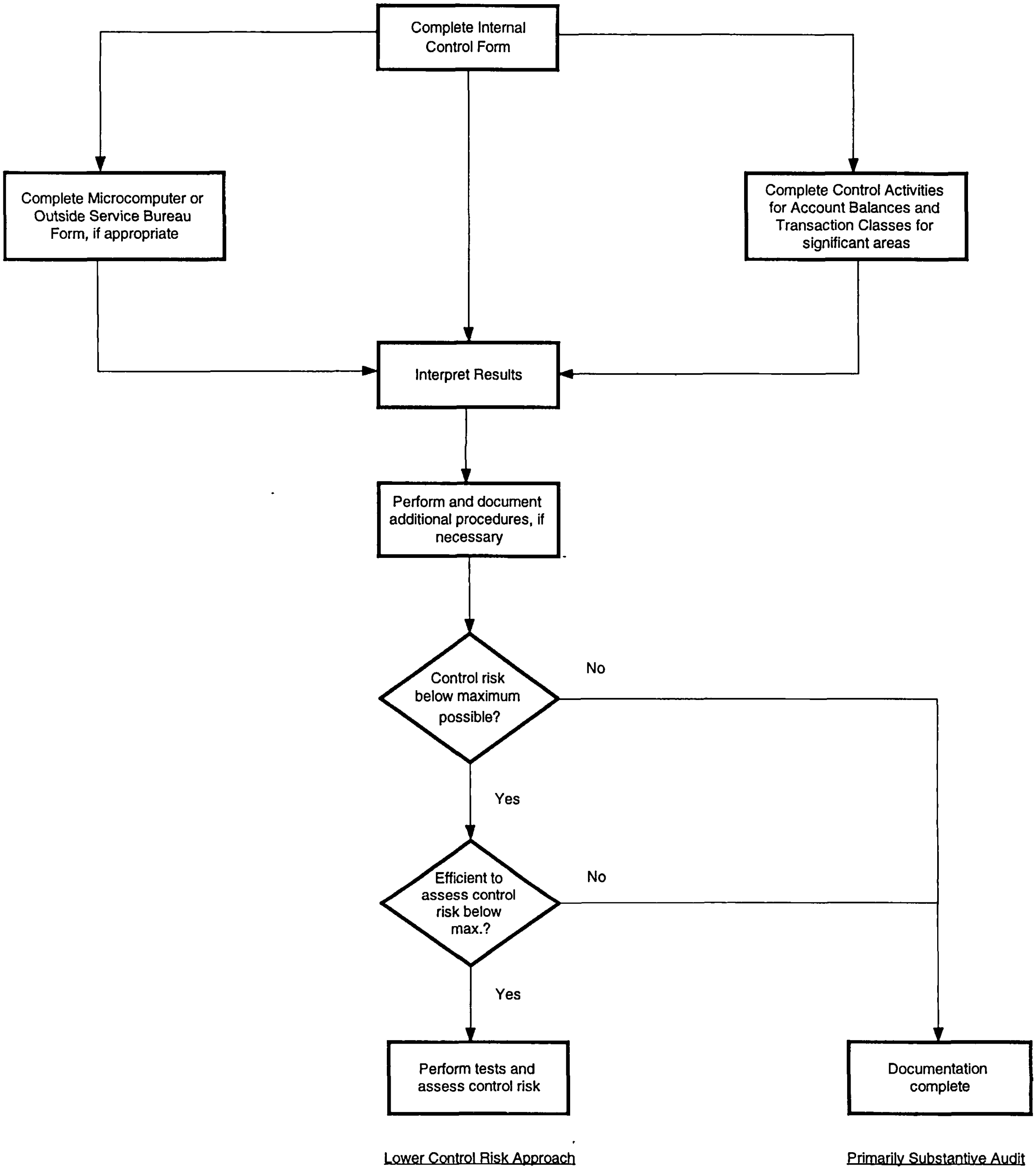
.07 If you plan a lower control risk assessment for certain assertions you are required to—

- Identify specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions, and

- Perform tests of controls to evaluate their effectiveness.

.08 These forms are organized to conform to the control components and overall internal control framework described in the Audit Guide *Consideration of Internal Control in a Financial Statement Audit*. This framework is only a way for you to consider the impact of internal control on an audit. The classification of any specific control into a particular component should not be your primary concern. Rather, your primary consideration is whether a specific control affects financial statement assertions.

.09 The following flowchart describes how this form can be used in conjunction with the other forms included in this section to document your understanding of internal controls.



Interpreting the Results

.10 When obtaining an understanding of internal control, you should consider the *collective* effect of the strengths and weaknesses in various control components. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, owner-manager controls may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by the owner-manager to overstate earnings.

.11 Answers that fall toward the right side of the form ("Strongly Agree" or "Somewhat Agree") indicate areas of strength in the control environment. You should consider whether these areas of strength indicate that a control risk assessment below the maximum may be possible for some assertions.

.12 Answers that fall toward the left side of the form ("Strongly Disagree" or "Somewhat Disagree") indicate areas of weakness in the entity's internal controls. You should assess how these areas of weakness affect the planning of the audit. This assessment should be documented in section V of the form. In making this assessment, you normally focus on—

- The types of material misstatements that could occur as a result of the identified weakness, and
- The risk that those misstatements will occur.

Documenting a Conclusion

.13 After completing this form, the Financial Reporting Information Systems and Controls Checklist for significant areas, and the Control Environment Checklist—Microcomputers and Outside Service Bureaus, you should document your conclusion regarding internal control. In order to perform a primarily substantive audit, you must understand the entity's internal control sufficiently—

- To assess the risk of material misstatement in assertions related to material financial statement components, and
- To design effective substantive procedures.

.14 If the completion of this form is not sufficient for you to obtain the necessary level of understanding listed in AAM section 4300.13, you should perform and document the results of additional tests to gain that level of understanding.

.15

I. Document Your Understanding of the Control Environment

In the space provided below, indicate whether you strongly agree, somewhat agree, somewhat disagree, or strongly disagree with the following statements. Your answers should be based on—

- Your previous experience with the entity.
- Inquiries of appropriate management, supervisory, and staff personnel.
- Inspection of documents and records.
- Observation of the entity's activities and operations.

	No Opinion	Strongly Disagree	Somewhat Disagree	Somewhat Agree	Strongly Agree
A. Control Environment Factors					
Integrity and Ethical Values					
1. The business owners and management have high ethical and behavioral standards.					
2. Management has communicated (either formally through written policies or informally by its own behavior) the ethical and behavioral standards for the entity.					
3. The owner effectively segregates personal funds, income, and expenses from those of the business.					
4. Management reinforces its ethical and behavioral standards.					
5. Management appropriately deals with signs that problems exist (e.g., defective products or hazardous waste) even when the cost of identifying and solving the problem could be high.					
6. Management has removed or reduced incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts.					
For example, there is generally *no*—					
• Pressure to meet unrealistic performance targets.					
• High performance-dependent rewards.					
• Upper and lower cutoffs on bonus plans.					
7. Management has provided guidance on the situations and frequency with which intervention of established controls is appropriate.					
8. Management intervention is documented and explained appropriately.					
Commitment to Competence					
9. Management has appropriately considered the knowledge and skill levels necessary to accomplish financial reporting tasks.					

	No Opinion	*Strongly Disagree*	*Somewhat Disagree*	*Somewhat Agree*	*Strongly Agree*
10. Employees with financial reporting tasks generally have the knowledge and skills necessary to accomplish those tasks.					
Management's Philosophy and Operating Style					
11. Management moves carefully, proceeding only after carefully analyzing the risks and potential benefits of accepting business risks.					
12. Management is generally cautious or conservative in financial reporting and tax matters.					
13. There is relatively low turnover of key personnel.					
14. There is *no* undue pressure to meet budget, profit, or other financial and operating goals.					
Organizational Structure					
15. The entity has defined, either formally or informally, key areas of authority and responsibility.					
16. The entity has defined, either formally or informally, appropriate lines of reporting.					
Assignment of Authority and Responsibility					
17. Authority and responsibility are delegated only to the degree necessary to achieve the company's objectives.					
18. Proper resources are provided for personnel to carry out their duties.					
19. Personnel understand the entity's objectives and know how their individual actions interrelate and contribute to those objectives.					
20. Personnel recognize how and for what they will be held accountable.					
Human Resource Policies and Practices					
21. The entity generally hires the most qualified people for the job.					

	No Opinion	Strongly Disagree	Somewhat Disagree	Somewhat Agree	Strongly Agree
22. Hiring practices emphasize educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior.	______	______	______	______	______
23. Hiring practices include formal, indepth employment interviews.	______	______	______	______	______
24. Prospective employees are told of the entity's history, culture and operating style.	______	______	______	______	______
25. The entity provides training opportunities, and employees are well-trained.	______	______	______	______	______
26. Promotions and rotation of personnel are based on periodic performance appraisals.	______	______	______	______	______
27. Methods of compensation, including bonuses, are designed to motivate personnel and reinforce outstanding performance.	______	______	______	______	______
28. Management does not hesitate to take disciplinary action when violations of expected behavior occur.	______	______	______	______	______

B. Other Internal Control Components With a Pervasive Effect on the Organization

Risk Assessment

	No Opinion	Strongly Disagree	Somewhat Disagree	Somewhat Agree	Strongly Agree
1. Special action is taken to ensure new personnel understand their tasks.	______	______	______	______	______
2. Management appropriately considers the control activities performed by personnel who change jobs or leave the company.	______	______	______	______	______
3. Management assesses how new accounting and information systems will impact internal control.	______	______	______	______	______
4. Management reconsiders the appropriateness of existing control activities when new accounting and information systems are developed and implemented.	______	______	______	______	______
5. Employees are adequately trained when accounting and information systems are changed or replaced.	______	______	______	______	______

	No Opinion	*Strongly Disagree*	*Somewhat Disagree*	*Somewhat Agree*	*Strongly Agree*
6. Accounting and information system capabilities are upgraded when the volume of information increases significantly.	______	______	______	______	______
7. Accounting and data processing personnel are expanded as needed when the volume of information increases significantly.	______	______	______	______	______
8. The entity has the ability to reasonably forecast operating and financial results.	______	______	______	______	______
General Control Activities					
9. The entity prepares operating budgets and cash flow projections.	______	______	______	______	______
10. Operating budgets and projections lend themselves to effective comparisons with actual results.	______	______	______	______	______
11. Significant variances between budgeted or projected amounts and actual results are reviewed and explained.	______	______	______	______	______
12. The company has adequate safekeeping facilities for custody of the accounting records such as fireproof storage areas and restricted access cabinets.	______	______	______	______	______
13. The entity has a suitable record retention plan.	______	______	______	______	______
14. Periodically, personnel compare counts of assets to amounts shown on control records.	______	______	______	______	______
15. There is adequate segregation of duties among those responsible for authorizing transactions, recording transactions, and maintaining custody of assets.	______	______	______	______	______
Information and Communication					
16. Management receives the information they need to carry out their responsibilities.	______	______	______	______	______
17. Information is provided at the right level of detail for different levels of management.	______	______	______	______	______
18. Information is available on a timely basis.	______	______	______	______	______

	No Opinion	Strongly Disagree	Somewhat Disagree	Somewhat Agree	Strongly Agree
19. Information with accounting significance (for example, slow paying customers) is transmitted across functional lines in a timely manner.	______	______	______	______	______
Monitoring					
20. Customer complaints about billings are investigated for their underlying causes.	______	______	______	______	______
21. Communications from bankers, regulators, or other outside parties are monitored for items of accounting significance.	______	______	______	______	______
22. Management responds appropriately to auditor recommendations on ways to strengthen internal controls.	______	______	______	______	______
23. Employees are required to "sign off" to evidence the performance of critical control functions.	______	______	______	______	______

II. Determine Other Areas for Evaluation

The completion of section I of this form is the first of several forms that may be used to document your understanding of internal control sufficiently to plan a primarily substantive audit. In the space provided below, determine which of the following areas apply. A "Yes" answer generally indicates you should complete the related form.

	No	Yes	W/P Ref.
Microcomputers or Outside Service Bureaus			
1. The company uses microcomputers or outside computer service bureaus to process significant accounting information.	____	____	
If "yes," the Control Environment Checklist—Small Business Computer Applications can be found at—			____________
Significant Account Balances and Transaction Cycles			
2. The following account balances or transaction cycles are significant to the company's financial statements.			
a. Revenue cycle, including sales, accounts receivable, or cash receipts. (Normally considered significant for most small businesses.)	____	____	
If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—			____________
b. Purchasing cycle, including purchasing, accounts payable, or cash disbursements. (Normally considered significant for most small businesses.)	____	____	
If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—			____________

	No	Yes	W/P Ref.
c. Inventory, including inventory and cost of sales.	___	___	
If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—			________
d. Financing, including investments and debt.	___	___	
If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—			________
e. Property, plant, and equipment, including fixed assets and depreciation.	___	___	
If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—			________
f. Payroll.	___	___	
If "yes," the related Financial Reporting Information Systems and Controls checklist can be found at —			________

III. Assess Segregation of Duties

An appropriate segregation of duties often appears to present difficulties in small business organizations, at least on the surface. Even companies that have only a few employees, however, can usually parcel out their responsibilities to achieve the necessary checks and balances. But if that is not possible—as may occasionally be the case—direct oversight of the incompatible activities by the owner-manager can provide the necessary control. For example, it is not uncommon, where there is a risk of improper cash payments, for the owner-manager to be named the only authorized check signer, or to require that monthly bank statements be delivered unopened directly to him or her for review of paid checks. In the space provided below, assess the segregation of duties for the company based on the completion of sections I and II of this form. Your comments should address—

- The person with incompatible responsibilities and the nature of those responsibilities.
- Any mitigating factors or controls, such as direct management oversight.
- The risk that material misstatements might occur as a result of a lack of segregation of duties and the type of those misstatements.
- How substantive procedures will be designed to limit the risk of those misstatements to an acceptable level.

IV. Assess the Risk of Management Override

Even in effectively controlled entities—those with generally high levels of integrity and control consciousness—a manager might be able to override controls. The term "management override" means—

> Overruling prescribed policies or procedures for *illegitimate* purposes with the intent of personal gain or enhanced presentation of an entity's financial condition or compliance status.

An owner-manager might override controls for many reasons: to increase reported revenue, to boost market value of the entity prior to sale, to meet sales or earnings projections, to bolster bonus pay-outs tied to performance, to appear to cover violations of debt covenant agreements, or to hide lack of compliance with legal requirements. Override practices include deliberate misrepresentations to bankers, lawyers, accountants, and vendors, and intentionally issuing false documents such as sales invoices.

Management override is different from management intervention, which is the overrule of prescribed policies or procedures for legitimate purposes. For example, management intervention is usually necessary to deal with non-recurring and non-standard transactions or events that otherwise might be handled by the system.

In the space below, assess the risk of management *override* for this company. You should consider the risk that management override possibilities exist, the risk that management will take advantage of those possibilities, and any evidence that management has engaged in override practices. If the risk of management override is greater than low, indicate how planned audit procedures will reduce this risk to an acceptable level.

V. Interpret Results

You should consider the *collective* effect of the strengths and weaknesses in various control components. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, owner-manager controls may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by the owner-manager to overstate earnings.

A. Areas That May Allow for Control Risk to Be Assessed Below the Maximum

Based on the completion of sections I through IV of this form you may have become aware of certain accounts, transactions and assertions where it may be possible and efficient to plan a control risk assessment below the maximum. In the area below, document those accounts, transactions, and assertions and the related tests of controls.

Accounts, Transactions, and Assertions	*Test of Controls Working Paper Reference*

B. Areas of Possible Control Weakness

Based on the completion of sections I through IV of this form you may have become aware of certain areas that may indicate possible control weaknesses, *not including those areas relating to segregation of duties and management override documented in sections III and IV.*

In the space provided below, document those areas of possible weakness and the impact the identified weakness will have on the audit. Discuss—

- The nature of the identified possible weakness.
- Any mitigating factors or controls, such as direct management oversight.
- The risk that material misstatements might occur as a result of the weakness and the type of those misstatements.
- How substantive procedures will be designed to reduce the risk of those misstatements to an acceptable level.

VI. Document Your Conclusion With Respect to Internal Controls

	19__	19__	19__	19__
Prepared or updated by:				
In-Charge	______	______	______	______
Reviewed by:				
Engagement Partner	______	______	______	______

[The next page is 4325.]

AAM Section 4310

Control Environment Checklist—Small Business Computer Applications

.01 This questionnaire may be used to document your understanding of the way computers are used in the information and communication systems of a small business. This questionnaire should be used when the client uses either or both of the following to process significant accounting information.

- Microcomputers and off-the-shelf, unmodified software
- Outside computer service bureaus

.02

I. Microcomputer Hardware

Complete the form on the next page to describe the company's microcomputer hardware; for example:

CPU Model/Make:	Digital Starion 942
Processor:	133 MHZ Pentium
RAM:	16 MB
Hard-Disk Storage:	1600 MB
Operating System:	Windows 95 and DOS
Peripherals:	Dedicated printer

CONTROL ENVIRONMENT CHECKLIST
SMALL BUSINESS MICROCOMPUTER HARDWARE

Person/Department	*CPU Model/Make*	*Processor*	*RAM*	*Operating System*	*Hard-Disk Storage*	*Peripherals*

II. Microcomputer Accounting Software

Describe the name and version of the microcomputer accounting software package.

____

____

____

Which of the following modules have been implemented?

	Module Implemented		
Module	*Yes*	*No*	*N/A*
General ledger			
Cash receipts			
Cash disbursements			
Accounts receivable			
Accounts payable			
Inventory			
Fixed assets and depreciation			
Other:			

III. Other Microcomputer Software

List the other software products used by the company.

	Name and Version
Spreadsheet	
Word processing	
Database management	
Communications	
Other:	

IV. Local Area Network

If the company processes significant financial information in a local area network (LAN) environment, consider attaching a description of the LAN configuration, including the location of the server and workstations. Describe the following:

	Name and Version
Operating system	
Network software	
Network management software	

V. Microcomputer Control Environment

In the space provided below, indicate whether you strongly agree, somewhat agree, somewhat disagree, or strongly disagree with the following statements. Your answers should be based on—

- Your previous experience with the entity.
- Inquiries of appropriate management, supervisory, and staff personnel.
- Inspection of documents and records.
- Observation of the entity's activities and operations.

	No Opinion	Strongly Disagree	Somewhat Disagree	Somewhat Agree	Strongly Agree
Acquisition of Hardware					
1. The company has a coherent management plan for the purchase of and continued investment in computer hardware.	______	______	______	______	______
2. The processing chips, RAM, and hard-disk storage are sufficient to meet the company's needs.	______	______	______	______	______
3. The company's computer hardware is safely and properly installed.	______	______	______	______	______
4. The company has standard, regular hardware maintenance procedures	______	______	______	______	______
Acquisition of Software					
5. The company has a coherent management plan for the purchase and continued investment in computer software.	______	______	______	______	______
6. The company researches software products to determine whether they meet the needs of the intended users.	______	______	______	______	______
7. The company's application programs are compatible with each other.	______	______	______	______	______
8. The company obtains recognized software from reputable sources and only accepts delivery if the software is in the manufacturer's sealed package.	______	______	______	______	______
9. Company policy prohibits the use of unauthorized programs introduced by employees.	______	______	______	______	______
10. Company policy prohibits the downloading of untested software from sources such as dial-up bulletin boards.	______	______	______	______	______
11. The company uses virus protection software to screen for virus infections.	______	______	______	______	______
Physical Security					
12. The company has established procedures for the periodic back-up of files.	______	______	______	______	______

	No Opinion	*Strongly Disagree*	*Somewhat Disagree*	*Somewhat Agree*	*Strongly Agree*
13. Back-up procedures include multiple generations.	______	______	______	______	______
14. Back-up files are stored in a secure, off-site location.	______	______	______	______	______
Logical Access					
15. Management has identified confidential and sensitive data for which access should be restricted.	______	______	______	______	______
16. Procedures are in place to restrict access to confidential and sensitive data.	______	______	______	______	______
17. Procedures are in place to reduce the risk of unauthorized transactions being entered into processing.	______	______	______	______	______
18. The use of utility programs is controlled or monitored carefully.	______	______	______	______	______
General Operations					
19. Clear job descriptions exist for the use of microcomputers.	______	______	______	______	______
20. Management periodically assesses the training needs for personnel who use microcomputers to process significant accounting information.	______	______	______	______	______
21. Personnel who use microcomputers to process significant accounting information are adequately trained.	______	______	______	______	______

VI. Outside Computer Service Organizations

This section should be used to document your understanding of how the company uses an outside computer service organization to process significant accounting information. Guidance on auditing entities that use computer service organizations is contained in SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324).

1. List the name of the service organization and the general types of services it provides.

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2. Are the general ledger and other primary accounting records processed by an outside service organization?_______Yes_______No

   If yes, describe the source documents provided to the service organization, the reports and other documentation received from the organization, and the controls maintained by the user over input and output to prevent or detect material misstatement.

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3. List the type and date of the most recent service auditor's report.

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[*The next page is 4341.*]

AAM Section 4320

Financial Reporting Information Systems and Controls Checklist—Small Business

Revenue Cycle

Revenue, Accounts Receivable, and Cash Receipts

.01 This checklist may be used on any small business audit engagement when the revenue cycle is significant. Normally, the revenue cycle is significant in most small businesses.

.02 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the revenue cycle should be sufficient for you to understand—

- How cash and credit sales are initiated.
- How cash receipts are recorded.
- How sales and cash receipts are processed by the financial reporting information system.
- The accounting records and supporting documents involved in the processing and reporting of sales, accounts receivable, and cash receipts.
- The processes used to prepare significant accounting estimates and disclosures.

Interpreting Results

.03 This checklist documents your understanding of how internal control over the revenue cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. To assess control risk below the maximum, you will need to design tests of controls and then test specific controls to determine the effectiveness of their design and operation.

.04 The processes, documents, and controls listed on this questionnaire are typical for small business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.05

	Personnel	*N/A*	*No*	*Yes*
I. **Revenue and Accounts Receivable**				
A. **Initiating Sales Transactions**				
1. Cash sales are controlled by cash registers or prenumbered cash receipts forms.				
2. Someone other than the cashier has custody of the cash register tape compartment.				

	Personnel	N/A	No	Yes
3. Someone other than the cashier takes periodic readings of the cash register and balances the cash on hand.				
4. Credit limits are established by the owner or credit manager for customers who purchase on account.				
5. Prenumbered sales orders are used and accounted for.				
6. Prenumbered shipping documents are used to record shipments.				
7. Shipping document information is verified prior to shipment.				
8. All shipping documents are accounted for.				
9. Prenumbered credit memos are used to document sales returns.				
10. All credit memos are approved and accounted for.				
11. Credit memos are matched with receiving reports for returned goods.				
B. Processing Sales Transactions				
12. Prenumbered invoices are prepared promptly after goods are shipped.				
13. Quantities on the invoices are compared to shipping documents.				
14. The prices on the invoices are current.				
15. Invoices are mailed to customers on a timely basis.				
16. Invoices are posted to the general ledger on a timely basis.				
17. Standard journal entries are used to record sales.				
18. Invoices are posted to the sales and accounts receivable subsidiary ledgers or journals on a timely basis.				
19. Credit memos are posted to the general ledger on a timely basis.				
20. Credit memos are posted to the sales and accounts receivable subsidiary ledgers or journals on a timely basis.				
21. Procedures exist for determining proper cut-off of sales at month end.				
22. The sales and accounts receivable balances shown in the general ledger are reconciled to the sales and accounts receivable subsidiary ledgers on a regular basis.				
C. Estimates and Disclosures for Sales Transactions				
23. The accounting system generates a monthly aging of accounts receivable.				

	Personnel	N/A	No	Yes
24. The owner uses the accounts receivable aging to investigate, write-off or adjust delinquent accounts receivable.				
25. The owner uses the accounts receivable aging and other information to estimate an allowance for doubtful accounts.				
26. The person responsible for financial reporting identifies significant concentrations of credit risk.				
II. Cash Receipts				
A. Initiating Cash Receipts Transactions				
1. The entity maintains records of payments on accounts by customer.				
2. Someone other than the person responsible for maintaining accounts receivable opens the mail and lists the cash receipts.				
3. Cash receipts are deposited intact.				
4. Cash receipts are deposited in separate bank accounts when required.				
B. Processing Cash Received on Account				
5. Cash receipts are posted to the general ledger on a timely basis.				
6. Cash receipts are posted to the accounts receivable subsidiary ledger on a timely basis.				
7. Standard journal entries are used to post cash receipts.				
8. Timely bank reconciliations are prepared or reviewed by the owner or manager or someone independent of the cash receipts function.				

End User Computing in the Revenue Cycle

.06 End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet which shows amortization of premiums or discounts, and the information from the spreadsheet is the source of a journal entry.

.07 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of off-the-shelf computer software accounting applications such as the general ledger. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the revenue cycle to process significant accounting information outside of the general accounting software.

.08 You should obtain an understanding of any spreadsheet application, database, or separate computer system that has been developed by end users to—

- Process significant accounting information outside of the off-the-shelf accounting software package. For example, a spreadsheet accumulates invoices for batch processing.

- Make significant accounting decisions. For example, a spreadsheet application that ages accounts receivable and helps in determining write-offs.
- Accumulate footnote information. For example, a database of customers provides information about the location of customers for possible concentration of credit risk disclosures.

.09 In the space provided below, describe how end user computing is used in the revenue cycle. Describe—

- The person or department who performs the computing.
- A general description of the application and its type (e.g., spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

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Procedures and Controls Over End User Computing

.10 Answer the following questions relating to procedures and controls over end user computing related to the revenue cycle.

	Personnel	*N/A*	*No*	*Yes*
Revenue Cycle				
1. End user applications listed in paragraph .09 of this form have been adequately tested before use.	______	___	___	___
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	______	___	___	___
3. Access controls limit access to the end user application.	______	___	___	___
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	______	___	___	___
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	______	___	___	___

Information Processed by Outside Computer Service Organizations

.11 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the revenue cycle.

.12 In the space below, describe the revenue cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

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Purchasing Cycle

Purchasing, Accounts Payable, and Cash Disbursements

.13 This checklist may be used on any small business audit engagement where the purchasing cycle is significant. Normally, the purchasing cycle is significant for most small businesses.

.14 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the purchasing cycle should be sufficient for you to understand—

- How purchases are initiated and goods received.
- How cash disbursements are recorded.
- How purchases and cash disbursements are processed by the accounting system.
- The accounting records and supporting documents involved in the processing and reporting of purchases, accounts payable, and cash disbursements.
- The processes used to prepare significant accounting estimates and disclosures.

Interpreting Results

.15 This checklist documents your understanding of how internal control over the purchasing cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. To assess control risk below the maximum, you will need to design tests of controls and then test specific controls to determine the effectiveness of their design and operation.

.16 The processes, documents, and controls listed on this questionnaire are typical for small business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.17

	Personnel	*N/A*	*No*	*Yes*
I. Purchases and Accounts Payable				
A. Initiating Purchases and Receipt of Goods				
1. All purchases over a predetermined amount are approved by the owner.				
2. Non-routine purchases (for example, services, fixed assets, or investments) are approved by the owner.				
3. A purchase order system is used, prenumbered purchase orders are accounted for, and physical access to purchase orders is controlled.				
4. Open purchase orders are periodically reviewed.				
5. All goods are inspected and counted when received.				
6. Prenumbered receiving reports, or a log, are used to record the receipt of goods.				
7. The receiving reports or log indicate the date the items were received.				
B. Processing Purchases				
8. Invoices from vendors are matched with applicable receiving reports.				
9. Invoices are reviewed for proper quantity and prices, and mathematical accuracy.				
10. Invoices from vendors are posted to the general ledger on a timely basis.				
11. Invoices from vendors are posted to the accounts payable subsidiary ledger on a timely basis.				
12. Standard journal entries are used to post accounts payable.				
13. Accounts payable account per the general ledger is reconciled periodically to the accounts payable subsidiary ledger.				
14. Statements from vendors are reconciled to the accounts payable subsidiary ledger.				
C. Disclosures				
15. Management has the information to identify vulnerability due to concentrations of suppliers (SOP 94-6).				

	Personnel	N/A	No	Yes
II. Cash Disbursements				
A. Initiating Cash Disbursements				
1. All disbursements except those from petty cash are made by check.				
2. All checks are recorded.				
3. Supporting documentation such as invoices and receiving reports are reviewed before the checks are signed.				
4. Supporting documents are canceled to avoid duplicate payment.				
B. Processing Cash Disbursements				
5. Cash disbursements are posted to the general ledger on a timely basis.				
6. Cash disbursements are posted to the accounts payable subsidiary ledger on a timely basis.				
7. Standard journal entries are used to post cash disbursements.				
8. Timely bank reconciliations are prepared or reviewed by the owner or manager or someone independent of the cash receipts function.				

End User Computing in the Purchasing Cycle

.18 End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that amortizes premiums or discounts, and the information from the spreadsheet is the source of a journal entry.

.19 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of off-the-shelf computer software accounting applications such as the general ledger. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the purchasing cycle to process significant accounting information outside of the general accounting software.

.20 You should obtain an understanding of any spreadsheet application, database, or separate computer system that has been developed by end users to—

- Process significant accounting information outside of the off-the-shelf accounting software package. For example, a spreadsheet accumulates non-routine purchases for batch processing.
- Make significant accounting decisions.
- Accumulate footnote information. For example, a database of vendors provides information for possible concentration of risk disclosures.

.21 In the space provided below, describe how end user computing is used in the purchasing cycle. Describe—

- The person or department who performs the computing.
- A general description of the application and its type (e.g., spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

Procedures and Controls Over End User Computing

.22 Answer the following questions relating to procedures and controls over end user computing related to the purchasing cycle.

	Personnel	N/A	No	Yes
Purchasing Cycle				
1. End user applications listed in paragraph .21 of this form have been adequately tested before use.				
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.				
3. Access controls limit access to the end user application.				
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.				
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.				

Information Processed by Outside Computer Service Organizations

.23 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the purchasing cycle.

.24 In the space below, describe the purchasing cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

Inventory

Inventory and Cost of Sales

.25 This checklist may be used on any small business audit engagement where inventory is a significant transaction cycle.

.26 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the inventory cycle should be sufficient for you to understand—

- How costs are capitalized to inventory.
- How cost is relieved from inventory.
- How inventory costs and cost of sales are processed by the financial reporting information system.
- The procedures used to take the physical inventory count.
- The accounting records and supporting documents involved in the processing and reporting of inventory and cost of sales.
- The processes used to prepare significant accounting estimates and disclosures.

Interpreting Results

.27 This checklist documents your understanding of how internal control over the inventory cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. To assess control risk below the maximum, you will need to design tests of controls and then test specific controls to determine the effectiveness of their design and operation.

.28 The processes, documents, and controls listed on this questionnaire are typical for small business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.29

	Personnel	*N/A*	*No*	*Yes*
I. Inventory and Cost of Sales				
A. Capturing Capitalizable Costs[1]				
1. The entity uses a cost accounting system to accumulate capitalizable costs.				

[1] You should also consider completing the Financial Reporting Information Systems and Controls Checklist for the purchasing cycle to document your understanding of how the purchase of inventory is initiated.

	Personnel	N/A	No	Yes
2. The cost accounting system distinguishes between costs that should be capitalized for GAAP purposes and those that should be capitalizable for tax purposes.				
3. The cost accounting system interfaces with the general ledger.				
4. Production cost budgets are periodically compared to actual costs, and significant differences are explained.				
B. Inventory Records				
5. The entity maintains adequate inventory records of prices and amounts on hand.				
6. Withdrawals from inventory are based on prenumbered finished inventory requisitions, shipping reports, or both.				
7. Additions to and withdrawals from inventory are posted to the inventory records and the general ledger.				
8. Standard journal entries are used to post inventory transactions to the inventory records and the general ledger.				
9. Inventory records are periodically reconciled to the general ledger.				
10. Inventory records are reconciled to a physical inventory count.				
C. Physical Inventory Counts				
11. Inventory is counted at least once a year.				
12. Physical inventory counters are given adequate instructions.				
13. Inventory count procedures are sufficient to provide an accurate count, including steps to ensure—				
• Proper cut-off.				
• Identification of obsolete items.				
• All items are counted once and only once.				
• Tag control.				
D. Estimates and Disclosures				
14. Management is able to identify excess, slow-moving, or obsolete inventory.				
15. Excess, slow-moving, or obsolete inventory is periodically written off.				
16. Management can identify inventory subject to rapid technological obsolescence that may need to be disclosed under SOP 94-6.				

End User Computing in the Inventory Cycle

.30 End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that amortizes premiums or discounts, and the information from the spreadsheet is the source of a journal entry.

.31 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of off-the-shelf computer software accounting applications such as the general ledger. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the inventory cycle to process significant accounting information outside of the general accounting software.

.32 You should obtain an understanding of any spreadsheet application, database, or separate computer system that has been developed by end users to—

- Process significant accounting information outside of the off-the-shelf accounting software package. For example, a spreadsheet calculates overhead cost allocations.
- Make significant accounting decisions. A spreadsheet application tracks slow-moving items for possible write-off.
- Accumulate footnote information.

.33 In the space provided below, describe how end user computing is used in the inventory cycle. Describe—

- The person or department who performs the computing.
- A general description of the application and its type (e.g., spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

Procedures and Controls Over End User Computing

.34 Answer the following questions relating to procedures and controls over end user computing related to the inventory cycle.

	Personnel	N/A	No	Yes
Inventory Cycle				
1. End user applications listed in paragraph .33 of this form have been adequately tested before use.	______	___	___	___
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	______	___	___	___
3. Access controls limit access to the end user application.	______	___	___	___
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	______	___	___	___
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	______	___	___	___

Information Processed by Outside Computer Service Organizations

.35 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the inventory cycle.

.36 In the space below, describe the inventory cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

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Financing

Investments and Debt

.37 This checklist may be used on any small business audit engagement where investments or debt are a significant transaction cycle.

.38 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the financing cycle should be sufficient for you to understand—

- How investment decisions are authorized and initiated.
- How financing is authorized and captured by the financial reporting information system.
- How investment and debt transactions are processed by the financial reporting system.
- The accounting records and supporting documents involved in the processing and reporting of investments and debt.
- The processes used to prepare significant accounting estimates, disclosures, and presentation.
- How management classifies investments as either trading, available-for-sale, or held to maturity.

Interpreting Results

.39 This checklist documents your understanding of how internal control over financing is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. To assess control risk below the maximum, you will need to design tests of controls and then test specific controls to determine the effectiveness of their design and operation.

.40 The processes, documents, and controls listed on this questionnaire are typical for small business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.41

	Personnel	*N/A*	*No*	*Yes*
I. Investments				
A. Authorization and Initiation				
1. Investment transactions are authorized by the owner.				
2. The owner assesses and understands the risks associated with the entity's investments.				
3. Investments are registered in the name of the company.				
4. At acquisition, investments are classified as trading, available-for-sale, or held-to-maturity.				
B. Processing				
5. Investment transactions are posted to the general ledger on a timely basis.				
6. Account statements received from brokers are reviewed for accuracy.				
7. Discounts and premiums are amortized regularly using the interest method.				
8. Procedures exist to determine the fair value of trading and available-for-sale securities.				

	Personnel	N/A	No	Yes
9. The general ledger is periodically reconciled to account statements from brokers or physical counts of securities on hand.				
C. Disclosures				
10. Management identifies investments with off-balance-sheet credit risk for proper disclosure.				
II. Debt				
A. Authorization and Initiation				
1. Financing transactions are authorized by the owner.				
2. The owner assesses and understands all terms, covenants, restrictions of debt transactions.				
B. Processing and Documentation				
3. Debt transactions are posted to the general ledger on a timely basis.				
4. Any premiums or discount are amortized using the interest method.				
5. The company maintains up-to-date files of all notes payable.				
C. Disclosure				
6. Procedures exist to determine the fair value of notes payable for proper disclosure.				
7. Management reviews their compliance with debt covenants on a timely basis.				

End User Computing in the Financing Cycle

.42 End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that amortizes premiums or discounts, and the information from the spreadsheet is the source of a journal entry.

.43 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of off-the-shelf computer software accounting applications such as the general ledger. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the financing cycle to process significant accounting information outside of the general accounting software.

.44 You should obtain an understanding of any spreadsheet application, database, or separate computer system that has been developed by end users to—

- Process significant accounting information outside of the off-the-shelf accounting software package. For example, a spreadsheet application calculates the amortization of premiums and discounts on investments.
- Make significant accounting decisions.
- Accumulate footnote information. For example, a spreadsheet application calculates five-year debt maturities for footnote disclosure.

.45 In the space provided below, describe how end user computing is used in the financing cycle. Describe—

- The person or department who performs the computing.
- A general description of the application and its type (e.g., spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

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Procedures and Controls Over End User Computing

.46 Answer the following questions relating to procedures and controls over end user computing related to the financing cycle.

	Personnel	*N/A*	*No*	*Yes*
Financing Cycle				
1. End user applications listed in paragraph .45 of this form have been adequately tested before use.	______	___	___	___
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	______	___	___	___
3. Access controls limit access to the end user application.	______	___	___	___
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	______	___	___	___
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	______	___	___	___

Information Processed by Outside Computer Service Organizations

.47 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the financing cycle.

.48 In the space below, describe the financing cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

Property, Plant, and Equipment

Fixed Assets and Depreciation

.49 This checklist may be used on any audit engagement where fixed assets are a significant transaction cycle.

.50 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the property, plant, and equipment cycle should be sufficient for you to understand—

- How fixed asset transactions are authorized and initiated. (Additional information on the acquisition of fixed assets is documented on the Accounting Systems and Control Checklist for the Purchasing Cycle.)
- How fixed asset transactions and depreciation are processed by the financial reporting information system.
- The accounting records and supporting documents involved in the processing and reporting of fixed assets and depreciation.
- The processes used to prepare significant accounting estimates and disclosures.

Interpreting Results

.51 This checklist documents your understanding of how internal control over property, plant, and equipment is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. To assess control risk below the maximum, you will need to design tests of controls and then test specific controls to determine the effectiveness of their design and operation.

.52 The processes, documents, and controls listed on this questionnaire are typical for small business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.53

	Personnel	N/A	No	Yes
I. Fixed Assets and Depreciation				
A. Authorization and Initiation				
1. Fixed asset acquisitions and retirements are authorized by the owner.	______	___	___	___
B. Processing and Documentation				
2. The company maintains detailed records of fixed assets and the related accumulated depreciation.	______	___	___	___
3. The general ledger and detailed fixed asset records are updated for fixed assets transactions on a timely basis.	______	___	___	___
4. A process exists for the timely calculation of depreciation expense for both book and tax purposes.	______	___	___	___
5. The general ledger and detailed fixed asset records are updated for depreciation expense on a timely basis.	______	___	___	___
6. The general ledger is periodically reconciled to the detailed fixed asset records.	______	___	___	___
C. Disclosure and Estimation				
7. Management identifies events or changes in circumstances that may indicate fixed assets have been impaired (SFAS 121).	______	___	___	___
8. Management assesses and understands the risk of specialized equipment becoming subject to technological obsolescence (SOP 94-6).	______	___	___	___

End User Computing in the Property, Plant, and Equipment Cycle

.54 End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that amortizes premiums or discounts, and the information from the spreadsheet is the source of a journal entry.

.55 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of off-the-shelf computer software accounting applications such as the general ledger. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the revenue cycle to process significant accounting information outside of the general accounting software.

.56 You should obtain an understanding of any spreadsheet application, database, or separate computer system that has been developed by end users to—

- Process significant accounting information outside of the off-the-shelf accounting software package. For example, a spreadsheet application calculates the depreciation expense.

- Make significant accounting decisions. For example, a spreadsheet application is used to analyze lease or buy decisions.
- Accumulate footnote information.

.57 In the space provided below, describe how end user computing is used in the property, plant, and equipment cycle. Describe—

- The person or department who performs the computing.
- A general description of the application and its type (e.g., spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

Procedures and Controls Over End User Computing

.58 Answer the following questions relating to procedures and controls over end user computing related to the property, plant, and equipment cycle.

	Personnel	*N/A*	*No*	*Yes*
Property, Plant, and Equipment Cycle				
1. End user applications listed in paragraph .57 of this form have been adequately tested before use.				
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.				
3. Access controls limit access to the end user application.				
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.				
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.				

Information Processed by Outside Computer Service Organizations

.59 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the property, plant, and equipment cycle.

.60 In the space below, describe the property, plant, and equipment cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

Payroll Cycle

Payroll Expense

.61 This checklist may be used on any small business audit engagement where the payroll cycle is significant.

.62 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the payroll cycle should be sufficient for you to understand—

- How the time worked by employees is captured by the financial reporting information system.
- How salaries and hourly rates are established.
- How payroll and the related withholdings are calculated.
- The accounting records and supporting documents involved in the processing and reporting of payroll.

Interpreting Results

.63 This checklist documents your understanding of how internal control over the payroll cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. To assess control risk below the maximum, you will need to design tests of controls and then test specific controls to determine the effectiveness of their design and operation.

.64 The processes, documents, and controls listed on this questionnaire are typical for small business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.65

	Personnel	N/A	No	Yes
I. Payroll				
A. Initiating Payroll Transactions				
1. Wages and salaries are approved by the owner.				
2. Proper authorization is obtained for all payroll deductions.				
3. Access to personnel files is limited to the owner or someone who is independent of the payroll or cash functions.				
4. Adequate time records are maintained for employees paid by the hour.				
5. Time records for hourly employees are approved by a supervisor.				
B. Processing Payroll				
6. Payroll is calculated using authorized pay rates, payroll deductions, and time records.				
7. Payroll registers are reviewed for accuracy.				
8. Standard journal entries are used to post payroll transactions to the general ledger.				

End User Computing in the Payroll Cycle

.66 End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that amortizes premiums or discounts, and the information from the spreadsheet is the source of a journal entry.

.67 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of off-the-shelf computer software accounting applications such as the general ledger. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the payroll cycle to process significant accounting information outside of the general accounting software.

.68 You should obtain an understanding of any spreadsheet application, database, or separate computer system that has been developed by end users to—

- Process significant accounting information outside of the off-the-shelf accounting software package. For example, a spreadsheet accumulates time card information for batch processing.
- Make significant accounting decisions. For example, a spreadsheet application is used to accumulate payroll information by job for further analysis.
- Accumulate footnote information.

.69 In the space provided below, describe how end user computing is used in the payroll cycle. Describe—

- The person or department who performs the computing.

- A general description of the application and its type (e.g., spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

Procedures and Controls Over End User Computing

.70 Answer the following questions relating to procedures and controls over end user computing related to the payroll cycle.

	Personnel	*N/A*	*No*	*Yes*
Payroll Cycle				
1. End user applications listed in paragraph .69 of this form have been adequately tested before use.				
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.				
3. Access controls limit access to the end user application.				
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.				
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.				

Information Processed by Outside Computer Service Organizations

.71 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the payroll cycle.

.72 In the space below, describe the payroll cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.

- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

[*The next page is 4401.*]

AAM Section 4400

Illustrative Internal Control Forms—Medium to Large Business

.01 The following are illustrative internal control forms you might use to document your understanding of internal controls sufficient to plan an audit. The illustrative questions are numbered merely for organizational purposes. The numbers are in no way intended to infer completeness or a preferred sequence. These forms may require modifications to meet the needs, preferences, and circumstances of individual firms and their clients. Whenever you use standardized forms, checklists, or questionnaires, you should recognize that important matters in a particular set of circumstances may not be covered.

Instructions

.02 The forms in AAM sections 4410 and 4420 may be used on all audit engagements of medium to large businesses. For audits of small businesses, see AAM section 4300.

.03 In every audit, you should obtain an understanding of each of the components of internal control sufficient to plan the audit. These forms should be used as a tool in documenting your understanding of internal control, how internal control is designed, and whether controls have been placed in operation.

.04 These forms should be used in conjunction with other forms in the following circumstances:

- *Computer Applications Checklist—Medium to Large Business* [AAM section 4410]. To be used to document your understanding of how the entity uses computers to process significant accounting information.
- *Financial Reporting Information Systems and Controls Checklist* [AAM section 4420]. To be used for each significant account and transactions cycle.

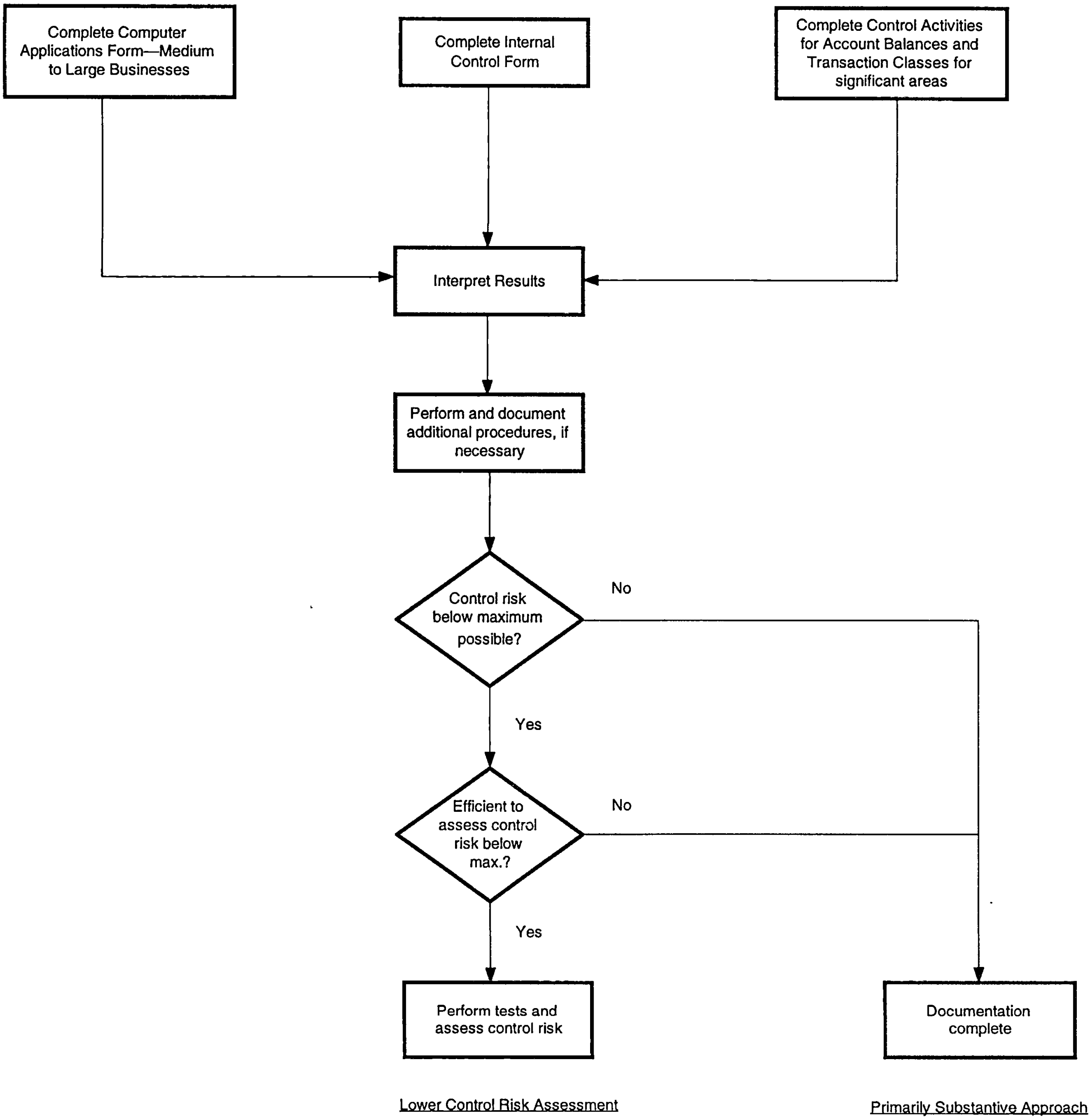
.05 These forms are appropriate whenever you plan a primarily substantive audit approach. That is, their completion generally results in control risk being assessed at or slightly below the maximum for all assertions related to account balances and transactions.

.06 If you plan a lower control risk assessment for certain assertions you are required to—

- Identify specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions, and
- Perform tests of controls to evaluate their effectiveness.

.07 These forms are organized to conform to the control components and overall internal control framework described in the Audit Guide *Consideration of Internal Control in a Financial Statement Audit*. This framework is a way for you to consider the impact of internal control on an audit. The classification of any specific control into a particular component should not be your primary concern. Rather, your primary consideration is whether a specific control affects financial statement assertions.

.08 The following flowchart describes how this form can be used in conjunction with the other forms included in this section to document your understanding of internal controls.


Complete Computer Applications Form—Medium to Large Businesses
Complete Internal Control Form
Complete Control Activities for Account Balances and Transaction Classes for significant areas
Interpret Results
Perform and document additional procedures, if necessary
Control risk below maximum possible?
No
Yes
Efficient to assess control risk below max.?
No
Yes
Perform tests and assess control risk
Documentation complete
Lower Control Risk Assessment
Primarily Substantive Approach

Interpreting the Results

.09 When obtaining an understanding of internal control, you should consider the *collective* effect of the strengths and weaknesses in various control components. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, strong management oversight may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by management to overstate earnings.

.10 Answers that fall toward the right side of the form ("Strongly Agree" or "Somewhat Agree") indicate areas of strength in the control environment. You should consider whether these areas of strength indicate that a control risk assessment below the maximum may be possible for some assertions.

.11 Answers that fall toward the left side of the form ("Strongly Disagree" or "Somewhat Disagree") indicate areas of weakness in the entity's internal controls. You should assess how these areas of weakness affect the planning of the audit. This assessment should be documented in section V of the form. In making this assessment, you normally focus on—

- The types of material misstatement that could occur as a result of the identified weakness, and
- The risk that those misstatements will occur.

Documenting a Conclusion

.12 After completing this form, the Financial Reporting Information Systems and Controls Checklist for significant areas, and the Computer Applications Checklist—Medium to Large Business, you should document your conclusion regarding internal control. In order to perform a primarily substantive audit, you must understand the entity's internal control sufficiently—

- To assess the risk of material misstatement in assertions related to material financial statement components, and
- To design effective substantive procedures.

.13 If the completion of this form is not sufficient for you to obtain the necessary level of understanding listed in AAM section 4400.12, you should perform and document the results of additional tests to gain that level of understanding.

.14

I. Document Your Understanding of the Control Environment

In the space provided below, indicate whether you strongly agree, somewhat agree, somewhat disagree, or strongly disagree with the following statements. Your answers should be based on—

- Your previous experience with the entity.
- Inquiries of appropriate management, supervisory, and staff personnel.
- Inspection of documents and records.
- Observation of the entity's activities and operations.

	No Opinion	*Strongly Disagree*	*Somewhat Disagree*	*Somewhat Agree*	*Strongly Agree*
A. Control Environment Factors					
Integrity and Ethical Values					
1. Management has high ethical and behavioral standards.					
2. The company has a written code of ethical and behavioral standards that is comprehensive and periodically acknowledged by all employees.					
3. If a written code of conduct does not exist, the management culture emphasizes the importance of integrity and ethical values.					
4. Management reinforces its ethical and behavioral standards.					
5. Management appropriately deals with signs that problems exist (e.g., defective products or hazardous waste) even when the cost of identifying and solving the problem could be high.					
6. Management has removed or reduced incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. For example, there is generally *no*—					
• Pressure to meet unrealistic performance targets.					
• High performance-dependent rewards.					
• Upper and lower cutoffs on bonus plans.					
7. Management has provided guidance on the situations and frequency with which intervention of established controls is appropriate.					
8. Management intervention is documented and explained appropriately.					
Commitment to Competence					
9. Management has appropriately considered the knowledge and skill levels necessary to accomplish financial reporting tasks.					

	No Opinion	Strongly Disagree	Somewhat Disagree	Somewhat Agree	Strongly Agree
10. Employees with financial reporting tasks generally have the knowledge and skills necessary to accomplish those tasks.	______	______	______	______	______
Board of Directors and Audit Committee					
11. The board of directors is independent from management.	______	______	______	______	______
12. The board constructively challenges management's planned decisions.	______	______	______	______	______
13. Directors have sufficient knowledge, industry experience and time to serve effectively.	______	______	______	______	______
14. The board regularly receives the information they need to monitor management's objectives and strategies.	______	______	______	______	______
15. The audit committee reviews the scope of activities of the internal and external auditors annually.	______	______	______	______	______
16. The audit committee meets privately with the chief financial and/or accounting officers, internal auditors and external auditors to discuss the—					
• Reasonableness of the financial reporting process.	______	______	______	______	______
• System of internal control.	______	______	______	______	______
• Significant comments and recommendations.	______	______	______	______	______
• Management's performance.	______	______	______	______	______
17. The board takes steps to ensure an appropriate "tone at the top."	______	______	______	______	______
18. The board or committee takes action as a result of its findings.	______	______	______	______	______
Management's Philosophy and Operating Style					
19. Management moves carefully, proceeding only after carefully analyzing the risks and potential benefits of accepting business risks.	______	______	______	______	______
20. Management is generally cautious or conservative in financial reporting and tax matters.	______	______	______	______	______

	No Opinion	Strongly Disagree	Somewhat Disagree	Somewhat Agree	Strongly Agree
21. There is relatively low turnover of key personnel (e.g., operating, accounting, data processing, internal audit).	______	______	______	______	______
22. There is *no* undue pressure to meet budget, profit, or other financial and operating goals.	______	______	______	______	______
23. Management views the accounting and internal audit function as a vehicle for exercising control over the entity's activities.	______	______	______	______	______
24. Operating personnel review and "sign off" on reported results.	______	______	______	______	______
25. Senior managers frequently visit subsidiary or divisional operations.	______	______	______	______	______
26. Group or divisional management meetings are held frequently.	______	______	______	______	______
Organizational Structure					
27. The entity's organizational structure facilitates the flow of information upstream, downstream, and across all business activities.	______	______	______	______	______
28. Responsibilities and expectations for the entity's business activities are communicated clearly to the executives in charge of those activities.	______	______	______	______	______
29. The executives in charge have the required knowledge, experience, and training to perform their duties.	______	______	______	______	______
30. Those in charge of business activities have access to senior operating management.	______	______	______	______	______
Assignment of Authority and Responsibility					
31. Authority and responsibility are delegated only to the degree necessary to achieve the company's objectives.	______	______	______	______	______
32. Job descriptions, for at least management and supervisory personnel, exist.	______	______	______	______	______
33. Job descriptions contain specific references to control-related responsibilities.	______	______	______	______	______

	No Opinion	Strongly Disagree	Somewhat Disagree	Somewhat Agree	Strongly Agree
34. Proper resources are provided for personnel to carry out their duties.	______	______	______	______	______
35. Personnel understand the entity's objectives and know how their individual actions interrelate and contribute to those objectives.	______	______	______	______	______
36. Personnel recognize how and for what they will be held accountable.	______	______	______	______	______
Human Resource Policies and Practices					
37. The entity generally hires the most qualified people for the job.	______	______	______	______	______
38. Hiring and recruiting practices emphasize educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior.	______	______	______	______	______
39. Recruiting practices include formal, in-depth employment interviews.	______	______	______	______	______
40. Prospective employees are told of the entity's history, culture and operating style.	______	______	______	______	______
41. The entity provides training opportunities, and employees are well-trained.	______	______	______	______	______
42. Promotions and rotation of personnel are based on periodic performance appraisals.	______	______	______	______	______
43. Methods of compensation, including bonuses, are designed to motivate personnel and reinforce outstanding performance.	______	______	______	______	______
44. Management does not hesitate to take disciplinary action when violations of expected behavior occur.	______	______	______	______	______
B. Other Internal Control Components With a Pervasive Effect on the Organization					
Risk Assessment					
1. Special action is taken to ensure new personnel understand their tasks.	______	______	______	______	______
2. Management appropriately considers the control activities performed by personnel who change jobs or leave the company.	______	______	______	______	______

	No Opinion	*Strongly Disagree*	*Somewhat Disagree*	*Somewhat Agree*	*Strongly Agree*
3. Management assesses how new accounting and information systems will impact internal control.					
4. Management reconsiders the appropriateness of existing control activities when new accounting and information systems are developed and implemented.					
5. Employees are adequately trained when accounting and information systems are changed or replaced.					
6. Accounting and information system capabilities are upgraded when the volume of information increases significantly.					
7. Accounting and data processing personnel are expanded as needed when the volume of information increases significantly.					
8. The entity has the ability to reasonably forecast operating and financial results.					
9. Management keeps abreast of the political, regulatory, business, and social culture of areas in which foreign operations exist.					
General Control Activities					
10. The entity prepares operating budgets and cash flow projections.					
11. Operating budgets and projections lend themselves to effective comparison with actual results.					
12. Significant variances between budgeted or projected amounts and actual results are reviewed and explained.					
13. The company has adequate safekeeping facilities for custody of the accounting records such as fireproof storage areas and restricted access cabinets.					
14. The entity has a suitable record retention plan.					
15. The entity has adequate controls to limit access to computer programs and data files.					
16. Periodically, personnel compare counts of assets to amounts shown on control records.					

	No Opinion	*Strongly Disagree*	*Somewhat Disagree*	*Somewhat Agree*	*Strongly Agree*
17. There is adequate segregation of duties among those responsible for authorizing transactions, recording transactions, and maintaining custody of assets.					
Information and Communication					
18. Management receives the information they need to carry out their responsibilities.					
19. Information is provided at the right level of detail for different levels of management.					
20. Information is available on a timely basis.					
21. Information with accounting significance (for example, slow-paying customers) is transmitted across functional lines in a timely manner.					
Monitoring					
22. Customer complaints about billings are investigated for their underlying causes.					
23. Communications from bankers, regulators, or other outside parties are monitored for items of accounting significance.					
24. Management responds appropriately to auditor recommendations on ways to strengthen internal controls.					
25. Employees are required to "sign off" to evidence the performance of critical control functions.					
26. The internal auditors are independent of the activities they audit.					
27. Internal auditors have adequate training and experience.					
28. Internal auditors document the planning and execution of their work by such means as audit programs and working papers.					
29. Internal audit reports are submitted to the board of directors or audit committee.					

II. Determine Other Areas For Evaluation

The completion of section I of this form is the first of several forms that may be used to document your understanding of internal controls sufficiently to plan a primarily substantive audit. In the space provided below, determine which of the following areas apply. A "Yes" answer generally indicates you should complete the related form.

	No	*Yes*	*W/P Ref.*
Significant Account Balances and Transaction Cycles			
1. The following account balances or transaction cycles are significant to the company's financial statements.			
a. Revenue Cycle, including sales, accounts receivable, or cash receipts. (Normally considered significant for most businesses.)	____	____	
If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—			________
b. Purchasing Cycle, including purchasing, accounts payable, or cash disbursements. (Normally considered significant for most businesses.)	____	____	
If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—			________
c. Inventory, including inventory and cost of sales.	____	____	
If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—			________
d. Financing, including investments and debt.	____	____	
If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—			________
e. Property, Plant, and Equipment, including fixed assets and depreciation.	____	____	
If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—			________
f. Payroll.	____	____	
If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—			________

III. Assess Lack of Segregation of Duties

In the space provided below, assess risk due to a lack of segregation of duties for the company, based on the completion of sections I and II of this form. Your comments should address—

- The person with incompatible responsibilities and the nature of those responsibilities.
- Any mitigating factors or controls, such as direct management oversight.
- The risk that material misstatements might occur as a result of a lack of segregation of duties, and the type of those misstatements.
- How substantive procedures will be designed to limit the risk of those misstatements to an acceptable level.

IV. Assess the Risk of Management Override

Even in effectively controlled entities—those with generally high levels of integrity and control consciousness—a manager might be able to override controls. The term "management override" means—

> Overruling prescribed policies or procedures for *illegitimate* purposes with the intent of personal gain or enhanced presentation of an entity's financial condition or compliance status.

Management might override the control system for many reasons: to increase reported revenue, to boost market value of the entity prior to sale, to meet sales or earnings projections, to bolster bonus pay-outs tied to performance, to appear to cover violations of debt covenant agreements, or to hide lack of compliance with legal requirements. Override practices include deliberate misrepresentations to bankers, lawyers, accountants, and vendors, and intentionally issuing false documents such as sales invoices.

An active, involved board of directors can significantly reduce the risk of management override.

Management override is different from management intervention, which is the overrule of prescribed policies or procedures for legitimate purposes. For example, management intervention is usually necessary to deal with non-recurring and non-standard transactions or events that otherwise might be handled by the system.

In the space below, assess the risk of management *override* for this company. You should consider the risk that management override possibilities exist, the risk that management will take advantage of those possibilities, and any evidence that management has engaged in override practices. If the risk of management override is greater than low, indicate how planned audit procedures will reduce this risk to an acceptable level.

V. Interpret Results

You should consider the *collective* effect of the strengths and weaknesses in various control components. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, management controls may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by management to overstate earnings.

A. Areas That May Allow for Control Risk to Be Assessed Below the Maximum

Based on the completion of sections I through IV of this form you may have become aware of certain accounts, transactions and assertions where it may be possible and efficient to plan a control risk assessment below the maximum. In the area below, document those accounts, transactions, and assertions and the related tests of controls.

Accounts, Transactions, and Assertions	*Test of Controls Working Paper Reference*
______________________________	________________
______________________________	________________
______________________________	________________
______________________________	________________

B. **Areas of possible control weakness**

Based on the completion of sections I through IV of this form, you may have become aware of certain areas that may indicate possible control weaknesses, not including those areas relating to segregation of duties and management override which were assessed and documented in sections III and IV.

In the space provided below, document those areas of possible weakness and the impact the identified weakness will have on the audit. Discuss—

- The nature of the identified possible weakness.
- Any mitigating factors or controls, such as direct management oversight.
- The risk that material misstatements might occur as a result of the weakness and the type of those misstatements.
- How substantive procedures will be designed to reduce the risk of those misstatements to an acceptable level.

____
____
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____

VI. Document Your Conclusion With Respect to Internal Controls

	19__	19__	19__	19__
Prepared or updated by:				
In-Charge	________	________	________	________
Reviewed by:				
Engagement Partner	________	________	________	________

____

[*The next page is 4427.*]

AAM Section 4410

Computer Applications Checklist—Medium to Large Business

.01 This questionnaire may be used to document your understanding of the way computers are used in the information and communication systems of a medium to large business.

.02

I. Computer Hardware

Describe the computer hardware for the entity, and its configuration. Consider—

- The make and model of company's main processing computer(s).
- Input and output devices.
- Storage means and capabilities.
- Local area networks.
- Stand-alone microcomputers.

You may wish to attach a separate page to this checklist to document the entity's computer hardware.

II. Computer Software

Describe the entity's main software packages and whether they are unmodified, commercially available packages, or were developed or modified in-house. (End-user computing applications will be considered only for significant account balances and transaction cycles. See the Financial Reporting Information Systems and Control Checklist—Medium to Large Business.)

	Unmodified Commercial	*In-House*	*N/A*
Operating system	______	______	______
Access control	______	______	______
General accounting	______	______	______
Network	______	______	______
Database management	______	______	______
Communications	______	______	______
Utilities	______	______	______
Other:			
____________________	______	______	______
____________________	______	______	______
____________________	______	______	______
____________________	______	______	______

III. Computer Control Environment

In the space provided below, indicate whether you strongly agree, somewhat agree, somewhat disagree, or strongly disagree with the following statements. Your answers should be based on—

- Your previous experience with the entity.
- Inquiries of appropriate management, supervisory, and staff personnel.
- Inspection of documents and records.
- Observation of the entity's activities and operations.

	No Opinion	*Strongly Disagree*	*Somewhat Disagree*	*Somewhat Agree*	*Strongly Agree*
Acquisition of Hardware					
1. The company has a coherent management plan for the purchase and continued investment in computer hardware.	______	______	______	______	______
2. The computer hardware is sufficient to meet the company's needs.	______	______	______	______	______

	No Opinion	*Strongly Disagree*	*Somewhat Disagree*	*Somewhat Agree*	*Strongly Agree*
3. The company's computer hardware is safely and properly installed.	______	______	______	______	______
4. The company has standard, regular hardware maintenance procedures.	______	______	______	______	______
Acquisition of Software					
5. The company has a coherent management plan for the purchase of and continued investment in computer software.	______	______	______	______	______
6. The company researches software products to determine whether they meet the needs of the intended users.	______	______	______	______	______
7. The company's application programs are compatible with each other.	______	______	______	______	______
8. The company obtains recognized software from reputable sources.	______	______	______	______	______
9. Company policy prohibits the use of unauthorized programs introduced by employees.	______	______	______	______	______
10. Company policy prohibits the downloading of untested software from sources such as dial-up bulletin boards.	______	______	______	______	______
11. The company uses virus protection software to screen for virus infections.	______	______	______	______	______
Program Development					
12. Users are involved in the design and approval of systems.	______	______	______	______	______
13. Users review the completion of various phases of the application.	______	______	______	______	______
14. New programs are thoroughly tested.	______	______	______	______	______
15. Users are involved in the review of tests of the program.	______	______	______	______	______
16. Adequate procedures exist to transfer programs from development to production libraries.	______	______	______	______	______
Program Changes					
17. Users are involved in the design and approval of program changes.	______	______	______	______	______

	No Opinion	Strongly Disagree	Somewhat Disagree	Somewhat Agree	Strongly Agree
18. Program changes are thoroughly tested.					
19. Users are involved in the review of tests of the program changes.					
20. Adequate procedures exist to transfer changed programs from development to production libraries.					
Logical Access					
21. Management has identified confidential and sensitive data for which access should be restricted.					
22. Procedures are in place to restrict access to confidential and sensitive data.					
23. Procedures are in place to reduce the risk of unauthorized transactions being entered into processing.					
24. The use of utility programs is controlled or monitored carefully.					
25. Procedures are in place to detect unauthorized changes to programs supporting the financial statements.					
26. Programmer access to production programs, live data files, and job control language is controlled.					
27. Operator access to source code and individual elements of data files is controlled.					
28. Users have access only to defined programs and data files.					
Physical Security					
29. The company has established procedures for the periodic back-up of files.					
30. Back-up procedures include multiple generations.					
31. Back-up files are stored in a secure, off-site location.					
Computer Operations					
32. Operations management reviews lists of regular and unscheduled batch jobs.					
33. Job control instruction sets are menu-driven.					
34. Jobs are executed only from the operator's terminal.					

IV. Outside Computer Service Organizations

This section should be used to document your understanding of how the company uses an outside computer service organization to process significant accounting information. Guidance on auditing entities that use computer service organizations is contained in SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324).

1. List the name of the service organization and the general types of services it provides:

____

____

2. Are the general ledger and other primary accounting records processed by an outside service organization? _____ Yes _____ No

If "yes," describe the source documents provided to the service organization, the reports and other documentation received from the organization, and the controls maintained by the user over input and output to prevent or detect material misstatement.

____

____

____

3. List the type and date of the most recent service auditor report.

____

____

[*The next page is 4443.*]

AAM Section 4420

Financial Reporting Information Systems and Controls Checklist—Medium to Large Business

Revenue Cycle

Revenue, Accounts Receivable, and Cash Receipts

.01 This checklist may be used on any audit engagement of a medium to large company when the revenue cycle is significant. Normally, the revenue cycle is significant in most audit engagements.

.02 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the revenue cycle should be sufficient for you to understand—

- How cash and credit sales are initiated.
- How credit limits are established and maintained.
- How cash receipts are recorded.
- How sales and cash receipts are processed by the accounting system.
- The accounting records and supporting documents involved in the processing and reporting of sales, accounts receivable, and cash receipts.
- The processes used to prepare significant accounting estimates and disclosures.

Interpreting Results

.03 This checklist documents your understanding of how internal control over the revenue cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. To assess control risk below the maximum, you will need to design tests of controls and then test specific controls to determine the effectiveness of their design and operation.

.04 The processes, documents, and controls listed on this questionnaire are typical for medium to large business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.05

	Personnel	*N/A*	*No*	*Yes*
I. Revenue and Accounts Receivable				
A. Initiating Sales Transactions				
1. Credit limits are clearly defined.	________	____	____	____
2. Credit limits are clearly communicated.	________	____	____	____

	Personnel	*N/A*	*No*	*Yes*
3. The credit of prospective customers is investigated before it is extended to them.				
4. Credit limits are periodically reviewed.				
5. The people who perform the credit function are independent of—				
• Sales.				
• Billing.				
• Collection.				
• Accounting.				
6. Credit limits and changes in credit limits are communicated to persons responsible for approving sales orders on a timely basis.				
7. The company has clearly defined policies and procedures for acceptance and approval of sales orders.				
8. Prenumbered sales orders are used and accounted for.				
9. Prenumbered shipping documents are used to record shipments.				
10. Shipping document information is verified prior to shipment.				
11. The people who perform the shipping function are independent of—				
• Sales.				
• Billing.				
• Collection.				
• Accounting.				
12. All shipping documents are accounted for.				
13. Prenumbered credit memos are used to document sales returns.				
14. All credit memos are approved and accounted for.				
15. Credit memos are matched with receiving reports for returned goods.				
16. Cash sales are controlled by cash registers or prenumbered cash receipts forms.				
17. Someone other than the cashier has custody to the cash register tape compartment.				
18. Someone other than the cashier takes periodic readings of the cash register and balances the cash on hand.				
B. Processing Sales Transactions				
19. Information necessary to prepare invoices (e.g., prices, discount policies) is clearly communicated to billing personnel on a timely basis.				
20. Prenumbered invoices are prepared promptly after goods are shipped.				

	Personnel	N/A	No	Yes
21. Quantities on the invoices are compared to shipping documents.				
22. The prices on the invoices are current.				
23. The people who perform the billing function are independent of—				
• Sales.				
• Credit.				
• Collection.				
24. Invoices are mailed to customers on a timely basis.				
25. Invoices are posted to the general ledger on a timely basis.				
26. Standard journal entries are used to record sales.				
27. Invoices are posted to the sales and accounts receivable subsidiary ledgers or journals on a timely basis.				
28. Credit memos are posted to the general ledger on a timely basis.				
29. Credit memos are posted to the sales and accounts receivable subsidiary ledgers or journals on a timely basis.				
30. Procedures exist for determining proper cut-off of sales at month-end.				
31. The sales and accounts receivable balances shown in the general ledger are reconciled to the sales and accounts receivable subsidiary ledgers on a regular basis.				
C. Estimates and Disclosures for Sales Transactions				
32. The accounting system generates a monthly aging of accounts receivable.				
33. The people who prepare the aging are independent of—				
• Billing.				
• Collection.				
34. Management uses the accounts receivable aging to investigate, write off, or adjust delinquent accounts receivable.				
35. Management uses the accounts receivable aging and other information to estimate an allowance for doubtful accounts.				
36. The person responsible for financial reporting identifies significant concentrations of credit risk.				
II. Cash Receipts				
A. Initiating Cash Receipts Transactions				
1. The entity maintains records of payments on accounts by customer.				
2. Someone other than the person responsible for maintaining accounts receivable opens the mail and lists the cash receipts.				

	Personnel	N/A	No	Yes
3. Cash receipts are deposited intact.				
4. Cash receipts are deposited in separate bank accounts when required.				
5. People who handle cash receipts are adequately bonded.				
6. Local bank accounts used for branch office collections are subject to withdrawal only by the home office.				
B. Processing Cash Received on Account				
7. Cash receipts are posted to the general ledger on a timely basis.				
8. Cash receipts are posted to the accounts receivable subsidiary ledger on a timely basis.				
9. Standard journal entries are used to post cash receipts.				
10. The people who enter cash receipts to the accounting system are independent of the physical handling of collections.				
11. Timely bank reconciliations are prepared or reviewed by someone independent of the cash receipts function.				

End User Computing in the Revenue Cycle

.06 End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet which shows amortization of premiums or discounts, and the information from the spreadsheet is the source of a journal entry.

.07 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of computer applications operated by the company's MIS department. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the revenue cycle to process significant accounting information outside of the MIS department.

.08 You should obtain an understanding of any spreadsheet application, database, or separate computer system that has been developed by end users to—

- Process significant accounting information outside of the MIS-operated accounting application. For example, a spreadsheet accumulates invoices for batch processing.
- Make significant accounting decisions. For example, a spreadsheet application that ages accounts receivable and helps in determining write-offs.
- Accumulate footnote information. For example, a database of customers provides information about the location of customers for possible concentration of credit risk disclosures.

.09 In the space provided below, describe how end user computing is used in the revenue cycle. Describe—

- The person or department who performs the computing.
- A general description of the application and its type (e.g., spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

Procedures and Controls Over End User Computing

.10 Answer the following questions relating to procedures and controls over end user computing related to the revenue cycle.

Revenue Cycle	Personnel	N/A	No	Yes
1. End user applications listed in paragraph .09 of this form have been adequately tested before use.				
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.				
3. Access controls limit access to the end user application.				
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.				
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.				

Information Processed by Outside Computer Service Organizations

.11 The Computer Applications Checklist—Medium to Large Business Computer Applications was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the revenue cycle.

.12 In the space below, describe the revenue cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

Purchasing Cycle

Purchasing, Accounts Payable, and Cash Disbursements

.13 This checklist may be used on any audit engagement of a medium to large business where the purchasing cycle is significant. Normally, the purchasing cycle is significant for most businesses.

.14 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the purchasing cycle should be sufficient for you to understand—

- How purchases are initiated and goods received.
- How cash disbursements are recorded.
- How purchases and cash disbursements are processed by the financial reporting information system.
- The accounting records and supporting documents involved in the processing and reporting of purchases, accounts payable, and cash disbursements.
- The processes used to prepare significant accounting estimates and disclosures.

Interpreting Results

.15 This checklist documents your understanding of how internal control over the purchasing cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. To assess control risk below the maximum, you will need to design tests of controls and then test specific controls to determine the effectiveness of their design and operation.

.16 The processes, documents, and controls listed on this questionnaire are typical for medium to large business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.17

	Personnel	*N/A*	*No*	*Yes*
I. Purchases and Accounts Payable				
A. Initiating Purchases and Receipt of Goods				
1. All purchases over a predetermined amount are approved by management.				

	Personnel	N/A	No	Yes
2. Non-routine purchases (for example, services, fixed assets, or investments) are approved by management.				
3. A purchase order system is used, prenumbered purchase orders are accounted for, and physical access to purchase orders is controlled.				
4. Open purchase orders are periodically reviewed.				
5. The purchasing function is independent of—				
• Receiving				
• Invoice processing				
• Cash disbursements				
6. All goods are inspected and counted when received.				
7. Prenumbered receiving reports, or a log, are used to record the receipt of goods.				
8. The receiving reports or log indicate the date the items were received.				
9. The receiving function is independent of—				
• Purchasing				
• Invoice processing				
• Cash disbursements				
B. Processing Purchases				
10. Invoices from vendors are matched with applicable receiving reports.				
11. Invoices are reviewed for proper quantity and prices, and mathematical accuracy.				
12. Invoices from vendors are posted to the general ledger on a timely basis.				
13. Invoices from vendors are posted to the accounts payable subsidiary ledger on a timely basis.				
14. The invoice processing function is independent of—				
• Purchasing				
• Receiving				
• Cash disbursements				
15. Standard journal entries are used to post accounts payable.				
16. Accounts payable account per the general ledger is reconciled periodically to the accounts payable subsidiary ledger.				
17. Statements from vendors are reconciled to the accounts payable subsidiary ledger.				

	Personnel	N/A	No	Yes
C. Disclosures				
18. Management has the information to identify vulnerability due to concentrations of suppliers (SOP 94-6).				
II. Cash Disbursements				
A. Initiating Cash Disbursements				
1. All disbursements except those from petty cash are made by check.				
2. All checks are recorded.				
3. Supporting documentation such as invoices and receiving reports are reviewed before the checks are signed.				
4. Supporting documents are canceled to avoid duplicate payment.				
B. Processing Cash Disbursements				
5. Cash disbursements are posted to the general ledger on a timely basis.				
6. Cash disbursements are posted to the accounts payable subsidiary ledger on a timely basis.				
7. Standard journal entries are used to post cash disbursements.				
8. Timely bank reconciliations are prepared or reviewed by the owner or manager or someone independent of the cash receipts function.				

End User Computing in the Purchasing Cycle

.18 End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that amortizes premiums or discounts, and the information from the spreadsheet is the source of a journal entry.

.19 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of computer applications operated by the company's MIS department. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the purchasing cycle to process significant accounting information outside of the MIS department.

.20 You should obtain an understanding of any spreadsheet application, database, or separate computer system that has been developed by end users to—

- Process significant accounting information outside of the MIS-operated accounting application. For example, a spreadsheet accumulates non-routine purchases for batch processing.
- Make significant accounting decisions.
- Accumulate footnote information. For example, a database of vendors provides information for possible concentration of risk disclosures.

.21 In the space provided below, describe how end user computing is used in the purchasing cycle. Describe—

- The person or department who performs the computing.
- A general description of the application and its type (e.g., spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

Procedures and Controls Over End User Computing

.22 Answer the following questions relating to procedures and controls over end user computing related to the purchasing cycle.

Purchasing Cycle	*Personnel*	*N/A*	*No*	*Yes*
1. End user applications listed in paragraph .21 of this form have been adequately tested before use.				
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.				
3. Access controls limit access to the end user application.				
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.				
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.				

Information Processed by Outside Computer Service Organizations

.23 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the purchasing cycle.

.24 In the space below, describe the purchasing cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

Inventory

Inventory and Cost of Sales

.25 This checklist may be used on any audit engagement of a medium to large business where inventory is a significant transaction cycle.

.26 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the inventory cycle should be sufficient for you to understand—

- How costs are capitalized to inventory.
- How cost is relieved from inventory.
- How inventory costs and cost of sales are processed by the accounting system.
- The procedures used to take the physical inventory count.
- The accounting records and supporting documents involved in the processing and reporting of inventory and cost of sales.
- The processes used to prepare significant accounting estimates and disclosures.

Interpreting Results

.27 This checklist documents your understanding of how internal control over the inventory cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. To assess control risk below the maximum, you will need to design tests of controls and then test specific controls to determine the effectiveness of their design and operation.

.28 The processes, documents, and controls listed on this questionnaire are typical for medium to large business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.29

	Personnel	N/A	No	Yes
I. Inventory and Cost of Sales				
A. Capturing Capitalizable Costs[1]				
1. Management prepares production goals and schedules based on sales forecasts.				
2. The company budgets its planned inventory levels.				
3. All releases from storage of raw materials, supplies, and purchased parts inventory are based on approved requisition documents.				
4. Labor costs are reported promptly and in sufficient detail to allow for the proper allocation to inventory.				
5. The entity uses a cost accounting system to accumulate capitalizable costs.				
6. The cost accounting system distinguishes between costs that should be capitalized for GAAP purposes and those that should be capitalizable for tax purposes.				
7. For standard cost systems:				
a. Standard rates and volume are periodically compared to actual and revised accordingly.				
b. Significant variances are investigated.				
8. The cost accounting system interfaces with the general ledger.				
9. Transfers of completed units from production to custody of finished goods inventory are based on approved completion reports that authorize the transfer.				
10. The people responsible for maintaining detailed inventory records are independent from the physical custody and handling of inventories.				
11. Production cost budgets are periodically compared to actual costs, and significant differences are explained.				
B. Inventory Records				
12. The entity maintains adequate inventory records of prices and amounts on hand.				
13. Withdrawals from inventory are based on prenumbered finished inventory requisitions, shipping reports, or both.				

[1] You should also consider completing the Financial Reporting Information Systems and Controls Checklist for the purchasing cycle to document your understanding of how the purchase of inventory is initiated.

	Personnel	N/A	No	Yes
14. Additions to and withdrawals from inventory are posted to the inventory records and the general ledger.				
15. Standard journal entries are used to post inventory transactions to the inventory records and the general ledger.				
16. Inventory records are periodically reconciled to the general ledger.				
17. Inventory records are reconciled to a physical inventory count.				
C. Physical Inventory Counts				
18. Inventory is counted at least once a year.				
19. Physical inventory counters are given adequate instructions.				
20. Inventory count procedures are sufficient to provide an accurate count, including steps to ensure—				
• Proper cut-off.				
• Identification of obsolete items.				
• All items are counted once and only once.				
D. Estimates and Disclosures				
21. Management is able to identify excess, slow-moving, or obsolete inventory.				
22. Excess, slow-moving, or obsolete inventory is periodically written off.				
23. Management can identify inventory subject to rapid technological obsolescence that may need to be disclosed under SOP 94-6.				

End User Computing in the Inventory Cycle

.30 End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that amortizes premiums or discounts, and the information from the spreadsheet is the source of a journal entry.

.31 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of computer applications operated by the company's MIS department. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the inventory cycle to process significant accounting information outside of the MIS department.

.32 You should obtain an understanding of any spreadsheet application, database, or separate computer system that has been developed by end users to—

- Process significant accounting information outside of the MIS-operated accounting application. For example, a spreadsheet calculates overhead cost allocations.
- Make significant accounting decisions. A spreadsheet application tracks slow-moving items for possible write-off.

- Accumulate footnote information.

.33 In the space provided below, describe how end user computing is used in the inventory cycle. Describe—

- The person or department who performs the computing.
- A general description of the application and its type (e.g., spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

Procedures and Controls Over End User Computing

.34 Answer the following questions relating to procedures and controls over end user computing related to the inventory cycle.

Inventory Cycle	*Personnel*	*N/A*	*No*	*Yes*
1. End user applications listed in paragraph .33 of this form have been adequately tested before use.				
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.				
3. Access controls limit access to the end user application.				
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.				
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.				

Information Processed by Outside Computer Service Organizations

.35 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the inventory cycle.

.36 In the space below, describe the inventory cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

Financing

Investments and Debt

.37 This checklist may be used on any audit engagement of a medium to large business where investments or debt are a significant transaction cycle.

.38 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the financing cycle should be sufficient for you to understand—

- How investment decisions are authorized and initiated.
- How financing is authorized and captured by the accounting system.
- How management classifies investments as either trading, available-for-sale, or held to maturity.
- How investment and debt transactions are processed by the accounting system.
- The accounting records and supporting documents involved in the processing and reporting of investments and debt.
- The processes used to prepare significant accounting estimates, disclosures, and presentation.

Interpreting Results

.39 This checklist documents your understanding of how internal control is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. To assess control risk below the maximum, you will need to design tests of controls and then test specific controls to determine the effectiveness of their design and operation.

.40 The processes, documents, and controls listed on this questionnaire are typical for medium to large business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.41

	Personnel	*N/A*	*No*	*Yes*
I. Investments				
A. Authorization and Initiation				
1. Investment transactions are authorized by management.				
2. The company has established policies and procedures for determining when board of director approval is required for investment transactions.				
3. Management and the board assess and understand the risks associated with the entity's investment strategies.				
4. Investments are registered in the name of the company.				
5. At acquisition, investments are classified as trading, available-for-sale, or held-to-maturity.				
B. Processing				
6. Investment transactions are posted to the general ledger on a timely basis.				
7. Account statements received from brokers are reviewed for accuracy.				
8. Discounts and premiums are amortized regularly using the interest method.				
9. Procedures exist to determine the fair value of trading and available-for-sale securities.				
10. The general ledger is periodically reconciled to account statements from brokers or physical counts of securities on hand.				
C. Disclosures				
11. Management identifies investments with off-balance-sheet credit risk for proper disclosure.				
12. Management distinguishes between derivatives held or issued for trading purposes and those held or issued for purposes other than trading.				
13. The entity accumulates the information necessary to make disclosures about derivatives.				
II. Debt				
A. Authorization and Initiation				
1. Financing transactions are authorized by management.				

	Personnel	N/A	No	Yes
2. The company has established policies and procedures for determining when board of director approval is required for financing transactions.				
3. Management and the board assess and understand all terms, covenants, and restrictions of debt transactions.				
B. Processing and Documentation				
4. Debt transactions are posted to the general ledger on a timely basis.				
5. Any premiums or discount are amortized using the interest method.				
6. The company maintains up-to-date files of all notes payable.				
C. Disclosure				
7. Procedures exist to determine the fair value of notes payable for proper disclosure.				
8. Management reviews their compliance with debt covenants on a timely basis.				

End User Computing in the Financing Cycle

.42 End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that amortizes premiums or discounts, and the information from the spreadsheet is the source of a journal entry.

.43 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of computer applications operated by the company's MIS department. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the financing cycle to process significant accounting information outside of the MIS department.

.44 You should obtain an understanding of any spreadsheet application, database, or separate computer system that has been developed by end users to—

- Process significant accounting information outside of the MIS-operated accounting application. For example, a spreadsheet application calculates the amortization of premiums and discounts on investments.
- Make significant accounting decisions.
- Accumulate footnote information. For example, a spreadsheet application calculates five-year debt maturities for footnote disclosure.

.45 In the space provided below, describe how end user computing is used in the financing cycle. Describe—

- The person or department who performs the computing.
- A general description of the application and its type (e.g., spreadsheet).

- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

Procedures and Controls Over End User Computing

.46 Answer the following questions relating to procedures and controls over end user computing related to the financing cycle.

Financing Cycle	*Personnel*	*N/A*	*No*	*Yes*
1. End user applications listed in paragraph .45 of this form have been adequately tested before use.				
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.				
3. Access controls limit access to the end user application.				
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.				
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.				

Information Processed by Outside Computer Service Organizations

.47 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the financing cycle.

.48 In the space below, describe the financing cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.

- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

Property, Plant, and Equipment

Fixed Assets and Depreciation

.49 This checklist may be used on any audit engagement where fixed assets are a significant transaction cycle.

.50 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the property, plant, and equipment cycle should be sufficient for you to understand—

- How fixed asset transactions are authorized and initiated. (Additional information on the acquisition of fixed assets is documented on the Accounting Systems and Control Checklist for the Purchasing Cycle.)
- How fixed asset transactions and depreciation are processed by the accounting system.
- The accounting records and supporting documents involved in the processing and reporting of fixed assets and depreciation.
- The processes used to prepare significant accounting estimates and disclosures.

Interpreting Results

.51 This checklist documents your understanding of how internal control over property, plant, and equipment is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. To assess control risk below the maximum, you will need to design tests of controls and then test specific controls to determine the effectiveness of their design and operation.

.52 The processes, documents, and controls listed on this questionnaire are typical for medium to large business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.53

	Personnel	N/A	No	Yes
I. Fixed Assets and Depreciation				
A. Authorization and Initiation				
1. Fixed asset acquisitions and retirements are authorized by management.	______	___	___	___
B. Processing and Documentation				
2. The company maintains detailed records of fixed assets and the related accumulated depreciation.	______	___	___	___
3. Responsibilities for maintaining the fixed assets records are segregated from the custody of the assets.	______	___	___	___
4. The general ledger and detailed fixed asset records are updated for fixed assets transactions on a timely basis.	______	___	___	___
5. A process exists for the timely calculation of depreciation expense for both book and tax purposes.	______	___	___	___
6. The general ledger and detailed fixed asset records are updated for depreciation expense on a timely basis.	______	___	___	___
7. The general ledger is periodically reconciled to the detailed fixed asset records.	______	___	___	___
C. Disclosure and Estimation				
8. Management identifies events or changes in circumstances that may indicate fixed assets have been impaired (SFAS 121).	______	___	___	___
9. Management assesses and understands the risk of specialized equipment becoming subject to technological obsolescence (SOP 94-6).	______	___	___	___

End User Computing in the Property, Plant, and Equipment Cycle

.54 End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that amortizes premiums or discounts, and the information from the spreadsheet is the source of a journal entry.

.55 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of computer applications operated by the company's MIS department. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the revenue cycle to process significant accounting information outside of the MIS department.

.56 You should obtain an understanding of any spreadsheet application, database, or separate computer system that has been developed by end users to—

- Process significant accounting information outside of the MIS-operated accounting application. For example, a spreadsheet application calculates the depreciation expense.
- Make significant accounting decisions. For example, a spreadsheet application is used to analyze lease or buy decisions.
- Accumulate footnote information.

.57 In the space provided below, describe how end user computing is used in the property, plant, and equipment cycle. Describe—

- The person or department who performs the computing.
- A general description of the application and its type (e.g., spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

Procedures and Controls Over End User Computing

.58 Answer the following questions relating to procedures and controls over end user computing related to the property, plant, and equipment cycle.

	Personnel	*N/A*	*No*	*Yes*
Property, Plant, and Equipment Cycle				
1. End user applications listed in paragraph .57 of this form have been adequately tested before use.				
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.				
3. Access controls limit access to the end user application.				
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.				
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.				

Information Processed by Outside Computer Service Organizations

.59 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the property, plant, and equipment cycle.

.60 In the space below, describe the property, plant, and equipment cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

Payroll Cycle

Payroll Expense

.61 This checklist may be used on any audit engagement of a medium to large business where the payroll cycle is significant.

.62 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the payroll cycle should be sufficient for you to understand—

- How the time worked by employees is captured by the accounting system.
- How salaries and hourly rates are established.
- How payroll and the related withholdings are calculated.
- The accounting records and supporting documents involved in the processing and reporting of payroll.

Interpreting Results

.63 This checklist documents your understanding of how internal control over the payroll cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. To assess control risk below the maximum, you will need to design tests of controls and then test specific controls to determine the effectiveness of their design and operation.

.64 The processes, documents, and controls listed on this questionnaire are typical for medium to large business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.65

	Personnel	N/A	No	Yes
I. Payroll				
A. Initiating Payroll Transactions				
1. Wages and salaries are approved by management.				
2. Salaries of senior management are based on written authorization of the board of directors.				
3. Bonuses are authorized by the board of directors.				
4. Employee benefits and perks are granted in accordance with management's authorization.				
5. Senior management benefits and perks are authorized by the board of directors.				
6. Proper authorization is obtained for all payroll deductions.				
7. Access to personnel files is limited to those who are independent of the payroll or cash functions.				
8. Wage and salary rates and payroll deductions are reported promptly to employees who perform the payroll processing function.				
9. Changes in wage and salary rates and payroll deductions are reported promptly to employees who perform the payroll processing function.				
10. Adequate time records are maintained for employees paid by the hour.				
11. Time records for hourly employees are approved by a supervisor.				
B. Processing Payroll				
12. Payroll is calculated using authorized pay rates, payroll deductions, and time records.				
13. Payroll registers are reviewed for accuracy.				
14. Standard journal entries are used to post payroll transactions to the general ledger.				
15. Payroll cost distributions are reconciled to gross pay.				
16. Payroll information such as hours worked is periodically compared to production records.				
17. Net pay is distributed by persons who are independent of personnel, payroll preparation, time-keeping, and check preparation functions.				
18. The responsibility for custody and follow-up of unclaimed wages is assigned to someone who is independent of personnel, payroll processing, and cash disbursement functions.				
19. Procedures are in place to estimate the fair value of stock-based compensation plans.				

End User Computing in the Payroll Cycle

.66 End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that amortizes premiums or discounts, and the information from the spreadsheet is the source of a journal entry.

.67 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of off-the-shelf computer software accounting applications such as the general ledger. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the payroll cycle to process significant accounting information outside of the general accounting software.

.68 You should obtain an understanding of any spreadsheet application, database, or separate computer system that has been developed by end users to—

- Process significant accounting information outside of the MIS-operated accounting application. For example, a spreadsheet accumulates time card information for batch processing.
- Make significant accounting decisions. For example, a spreadsheet application is used to accumulate payroll information by job for further analysis.
- Accumulate footnote information.

.69 In the space provided below, describe how end user computing is used in the payroll cycle. Describe—

- The person or department who performs the computing.
- A general description of the application and its type (e.g., spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

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Procedures and Controls Over End User Computing

.70 Answer the following questions relating to procedures and controls over end user computing related to the payroll cycle.

	Personnel	N/A	No	Yes
Payroll Cycle				
1. End user applications listed in paragraph .69 of this form have been adequately tested before use.				
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.				
3. Access controls limit access to the end user application.				
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.				
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.				

Information Processed by Outside Computer Service Organizations

.71 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the payroll cycle.

.72 In the space below, describe the payroll cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

[*The next page is 4501.*]

AAM Section 4500
Flowcharting

Introduction

.01 AAM sections 4300 and 4400 provided a series of forms you may use to document your understanding of a client's internal control system. Included in those forms were several Financial Reporting Information Systems and Controls Checklists to document your understanding of the accounting system and controls for significant account balances. As an alternative or supplement to those checklists, you may wish to include a flowchart. In some instances, a flowchart may be easier to read and analyze than a checklist or memo.

.02 In general you will want to identify the following for your client's significant accounts and transactions:

- Source documents
- The conversion of documents to computer media
- The nature of computer files that are further processed in the flow of information to the general ledger and the financial statements
- Accounts (subsidiary or general ledger master files) affected by the transaction
- Relevant accounting reports, journals, and ledgers produced in the flow of information to the general ledger and the financial statements

.03 An entity's financial reporting information system may create many documents, files, and reports that are useful for managing the organization. As an auditor you need to understand and document only those aspects that are relevant to the audit of the financial statements. Documents, files, and reports that are not relevant to your audit need not be presented on a flowchart. For example, the same system that produces sales invoices and a sales journal may also produce a report of sales by salesperson. An understanding of this report may not be necessary to plan the audit.

.04 It is *not* necessary for you to understand how every copy of accounting documents may be used by the client. When the client prepares numerous copies of a document, you are concerned only with those relevant to the flow of transactions from initiation to inclusion in the financial statements.

Example: Jones Grocery

.05 *Jones Grocery is an eight-store chain of independent grocery stores in Anytown. The accounts payable cycle is described in the following paragraphs.*

.06 *When goods are received at each store, the store manager or another responsible employee counts and inspects the goods and checks them against the packing slip. A copy is retained by the store manager and the original is forwarded to the main store for processing.*

.07 *All vendor invoices are mailed directly to the main store, to the attention of Mrs. Jones. Her assistant matches the invoices to the packing slips received from individual stores. He investigates any discrepancies between quantities billed and quantities received, per the packing slips. He also follows up on any invoices received for which the store manager has not forwarded the packing slip.*

.08 *The invoices are coded and then entered into the accounts payable module of the company's accounting software system. The invoices with attached packing slips are stored in a temporary file until they are paid.*

.09 *The computer system automatically updates the general ledger. It also produces two reports: an accounts payable subledger and an accounts payable aging. When statements are received from the vendors, Mrs. Jones checks them against the accounts payable subledger and investigates any differences. Periodically, she reconciles the accounts payable subledger to the general ledger. The accounts payable aging is checked to make sure totals agree to the accounts payable subledger.*

.10 *Mr. Jones writes the checks. There is a module in the software that links the accounts payable module to the cash disbursements module and automatically prints checks, but this was too confusing to install. The volume of checks is not that great, so the company prepares them manually.*

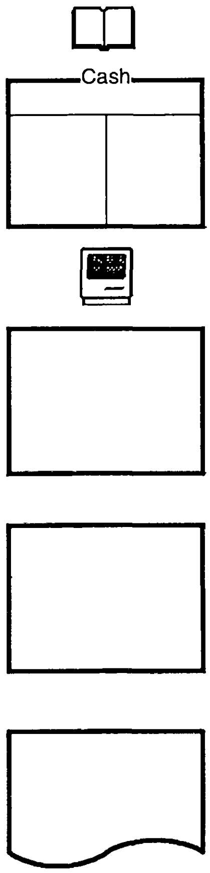
.11 *Vendors are paid by invoice, not by statement. Payments are made monthly. Mr. Jones uses the accounts payable aging to determine which invoices should be paid. He marks these on the report and gives it to his secretary to prepare the checks. The matched vendor invoices and receiving reports that have been stored in temporary files are attached to the typed check for Mr. Jones' signature. Two check copies are retained: one is attached and filed with the invoice and a second is filed numerically.*

.12 *Once the checks are signed, they are coded and entered into the cash disbursements module of the accounting software package. The software updates the general ledger, the accounts payable subledger and aging, and produces a cash disbursements report. It also produces a cash management report that may be used to estimate the future cash needs of the business.*

.13 *Monthly, the cash disbursements report is used to reconcile the cash accounts to the bank statements.*

The Flowchart

.14 The flowchart on the following page illustrates how an auditor might flowchart the accounts payable system described in AAM section 4500.05 through .13. The following symbols have been used.



General ledger

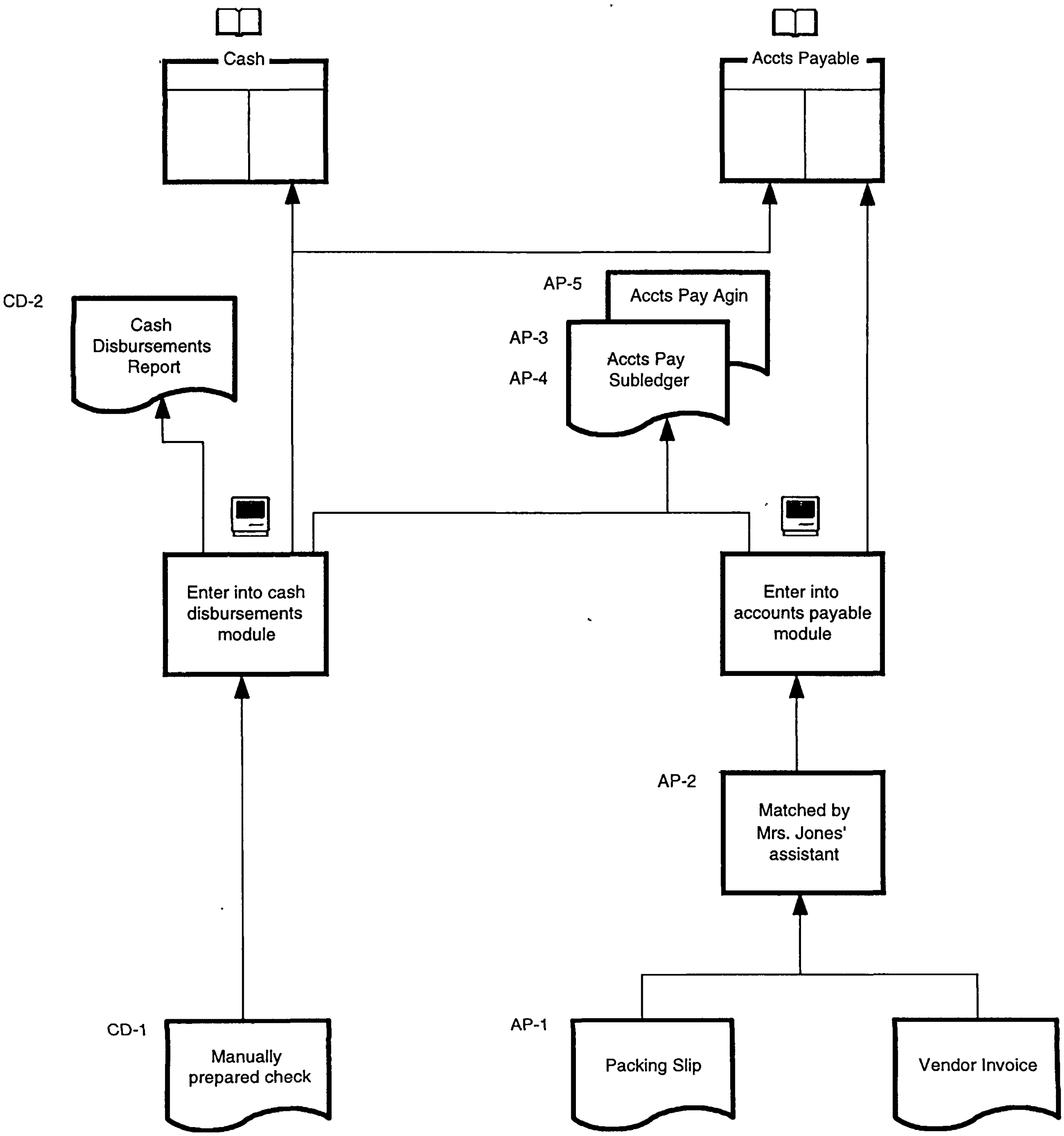
Computer process

Manual process

Source document or subledger

AP-1 Control procedure

Jones Grocery
Accounts Payable



.15 The flowchart should be read from the bottom to the top. The initiation of transactions and related source documents are depicted at the bottom of the page. The processing is described as an upwards flow until the information reaches the general ledger at the top of the page.

.16 Following the flowchart is a brief memo describing the controls that are documented on the flowchart.

Jones Grocery
Accounts Payable

Control No.	*Description*
AP-1	Store managers count and inspect goods received and compare to the packing slip.
AP-2	Packing slips are matched to vendor invoices and discrepancies are investigated.
AP-3	Accounts payable subledger is checked against monthly statements received from vendors. Differences are investigated.
AP-4	Accounts payable subledger is reconciled to the general ledger
AP-5	Accounts payable aging is reconciled to accounts payable subledger
CD-1	Accounts payable aging is used to determine which invoices to pay. Invoices and packing slips are attached to checks ready for signature.
CD-2	Cash disbursements journal is used to reconcile cash balances to monthly bank statements.

Analysis

.17 The flowchart on the preceding page includes only those documents, records, and processes that are relevant to the audit of the financial statements. The narrative description of the system included in AAM section 4500.05 through .13 included several items that are not relevant to the audit. These items are that—

- Individual stores maintain a copy of the packing slip (AAM section 4500.06).
- Invoices and packing slips are stored in a temporary file (AAM section 4500.08).
- Two check copies are retained: one is attached and filed with the invoice and a second is filed numerically (AAM section 4500.11).
- The system generates a cash management report (AAM section 4500.12).

.18 Because the above items are not relevant to the audit, they are not included on the flowchart.

.19 The flowchart starts at the bottom of the page with the initiation of the transaction. In the case of the cash disbursement, the transaction is initiated when Mr. Jones signs and mails the checks. Reviewing the accounts payable aging and checking off invoices is not a transaction that has accounting significance. This is a control activity that is described in narrative form. It is not depicted on the flowchart.

.20 The flowchart depicts the direct flow of accounting information, from the initiation of the transaction to the inclusion in the general ledger. Documents, reports, and processes outside of this direct flow need not be documented.

[*The next page is 4601.*]

AAM Section 4600

Assessing Control Risk Below the Maximum

Introduction

.01 As described in AAM section 3125, you may choose one of two general audit strategies.

- A primarily substantive approach, where control risk is assessed at or slightly below the maximum, or
- An approach where control risk is assessed below the maximum.

.02 Control risk should be assessed at the maximum (primarily substantive approach) for some or all assertions if—

- Controls are unlikely to pertain to an assertion.
- Controls are unlikely to be effective.
- It would not be efficient for you to obtain evidential matter to evaluate the effectiveness of controls.

.03 Thus, you may choose to assess control risk at the maximum either for audit efficiency purposes or because of ineffective controls. If you choose a primarily substantive audit because the controls are ineffective, you may have additional concerns about the auditability of the entity and other questions. Assuming you are able to overcome auditability concerns, you may respond by heightening the degree of professional skepticism, assigning more experienced staff, and changing the nature, timing, and extent of substantive procedures.

.04 Assessing control risk below the maximum involves—

- Identifying specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions.
- Designing and performing tests of controls to evaluate the effectiveness of such controls.

.05 Controls can have either a pervasive effect on many assertions or a specific effect on an individual assertion, depending on the nature of the particular control component involved. The more direct the relationship between the control and the assertion, the more effective that control may be in reducing control risk for that assertion. For example, regular physical inventory count procedures are more likely to detect and correct misstatements than management's monitoring of gross-profit percentages.

.06 Note that the choice of an audit strategy is done at the *assertion* level and is not a global strategy for the entire audit. For some assertions, you may choose a primarily substantive approach; for other assertions, you may plan to assess control risk below the maximum.

.07 *Jones Grocery is a small chain of independent grocery stores in Anytown. Assume you have been the auditor of Jones Grocery for several years. During that time you have helped Mr. and Mrs. Jones design and implement the procedures used for the annual inventory count. The count itself is performed by an outside inventory count company that specializes in taking inventory at grocery stores. The outside company is supervised by Jones Grocery employees.*

Based on this knowledge of the controls for the physical inventory count, you may assess internal control risk below the maximum for the existence assertion related to inventory.

.08 In the above example, the audit strategy was determined at the assertion level. The physical count of inventory is a control directly related to the existence assertion. It has little relevance to the valuation assertion and no relevance to the completeness assertion. Thus, you are able to modify tests related to the existence assertion, for example, reducing the number of test counts or stores where inventory is observed. Substantive audit procedures related to other assertions (for example, proper pricing) should not be modified.

Performing Tests of Controls

.09 Tests of controls are directed toward the effectiveness of either—

- The design of the control, or
- The operation of the control.

.10 Tests directed toward the effectiveness of the *design* of controls are concerned with whether the control is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Tests to obtain such evidential matter ordinarily include—

- Tests performed in previous audits.
- Inquiries of appropriate personnel.
- Inspection of documents and reports.
- Observation of the application of specific controls.

.11 Tests directed toward the effectiveness of the operation of a control are concerned with how the control was applied, the consistency with which it was applied during the audit period, and by whom it was applied. These tests ordinarily include—

- Tests performed in previous audits.
- Inquiries of appropriate personnel.
- Inspection of documents and reports indicating performance of the control.
- Observation of the application of specific controls.
- Reperformance of the application of the controls by the auditor.

.12 For controls for which documentary evidence exists, you may choose to examine the documents. For other controls (for example, segregation of duties) documentation may not exist. These controls often can be tested only by inquiry and observation.

.13 For example, you may decide to obtain evidence of the effectiveness of the design and operation of an entity's budgetary control methods. You could make inquiries of management about what variations from budget are investigated and the controls for reporting the reasons for these variances. Based solely on this inquiry, you would generally assess control risk at the maximum.

.14 The effectiveness of tests of controls may be increased by examining reports generated and asking more detailed question (such as about whether personnel follow up on budgets or about the timeliness of the investigations or the nature of the reports). By combining these inquiries with examination of written explanations of variances, the auditor can determine the operating effectiveness of these controls. This documentation may provide direct evidence for assessing the effectiveness of these controls in preventing or correcting misstatements in the financial statements.

.15 When performing tests of controls, caution is necessary. The tests cannot support an assessment of control risk below the maximum unless they provide evidence to evaluate the effectiveness of design and operation of controls. Accordingly you should consider that—

- Evidence from prior audits may be affected by subsequent changes in internal control.
- Inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the effectiveness of a specific control.
- Evidence from inquiry alone depends on the extent of the inquiries.
- Observation of employees in the performance of their duties may corroborate evidence obtained from other sources, but pertains only to the point in time at which the observation was made.
- Evidence from inspection of documents depends on the extensiveness of inspections made.

Evidence From Prior Audits

.16 You can use evidence from prior audits to help support your assessment of control risk in the current audit. To evaluate the use of such prior period evidential matter for the current audit, you should consider—

- The significance of the assertion involved.
- The specific controls that were evaluated during the prior audits.
- The degree to which the effective design and operation of those controls were evaluated.
- The results of the tests of controls used to make those evaluations.
- The evidential matter about design or operation that may result from substantive tests performed in the current audit.
- The time that has elapsed since the performance of the tests of controls.

.17 When using evidence from prior audits, you should consider that changes—either in the controls themselves or in personnel—may have occurred subsequent to the prior audit. You should obtain current evidence about whether changes have occurred subsequent to the prior audit, as well as the nature and extent of any changes. You should obtain evidential matter about changes in effectiveness of design and about changes in operating effectiveness.

.18 When changes in internal control between audits are relatively minor, evidential matter obtained in prior audits may provide assurance for the current audit. Conversely, changes may be so significant that evidential matter obtained in prior audits may provide limited or no assurance for the current audit.

.19 You should also obtain evidence in the current audit about the continued operating effectiveness of controls for which the design has remained unchanged. Decisions about the degree of assurance from prior audit evidence and about additional evidential matter needed in the current audit are affected by adverse conditions that may affect whether the controls are likely to continue to operate effectively, such as—

- Changes in the nature of transactions being processed or increases in volume.
- Changes in management attitudes or reduction of supervision.
- High turnover of employees.
- Increases in responsibilities or workloads of employees.
- The effect of related controls that reinforce the continued effective operation of the controls, such as the following:
  - Documented procedures manuals.

— Close management supervision, including frequent communication and responsibility reporting.

— Computer general control activities.

.20 You should obtain evidence in the current audit about the operating effectiveness of changed controls. If there are significant changes in design, prior evidence provides little, if any, assurance in the current audit.

Computer Applications

.21 As described in AAM section 4200, your understanding of the control activities in the computerized environment generally comprise a combination of the following:

- User control activities
- Programmed control activities and manual follow-up activities
- Computer general control activities and manual follow-up activities

.22 User controls may provide evidence that the programmed control activities operate effectively, in which case you may choose to understand and test the user controls. If these controls are designed and operating effectively, these tests may support a lower control risk assessment.

.23 You might plan an audit strategy of testing programmed control activities and the related manual follow-up. For example, you might use computer-assisted audit techniques, such as generalized audit software or the processing of test data, to test the programmed control activities that produce an exception report. These tests provide evidence about the design and operation of programmed control activities; however, they do not provide evidence about the consistent application of the control activities. Evidence is provided only about the point in time when they are performed.

.24 If you test programmed control activities you also need to test the related manual follow-up activities, for example the activities used to follow up on the items listed on an exception report. The effectiveness of the control activities relates to both an accurate computer produced exception report and an effective manual follow-up of the exceptions.

.25 The degree to which you may need to test programmed control activities depends on the effectiveness of computer general control activities, especially the effectiveness of controls over the development of and changes to programs.

[*The next page is 4701.*]

AAM Section 4700
The Auditor's Assessment of Control Risk

.01 Most of the auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. SAS No. 31, *Evidential Matter* (AU section 326), presents assertions as representations by management that are embodied in financial statement components. In obtaining evidential matter in support of financial statement assertions, the auditor develops specific audit objectives in light of those assertions. There is not necessarily a one-to-one relationship between audit objectives and audit procedures.

.02 Assertions are classified in SAS No. 31 (AU section 326), according to the following broad categories:

- *Existence or occurrence.* Reported assets and liabilities actually exist at the balance-sheet date, and transactions reported in the income statement actually occurred during the period covered.
- *Completeness.* All transactions and accounts that should be included in the financial statements are included, and there are no undisclosed assets, liabilities, or transactions.
- *Rights and obligations.* The entity owns and has clear title to assets and liabilities which are the obligations of the entity.
- *Valuation or allocation.* The assets and liabilities are valued properly and the revenues and expenses are measured properly.
- *Presentation and disclosure.* The assets, liabilities, revenues, and expenses are properly classified, described, and disclosed in the financial statements.

.03 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), and SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55,* state that the auditor should assess control risk in terms of assertions for material components of the financial statements. Many practitioners may consider audit objectives that relate to the assertions when assessing control risk. SAS Nos. 55 and 78 (AU section 319) do not preclude or require any specific approach as long as control risk is ultimately assessed at the assertion level. For example, an approach of identifying internal control policies and procedures and relating those to significant audit objectives for account balances or transaction classes would be appropriate. Practice aids for documenting the assessed level of control risk using this approach are illustrated in AAM section 4700.05–.10.

.04 The following working papers are to be used to document the auditor's assessment of control risk. They are to be completed when it is expected that control risk is to be assessed below maximum for certain assertions. The working papers should be modified as needed and are not meant to cover all types of controls. They are to initially be completed in the planning phase of the audit. Based on the results of tests of controls, the auditor then determines whether the initial assessment of control risk is appropriate and documents their conclusion.

.05

ABC Company
Assessment of Control Risk
12/31/X6

Transaction Class or Account Balance	*Financial Statement Assertions*				
Revenues	*Existence/ Occurrence*	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*
1. Use of prenumbered shipping documents.	✓	✓	N/A	N/A	N/A
2. Shipping documents matched with prenumbered invoices.	✓	✓	N/A	N/A	N/A
3. EDP functions segregated from users.	✓	✓	✓	✓	✓
4. Sales and accounts receivable postings are reconciled.	N/A	✓	N/A	✓	✓
5. Billing function segregated from collection function.	✓	✓	✓	✓	✓
6. Recording of sales journal and subsidiary ledger segregated.	✓	✓	✓	✓	✓
7. Monthly statements sent to customers.	✓	N/A	N/A	✓	N/A
8. Invoices are reviewed and verified.	N/A	N/A	N/A	✓	N/A
9. Accounts receivable aging is reviewed periodically.	N/A	N/A	N/A	✓	✓
Initial Assessment of Control Risk:	Moderate	Low	N/A	Moderate	Moderate
Tests of Controls—W/P Ref.:					
Final Assessment of Control Risk:					

.06

ABC Company
Assessment of Control Risk
12/31/X6

Transaction Class or Account Balance	*Financial Statement Assertions*				
Purchases	*Existence/ Occurrence*	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*
1. Use of purchase requisitions, purchase orders, receiving reports, and matching with vendor invoices.	✓	✓	✓	N/A	N/A
2. Cancellation of used documents.	✓	N/A	N/A	N/A	N/A
3. Use of prenumbered documents.	N/A	✓	N/A	N/A	N/A
4. Calculations and amounts are verified.	N/A	N/A	N/A	✓	N/A
5. Purchases recorded on a timely basis.	N/A	✓	N/A	✓	✓
6. Use of voucher or subsidiary ledger.	✓	✓	✓	✓	✓
7. Segregation of purchasing, cash disbursement, and recording functions.	✓	✓	✓	✓	✓
8. Monthly reconciliation of subsidiary ledgers to control accounts.	N/A	✓	N/A	✓	✓
Initial Assessment of Control Risk:	Moderate	Moderate	High	Low	Low
Tests of Controls—W/P Ref.:					
Final Assessment of Control Risk:					

.07

ABC Company
Assessment of Control Risk
12/31/X6

Transaction Class or Account Balance	*Financial Statement Assertions*				
Inventory	*Existence/ Occurrence*	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*
1. Inventory listing including pricing and amounts maintained.	✓	N/A	N/A	✓	✓
2. Listing reconciled with general ledger periodically.	N/A	✓	N/A	✓	✓
3. Listing reconciled with actual count periodically.	✓	✓	N/A	✓	✓
4. Supporting documents reconciled with actual inventory received.	✓	✓	✓	N/A	N/A
5. Excess, slow moving, and obsolete inventory is identified and written off.	N/A	N/A	N/A	✓	N/A
6. Requisition documents are required for release of inventory.	✓	N/A	N/A	N/A	N/A
Initial Assessment of Control Risk:	Moderate	Low	Moderate	Low	Low
Tests of Controls—W/P Ref.:					
Final Assessment of Control Risk:					

.08

ABC Company
Assessment of Control Risk
12/31/X6

Transaction Class or Account Balance	*Financial Statement Assertions*				
Financing	*Existence/ Occurrence*	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*
1. Account statements are reviewed.	✓	N/A	N/A	N/A	N/A
2. Account statements are reconciled with the general ledger.	N/A	✓	N/A	✓	✓
3. Management identifies investments with off-balance sheet credit risk.	N/A	N/A	N/A	N/A	✓
4. Investments are registered in the name of the company and are authorized by the owner.	N/A	N/A	✓	N/A	N/A
Initial Assessment of Control Risk:	Moderate	Moderate	Low	Moderate	High
Tests of Controls—W/P Ref.:					
Final Assessment of Control Risk:					

.09

ABC Company
Assessment of Control Risk
12/31/X6

Transaction Class or Account Balance	*Financial Statement Assertions*				
Property, Plant, and Equipment	*Existence/ Occurrence*	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*
1. Fixed asset acquisitions and retirements are authorized by the owner.	✓	N/A	✓	✓	N/A
2. Detailed fixed asset records with accumulated depreciation are maintained.	N/A	N/A	N/A	✓	N/A
3. Records are reconciled to the general ledger periodically.	N/A	✓	N/A	✓	✓
4. Impairment of fixed assets is identified.	N/A	N/A	N/A	✓	N/A
Initial Assessment of Control Risk:	Moderate	Moderate	Moderate	Low	Moderate
Tests of Controls—W/P Ref.:					
Final Assessment of Control Risk:					

.10

ABC Company
Assessment of Control Risk
12/31/X6

Transaction Class or Account Balance	*Financial Statement Assertions*				
Payroll	*Existence/ Occurrence*	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*
1. Time cards or documents are approved by appropriate personnel.	✓	N/A	N/A	N/A	N/A
2. Segregation of timekeeping, personnel, and payroll functions exist.	✓	✓	✓	✓	✓
3. Use of prenumbered payroll checks exists and all checks are accounted for.	N/A	✓	N/A	N/A	N/A
4. Payroll checking account is reconciled monthly.	N/A	✓	N/A	✓	✓
5. Review and verification of payroll calculations is performed.	N/A	✓	N/A	✓	✓
6. Payroll is recorded on a timely basis.	N/A	✓	N/A	✓	✓
Initial Assessment of Control Risk:	Moderate	Low	N/A	Moderate	Moderate
Tests of Controls—W/P Ref.:					
Final Assessment of Control Risk:					

[*The next page is 5001.*]

AAM Section 5000
Audit Approach and Programs

The material included in these sections on audit approach and programs is presented for illustrative purposes only. The comments, illustrative audit objectives, and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

This manual is a nonauthoritative kit of practice aids. Accordingly, these sections include minimal explanation and discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate. Users should also note that this manual does not deal with specialized industry problems; reference should be made to applicable AICPA Audit and Accounting Guides.

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AAM Section 5100
Designing the Audit Program

.01 The objective of an audit is to express an opinion on whether financial statements present fairly in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards. The procedures that the auditor plans to use to gather evidence are outlined in an audit program.

.02 Since the audit program describes the evidence-gathering steps to be used in the audit, it should be carefully designed. Designing an audit program involves three major considerations:

a. Deciding *what* procedures to apply—the *nature* of audit tests

b. Deciding *when* to apply the procedures—the *timing* of audit tests

c. Deciding *which* items to apply the procedures to—the *extent* of audit tests

.03 Flowchart 1 presents an overview of the structure of the audit process. To design an audit program that is efficient and effective, the auditor should—

a. Identify the client's assertions regarding each material component of the financial statements.

b. Consider the risk of material misstatement.

c. Establish specific audit objectives relating to the assertions in the financial statements.

d. Determine the audit procedures to be performed to accomplish the audit objectives.

e. Determine when to perform the audit procedures.

f. Determine which of many items to apply audit procedures to.

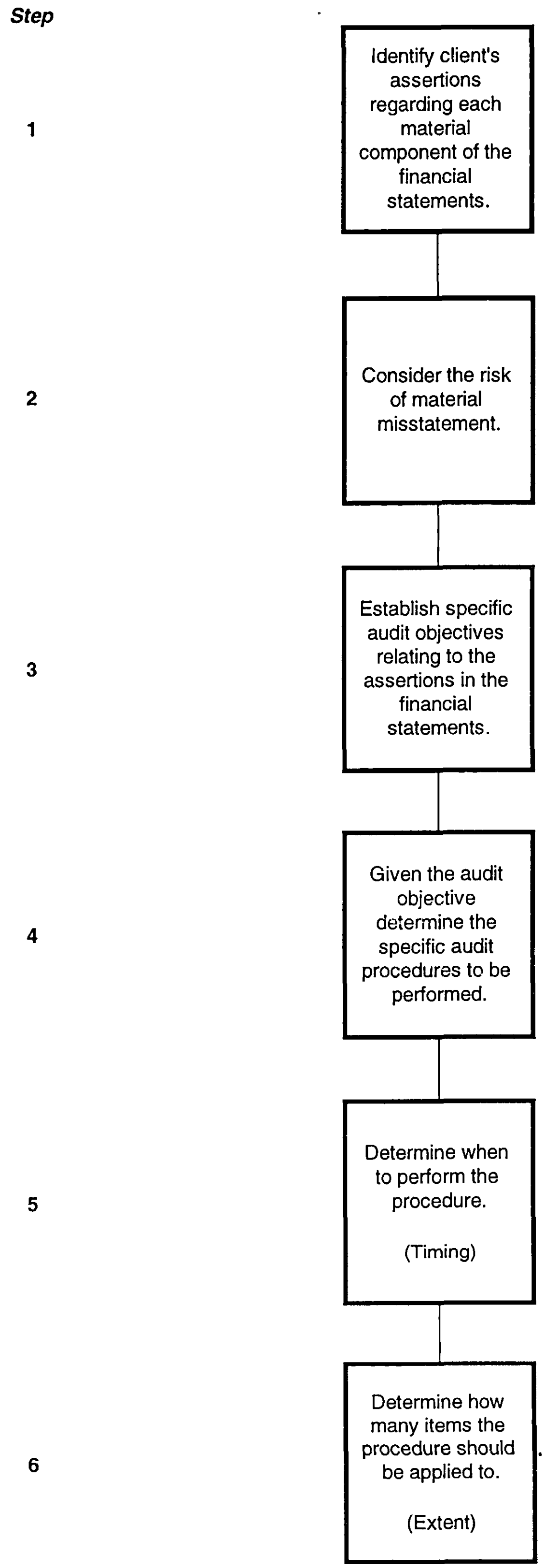
.04 The six steps illustrated in flowchart 1 result in a determination of the nature, timing, and extent of audit tests.

Financial Statement Assertions

.05 According to SAS No. 31, *Evidential Matter*, as amended by SAS No. 48 (AU section 326),* the independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. These assertions are embodied in the account balance, transaction class, and disclosure components of financial statements and are classified according to the following broad categories:

* In May 1995 the Auditing Standards Board issued a proposed amendment to SAS No. 31 (AU section 326), that would incorporate the concept of evidential matter in electronic form, including guidance on the potential audit impact of evidential matter in electronic form and a description of matters an auditor should consider in such circumstances. If approved, the final SAS would be effective for engagements beginning on or after January 1, 1997 with earlier application encouraged.

Flowchart 1
Audit Logic Process



a. *Existence or Occurrence.* Reported assets and liabilities actually exist at the balance-sheet date, and transactions reported in the income statement actually occurred during the period covered.

b. *Completeness.* All transactions and accounts that should be included in the financial statements are included, or there are no undisclosed assets, liabilities, or transactions.

c. *Rights and Obligations.* The company owns and has clear title to assets and liabilities are obligations of the company.

d. *Valuation or Allocation.* The assets and liabilities are valued properly, and the revenues and expenses are measured properly.

e. *Presentation and Disclosure.* The assets, liabilities, revenues, and expenses are properly classified, described, and disclosed in the financial statements.

Developing Audit Objectives

.06 A misrepresentation of any of the five financial statement assertions could cause a material misstatement in the financial statements. The auditor should consider the risk of material misstatement for each assertion in the financial statements, and then obtain evidence to support the financial statement assertions to reduce the risk of material misstatement to an acceptably low level. To determine what type of evidence to obtain, the auditor develops specific audit objectives related to each assertion.

.07 In determining audit objectives, the auditor should evaluate each of the five assertions as they relate to the specific account balance or class of transactions being examined. For example, if the auditor is attempting to gather evidence on the assertion of *existence* of inventory, the auditor's objective would be to gather evidence that inventory included in the balance sheet physically existed at the date of the balance sheet.

Figure 1

Relationship of Assertions and Objectives for Inventory

Financial Statement Assertion	*Illustrative Audit Objectives*
Existence or occurrence	—Inventories included in the balance sheet physically exist.
Completeness	—Inventory quantities include all products, materials, and supplies on hand.
	—Inventory quantities include all products. materials, and supplies owned by the client that are in transit or stored at outside locations.
	—Inventory listings are accurately compiled and the totals are properly included in the inventory accounts.
Right and obligations	—The entity has legal title or similar rights of ownership to the inventory.
Valuation or allocation	—Inventories are properly stated at cost (except when market is lower).
Presentation and disclosure	—Inventories are properly classified in the balance sheet as current assets.

An example of the relationship between financial statement assertions and audit objectives is shown in Figure 1.

Audit Tests

.08 After the auditor has determined the audit objectives, the method of achieving the objectives should be selected. Although these methods are referred to by various names such as audit procedures, audit techniques, and audit tests, they represent the evidence-gathering methods auditors use. The basic requirement for determining audit procedures, according to SAS No. 31, paragraph 12 (AU section 326.13), is that:

> The procedures adopted should be adequate to achieve the audit objectives developed by the auditor, and the evidential matter obtained should be sufficient for the auditor to form conclusions concerning the validity of the individual assertions embodied in the components of financial statements.

.09 Some audit procedures can satisfy a combination of audit objectives for a given account balance or class of transactions. For example, the auditor's observation of a physical inventory count can provide evidence that inventories physically exist and that inventory quantities include all products, materials, and supplies on hand.

.10 Audit tests or procedures can be classified or categorized in a variety of ways. The most common classifications are by purpose of the test or by type of test.

Purpose of the Test

.11 According to SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78 (AU section 319), the purpose of performing audit tests are:

a. To evaluate the effectiveness of the design and operation of internal controls. These tests are referred to as tests of controls.

b. To detect material misstatements in financial statement assertions. These tests are referred to as substantive tests.

.12 Substantive tests are procedures applied to account balances or classes of transactions to determine if there are material misstatements in the financial statements. The substantive test that the auditor performs consists of tests of details of transactions and balances and analytical procedures. In assessing control risk, the auditor also may use tests of details of transactions as tests of controls. The objective of tests of details of transactions performed as substantive tests is to detect material misstatements in the financial statements. The objective of tests of details of transactions as tests of controls is to evaluate whether controls operated effectively. Although these objectives are different, both may be accomplished concurrently through performance of a test of details on the same transaction.

.13 If the control risk is assessed at less than the maximum level, the auditor should obtain sufficient evidential matter to support that assessed level. The evidential matter that is sufficient to support a specific assessed level of control risk is a matter of auditor judgment. The type of evidential matter obtained all bear on the degree of assurance provided. Since the auditor's substantive testing is affected by the quality of the controls, the auditor is concerned with whether the controls established are designed and operating effectively. The role of tests of controls is to justify this assertion.

.14 The nature, timing, and extent of substantive tests are generally based on the assessment of inherent and control risk made during the planning phase of the engagement. For example, the higher the assessment of control risk, the more comprehensive the substantive tests should be. If analytical procedures performed during the planning phase of the engagement suggest that some account balances are unexpectedly high or low, the auditor may determine that those balances warrant more testing. Tests' effectiveness can be modified by changing their nature (for example, tests of balances versus analytical procedures), timing (testing as of the balance-sheet date versus an interim date), or extent (testing 100 percent versus sampling). Similarly, the auditor may be able to change the same factors to make audits more efficient. While the main objective is to perform an effective audit, if alternative tests are equally effective, the auditor should choose the most efficient one.

.15 Planning occurs throughout the engagement and as a result the auditor might have to reassess risk as the engagement unfolds. For example, even if tests of controls indicated that an area had low risk and the auditor planned substantive tests accordingly, information might come to the auditor's attention during the audit that requires reassessment of the risk. Such information might include, for example, unexpected deviations from control procedures, misstatements that the internal controls should have caught, or new information about transactions or balances.

.16 The most effective and efficient audit strategy for a small business engagement generally is to assess the control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control). In this case, the auditor will use the knowledge obtained from the understanding of internal control and the assessed level of control risk in designing substantive tests for financial statement assertions.

Type of Test

.17 Auditors perform four types of tests:

a. Analytical procedures

b. Inquiry and observation

c. Tests of transactions

d. Tests of balances

The relationship of audit tests by purpose to audit tests by type is shown in figure 2.

Analytical Procedures

.18 Analytical procedures are tests applied to the *total* recorded amounts and are based on the existence of plausible and consistent relationships among financial statement elements or between financial and nonfinancial amounts. Analytical procedures are used for the following purposes:

a. To assist the auditor in planning the nature, timing, and extent of other auditing procedures.

b. As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.

c. As an overall review of the financial information in the final review stage of the audit.

.19 Analytical procedures can be effective:

- For certain types of assertions (for example, the completeness assertion, which cannot be tested directly using a test of balances on recorded amounts).
- When the relationships between amounts are very predictable.
- When the data used to develop expectations based on the relationship are reliable.
- When relatively precise expectations can be developed.

.20 Analytical procedures can provide evidence supporting financial statement assertions and, thus, can be used as substantive tests. Because analytical procedures are often the least expensive tests, they should be used whenever practical.

.21 SAS No. 56, *Analytical Procedures* (AU section 329), describes analytical procedures as follows:

Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:

a. Financial information for comparable prior period(s) giving consideration to known changes.

b. Anticipated results—for example, budgets, or forecasts including extrapolations from interim or annual data.

c. Relationships among elements of financial information within the period, such as interest income in relation to the average loan balance.

d. Information regarding the industry in which the client operates—for example, cost of funds information.

e. Relationships of the financial information with relevant nonfinancial information.

.22 Whenever analytical procedures are applied as substantive tests, the auditor must apply the following procedures:

a. Consider whether the relationship is plausible and predictable.

b. Consider whether the data used for the comparison is reliable.

c. Consider whether the account balance tested is consistent with the auditor's expectations. If it is not consistent, obtain the client's explanation for the variance and get evidence to corroborate the client's explanation.

.23 SAS No. 56 (AU section 329) also requires that analytical procedures be performed at the planning and final review stages of the audit.

Inquiry and Observation

.24 Testing of controls that leave no audit trail of documentary evidence is usually tested by inquiry and observation. Auditors make inquiries of different individuals and conduct observation tests to determine who performs a particular activity or how or when the activity is done. For example, the auditor may ask different individuals about who posts to the receivables ledger, the auditor may observe who prepares the bank reconciliation, or the auditor may observe when cash is deposited in the bank.

.25 Inquiry and observation can also be used as substantive tests. For example, an audit procedure such as observation of a *physical asset* to determine that it exists is a substantive test relating to the existence assertion. Likewise, inquiries regarding subsequent events would be a substantive test because they provide evidence regarding the adequacy of disclosures in the financial statements.

Matrix of Audit Tests by Purpose and Type *Figure 2*

		Purpose of Test	
		Substantive Test	Test of Controls
Type of Test	Analytical Procedures	Yes Example A	No
	Inquiry and Observation	Yes Example H	Yes Examples B, C
	Tests of Transactions	Yes Example D	Yes Examples E, F
	Tests of Balances	Yes Examples G, H	No

Examples:

A—Comparison of this year's expenses with last year's expenses

B—Observation by auditor that cash is deposited daily by a specific clerk

C—Inquiry by auditor about who deposits cash and how often

D—Examination of invoices to support additions (specific transactions) to fixed assets account during year

E—Examine sales invoices to see if initials of credit manager are there to indicate a credit file and credit approval (Inspection Test)

F—Vouch from sales invoices to credit files to see if customer has a credit file and has been approved for credit (Reperformance Test)

G—Confirmation of year-end balances in accounts receivable

H—Observation of the existence of a building

Tests of Transactions

.26 Tests of transactions consist of the examination of the documents and accounting records involved in the processing of specific transactions. Such procedures can accomplish both testing of controls and substantive testing and are sometimes used concurrently.

.27 Tests of controls are accomplished when the auditor examines transaction documentation to determine if controls have been applied as prescribed. Tests of transactions as tests of controls can be classified as either inspection tests or reperformance tests. If the auditor examines documentation, the tests of controls are classified as an inspection test. Alternatively, if the auditor repeats controls performed by the client, the tests of controls are classified as reperformance tests. For example, a control may require employees to match vendors' invoices with purchase orders and receiving reports and then initial the invoices to indicate that the procedure was performed. If the auditor tests the control by examining invoices for initials, the test is an inspection test. If the auditor tests the control by comparing vendors' invoices with purchase orders and receiving reports, the test is a reperformance test. Regardless of whether the auditor tests by inspection or reperformance, the test of control is a test of transactions.

.28 The substantive objective of tests of transactions is accomplished when the auditor examines transaction documentation to determine if dollar errors exist in a balance. For example, if the auditor examines documentation supporting individual charges (debits) to an equipment account to determine that the account balance is fairly stated, the test is classified as a substantive test of transactions.

Tests of Balances

.29 Tests of balances are procedures applied to the *individual items* that compose an account balance or class of transactions. The tests involve confirmation, inspection, or observation procedures to provide evidence about the recorded amount. Tests of balances are substantive tests designed to identify misstatements by a direct test of the ending balance rather than by testing the transactions that make up that balance.

.30 Substantive tests of transactions and tests of balances are interrelated in that each class of transactions affects a related account balance. Since financial statement amounts are the accumulation of transactions, an auditor may test the transactions that enter the account (that is, the debits and credits), the account balance itself (that is, the ending balance), or both.

Linking Audit Procedures to Objectives

.31 To design an audit program, the audit should select audit procedures that achieve specific audit objectives developed from the five broad assertions for each material account balance in the financial statements.

.32 In selecting audit procedures to achieve the audit objectives developed, an auditor considers the following, according to SAS No. 31, as amended:

a. The risk of material misstatement of the financial statements including the assessed levels of control risk.

b. The expected efficiency and effectiveness of possible audit procedures.

c. The nature and materiality of the items being tested.

d. The kinds and competence of available evidential matter.

e. The nature of the audit objective to be achieved.

The Completeness Assertion

.33 SAS No. 31, paragraph 5, as amended (AU section 326.05), discusses the completeness assertion:

> Assertions about completeness deal with whether all transactions and accounts that should be presented in the financial statements are so included. For example, management asserts that all purchases of goods and services are recorded and are included in the financial statements. Similarly, management asserts that notes payable in the balance sheet include all such obligations of the entity.

.34 Substantive tests that provide assurance regarding the completeness assertion are those that provide evidence about whether all transactions have been captured by the client's accounting system and are included in the financial statements.

.35 Gathering evidence about whether all transactions have been recorded is one of the most difficult audit objectives to achieve. Evidence of completeness can be even more difficult to obtain when a client does not have good internal control or has only an informal record-keeping system. Because these two characteristics often apply to small business, satisfying the completeness objective can be difficult for the auditor in a small business engagement.

.36 Completeness relates to whether all items have been included in the financial statements. The completeness assertion is violated if a transaction or account is omitted from the financial statements. If a transaction is merely recorded in the wrong account, there is no violation of the completeness assertion since the transaction is still recorded in the financial statements. In such a situation, the accounts are not incorrect because of a completeness error; rather, they are incorrect because of a classification error. A classification error is a violation of the presentation and disclosure assertion.

.37 For many accounts, the completeness assertion is the most difficult to test. The difficulty arises because the auditor must gather evidence about potential unrecorded items. Sources of audit evidence regarding unrecorded items often are not readily available.

Lack of Evidence

.38 To give an unqualified opinion, the auditor must gather sufficient, competent evidential matter to reduce the level of audit risk to an appropriately low level. SAS No. 31, paragraph 23, as amended (AU section 326.23), provides the following guidance when the auditor is unable to gather sufficient evidence to be satisfied regarding the completeness assertion:

> To the extent the auditor remains in substantial doubt about an assertion of material significance, he must refrain from forming an opinion until he has obtained sufficient competent evidential matter to remove such substantial doubt, or he must express a qualified opinion or a disclaimer of opinion.

.39 SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, paragraph 8 (AU section 316.08), states:

> The auditor should exercise (*a*) due care in planning, performing and evaluating the results of audit procedures, and (*b*) the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected. Since the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor is not an insurer and his report does not constitute a guarantee.

.40 SAS No. 31, as amended, requires the auditor to obtain evidence concerning inclusion in the financial statements of all types of transactions that the auditor has reason to believe has occurred based on the auditor's knowledge of the client and the industry in which it operates. The excerpt from SAS No. 53 (AU section 316), refers to transactions which the auditor has reason to believe have occurred. Utilizing professional skepticism while performing the audit, this would require the auditor to question transactions which are peculiar to the particular client or industry as well as questioning the lack of specific types of transactions.

.41 The results of a research study on audit problems encountered in small business engagements (Auditing Research Monograph No. 5) indicates that many practitioners sometimes accept client representations as sufficient audit evidence when completeness of recorded transactions cannot be substantiated.[1] Client representations are part of the evidential matter the auditor gathers, but they should not be used as a substitute for the performance of those procedures considered necessary to form an opinion on the financial statements. An auditor cannot rely on client representations alone as sufficient audit evidence to substantiate the completeness of account balances and classes of transactions. Obtaining such representations complements but does not replace other auditing procedures that the auditor should perform. [See Auditing Interpretation No. 3 of SAS No. 31, "The Auditor's Consideration of the Completeness Assertion" (AU section 9326.18–.21).] When an auditor is unable to form an opinion, even though representations from the client have been received, there is a limitation on the scope of the audit that precludes the auditor from issuing an unqualified opinion (SAS No. 19, *Client Representations*, paragraph 12 [AU section 333.12]).

Controls for Completeness

.42 Controls for completeness are designed (1) to count or otherwise identify transactions executed by the entity and (2) to provide reasonable assurance that all transactions have been accurately recorded by the accounting system. For example, completeness controls over purchases can include reconciliation of all pre-numbered receiving reports that are missing, not recorded, or not otherwise accounted for. Many auditors prefer to rely on controls gathering evidence of completeness since extensive substantive tests for completeness may be more difficult to design than those for other SAS No. 31 assertions.

.43 If the auditor desires to assess control risk at less than the maximum level, tests of controls should be performed to determine that the controls are working as prescribed to make that control risk assessment.

[1] D.D. Raiborn, Auditing Research Monograph No. 5, *Audit Problems Encountered in Small Business Engagements* (New York: AICPA, 1982), p. 74.

Once the control risk is assessed at less than maximum, the auditor may restrict substantive procedures designed to obtain evidential matter regarding the completeness assertion. Taken alone, the assessed level of control risk, ordinarily, is not sufficiently low to eliminate the need to perform any substantive tests. In addition, small businesses often lack segregation of duties, which usually prevents the auditor from assessing control risk at a low level. As a result, it is necessary to perform substantive tests of the completeness assertion.

Substantive Tests

.44 Many substantive tests are of limited usefulness in detecting errors of omission because they are usually applied to recorded amounts. Unrecorded transactions are not included in the account balances or classes of transactions to which the auditor applies substantive tests.

.45 Of all the financial statement assertions, only completeness involves consideration of whether there are material amounts that are not included in the account balance or class of transactions being tested. Therefore, substantive tests of the completeness assertion differ somewhat from substantive tests of other financial statement assertions. The difference is highlighted by the following excerpt from SAS No. 31, paragraph 11, as amended (AU section 326.11):

> In designing substantive tests to achieve an objective related to the assertion of existence or occurrence, the auditor selects from items contained in a financial statement amount and searches for relevant evidential matter. On the other hand, in designing procedures to achieve an objective related to the assertion of completeness, the auditor selects from evidential matter indicating that an item should be included in the relevant financial statement amount and investigates whether that item is so included.

.46 Substantive tests can be designed to provide evidential matter to support a conclusion that specific account balances are not misstated by amounts that would cause the financial statements, taken as a whole, to be materially misstated because of unrecorded transactions.

.47 Important sources of evidential matter for completeness include source documents, such as order logs, shipping and receiving documents, and checks. One common test of completeness involves tracing amounts from source documents to amounts recorded in the accounting records. For example, the auditor may vouch selected cash disbursements after the end of the audit period to test the completeness of amounts recorded as accounts payable at the balance-sheet date. Other substantive procedures that provide evidence concerning the completeness of financial statement account balances include the following:

a. Sales-and-purchases cutoff procedures that include tracing shipping and receiving documents processed after the audit period to accounting records for the proper period.

b. Analytical procedures in which the auditor investigates relationships among data that indicate a financial statement account or balance may be understated. For example, the auditor may obtain evidence that all interest-bearing debt is recorded by examining the relationship between recorded interest expense and the average balance of interest-bearing debt outstanding for the period. Disproportionate relationships based on the auditor's knowledge of interest rates should be investigated. Other examples include: a comparison of investment income to average investments for the period to test whether income earned on investments is recorded; the relationship of average pay times number of employees to payroll expense to substantiate that salaries are recorded; and the relationship of membership fee revenue to the number of members of an organization.

c. Confirmations of balances or transactions designed to identify unrecorded amounts, such as accounts payable confirmations that request the creditor to specify the amount of the client's obligation.

d. Tests of bank reconciliations, including examination of checks clearing the bank after the audit period to identify cash disbursements processed but not recorded or inappropriately recorded in the subsequent period.

e. Reading the minutes of the meetings (of the) board of directors and stockholders and tracing transactions authorized in the minutes to amounts recorded in the accounting records.

f. Overall reconciliations using financial and nonfinancial data, such as "proofs" of cash and sales.

[*The next page is 5201.*]

AAM Section 5200
Timing of Audit Tests

.01 During the planning stage of the audit, the auditor should consider *when* to apply audit tests. In a small business engagement, the auditor typically assesses control risk at the maximum level and does not perform tests of controls. As a result, the question of when to perform audit tests in small business engagements frequently applies only to substantive testing.

.02 The determination of whether substantive tests can or should be applied prior to year-end is usually based on practical considerations. In making that determination, the auditor evaluates the benefits of performing a substantive test prior to year-end against the potential costs of performing such interim work.

.03 For example, the auditor considers whether the benefits of easing pressures caused by a tight year-end reporting deadline outweigh the cost of gathering additional audit evidence necessitated by the use of a less effective test at an interim date.

.04 Substantive tests can be divided into two categories: those that can generally be applied at an interim date and those that *may be* efficient at an interim date only if certain conditions are met.

.05 If substantive testing is performed at an interim date, roll-forward work should be performed to provide evidence relating to the account balances at the balance-sheet date. In addition, if balances are tested at an interim date, the auditor should:

- Consider whether there are rapidly changing economic conditions that might predispose management to misstate the financial statements in the period after the date tested,
- Compare information concerning the balance at the balance-sheet date with comparable information at the interim date tested to identify unusual amounts,
- Apply additional tests of balances or analytical procedures to provide a reasonable basis for extending the conclusions about the balance at the interim date to the balance at the balance-sheet date, and
- Consider coordinating the tests of interrelated accounts and cutoffs.

Generally balances are tested as of an interim date only when control risk for the related assertions is assessed at below the maximum.

Substantive Tests That Can Generally Be Applied at an Interim Date

.06 Some substantive tests can generally be performed through any date prior to year-end and still be efficient and effective tests. Substantive tests that fall into this category are tests that apply to data readily available prior to year-end. Such tests include:

a. Substantive tests of transactions to support balance sheet accounts (for example, supporting the details of additions and retirements to a fixed asset account)

b. Substantive tests of transactions to support income statement accounts (for example, reviewing all charges over a certain dollar amount to the repairs-and-maintenance account)

c. Analytical procedures that include calculations on an interim basis (for example, comparing actual and budgeted expenses for each month)

.07 In each of these tests, the auditor reviews information that is already available at an interim date. Even is these tests were done at year-end, the same information would be needed and the same procedure performed. Thus, these tests generally can be efficient when performed at an interim date.

.08 For example, auditors frequently support those balance sheet accounts with low activity, such as fixed assets, by analyzing the transactions within the account during the year. Consequently, for property, plant, and equipment the auditor can audit the account by analyzing material additions and retirements rather than by testing the ending balance. To support additions the auditor may vouch material additions to invoices. Vouching such invoices may be performed before year-end without reducing the efficiency or effectiveness of the test. At year-end, the auditor still may have to vouch invoices from the interim date to year-end. However, these invoices would have to be vouched regardless of whether the interim work was performed.

Conditional Substantive Tests

.09 Other substantive tests may be efficient when applied prior to year-end only if certain conditions are met. Generally, such substantive tests should only be applied prior to year-end if substantive tests for the remaining period from the interim date to year-end can be restricted.

.10 SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Substantive Tests Prior to the Balance Sheet Date" (AU section 313), describes several factors that should be considered before applying substantive tests to details of balance sheet accounts at interim dates. Those factors relate to the ability to control the additional risk of not detecting errors that may exist at the balance-sheet date when the balance is tested at an interim date. Factors described include:

a. Whether the effectiveness of the tests will be impaired because of the auditor's assessment of the control risk

b. Whether rapidly changing business conditions or circumstances might predispose management to misstate the financial statements between an interim date and year-end

c. Whether the year-end balances of the particular balance sheet accounts that might be selected for interim testing, are reasonably predictable with respect to amount, relative significance, and composition

.11 In many small business engagements, the cost of bringing the additional risk to an acceptably low level is too great. SAS No. 45 notes that "applying substantive tests . . . at an interim date may not be cost-effective if substantive tests to cover the remaining period cannot be restricted due to the assessment of control risk." In the case of a small business with limited segregation of duties, these substantive tests are generally not performed at an interim date because to do so would be inefficient. For example, in a small business engagement, the auditor generally audits cash, accounts receivable, inventory, and accounts payable at year-end.

[*The next page is 5301.*]

AAM Section 5300
Extent of Testing

.01 Once an auditor decides what audit procedures to apply (the nature of the tests) and when to apply them (the timing of the tests), a decision must be made about how many items to apply the procedures to—that is, the extent of testing.

Authoritative Standards*

.02 SAS No. 39, *Audit Sampling* (AU section 350), addresses a variety of issues relating to the auditor's use of sampling in an audit engagement. However, SAS No. 39 does not always apply when the auditor is examining less than 100 percent of a population. There has been some confusion in practice over when SAS No. 39 applies.

When SAS No. 39 Applies

.03 Audit sampling is only one of many tools used by auditors to obtain sufficient, competent evidential matter to support an opinion on financial statements. SAS No. 39 discusses design, selection, and evaluation considerations to be applied by the auditor when using audit sampling. As a general rule, audit sampling can be used—

a. In tests of controls in internal control to evaluate operating effectiveness from prescribed controls.

b. In substantive tests of details of account balances and classes of transactions.

c. In dual-purpose tests that assess control risk and test whether the monetary amount of a transaction is correct.

.04 The portion of SAS No. 39 pertaining to tests of controls applies when sampling techniques are used to assess control risk. The portion pertaining to substantive tests apply when sampling techniques are used to test details of transactions or balances.

.05 According to SAS No. 39, sampling occurs when the auditor tests less than 100 percent of a population *to make some conclusion about the population.* SAS No. 39 applies to tests of controls when such tests are performed and to tests of balances when sampling populations are material. The extent to which sampling is used in an audit depends on the size of the client and the nature of the client's internal control. Also, if the sampling populations are small, it is usually more efficient to audit individually significant items and obtain audit assurance about the remaining balance through analytical procedures than to perform audit sampling. As the size and sophistication of the client's internal control increases, the auditor is more likely to use audit sampling to perform tests of controls and tests of balances.

.06 In determining whether SAS No. 39 is applicable to circumstances in which an auditor examines less than 100 percent of the items making up an account balance or class of transactions, the auditor should consider the purpose of the test. If the auditor intends to project the test results to the entire account balance or class of transactions for the purpose of evaluating a characteristic of the balance or class, the guidance in SAS No. 39 should be followed. For example, if the auditor intends to examine selected sales invoices to draw

* The Audit and Attest Standards Division of the AICPA is developing an Auditing Procedure Study (APS) to replace the AICPA Audit and Accounting Guide *Audit Sampling* (the Audit Sampling Guide). The APS is expected to be issued in the fourth quarter of 1996.

a conclusion about whether sales are overstated, audit sampling as described in SAS No. 39 should be applied because the auditor intends to draw a conclusion about all sales. On the other hand, if the auditor selects several large sales invoices for certain audit tests and then applies analytical procedures to the remaining invoices, the auditor is not sampling according to SAS No. 39—the examination of the large items is not intended to lead the auditor to a conclusion about the other items. In that case, any conclusion about whether sales are overstated would be based on the combined results of the test of large sales invoices, inquiry and observations, analytical procedures, and other auditing procedures performed related to overstatement of sales.

.07 The auditor should remember that the way in which the population is defined can determine whether the requirements of SAS No. 39 apply. The auditor might choose to divide a single reporting line on the financial statements into several populations. For example, accounts receivable might be divided into wholesale receivables, retail receivables, and employee receivables. Each of these populations can be tested using a different audit strategy—some using audit sampling and others not. The sampling concepts in SAS No. 39 apply only to populations for which audit sampling is used. Use of audit sampling on one population does not mandate its use on remaining populations.

Authoritative Guidance About the Application of Audit Sampling to Substantive Tests Provided by SAS No. 39

.08 There has been confusion in the accounting profession regarding what requirements are imposed by SAS No. 39. SAS No. 39 added the following seven specific provisions to professional standards.

a. The concept that some items exist for which, in the auditor's judgment, acceptance of some sampling risk is not justified, and that these should be examined 100 percent (paragraph 21 [AU section 350.21]). This simply reminds the auditor that some of the items encountered in an examination of financial statements may be so significant individually or may have such a high likelihood of being in error or misstated that *all* such items should be examined.

b. The suggestion that the efficiency of a sample may be improved by separating items subject to sampling into relatively homogeneous groups based on some characteristic (paragraph 22 [AU section 350.22]). This indicates that audit efficiency can sometimes be improved by, for example, stratifying or segregating the items constituting a balance or class of transactions into groups based on individual dollar value or some other characteristic.

c. A requirement that the auditor consider tolerable misstatement in planning audit sampling applications in the examination of account balances and classes of transactions (paragraph 18 [AU section 350.18]). This asks the auditor to consider, in the early stages of an audit, how much misstatement the auditor will be able to tolerate for each balance and class of transactions that is sampled, in combination with misstatements in other accounts, and still render an unqualified opinion on the financial statements. SAS No. 39 asks the auditor to consider tolerable misstatement and to recognize that it is one of the factors influencing sample size. There is no requirement to document or quantify tolerable misstatement.

d. A requirement that the auditor select a sample that can be expected to be representative of the population (paragraph 24 [AU section 350.24]). Simply put, this means that each item in the population being sampled should have *a chance* of being selected, not necessarily *an equal chance* of being selected. This does not mean that the auditor is required to use a random or probability sample.

e. A requirement that the auditor consider selected sample items to which the auditor is unable to apply planned audit procedures to determine their effect on the evaluation of the sample (paragraph 25 [AU section 350.25]). For example, sometimes the auditor may not be able to apply planned audit procedures to selected sample items because supporting documentation may be missing. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be in error, it is not necessary to examine the items. However, if considering those unexamined items to be misstated would lead to a conclusion that the balance or class is materially in error, the auditor should consider alternative procedures that would provide sufficient evidence to form a conclusion.

f. A requirement that the auditor project the misstatement results of the sample to the items from which the sample was selected (paragraph 26 [AU section 350.26]). Since the sample is expected to be representative of the population from which it was selected, misstatements found are also expected to be representative of the population. This merely asks the auditor to measure the likely misstatement in the population from which the sample was drawn and to consider it in reaching conclusions.

g. A requirement that the auditor consider, in the aggregate, project misstatement results for all audit sampling applications and all known misstatements from nonsampling applications when evaluating whether the financial statements taken as a whole may be materially misstated (paragraph 30 [AU section 350.30]).

Documentation Requirements in SAS No. 39

.09 SAS No. 39 contains no new or specific documentation requirements. However, the documentation standards set forth in the Statements on Auditing Standards dealing with documentation apply to audit sampling applications just as they apply to other auditing procedures. For example, SAS No. 22, *Planning and Supervision* (AU section 311), states that the auditor should prepare a written audit program and SAS No. 41, *Working Papers* (AU section 339), requires the auditor to prepare working papers recording the work that the auditor has done and the conclusions that the auditor has reached concerning significant matters. Thus, with regard to audit sampling applications, the audit program might document such items as the objectives of the sampling application and the audit procedures related to those objectives. Documentation might also include the definition of the population and the sampling unit, including: (1) how the auditor considered completeness of the population, (2) the definition of misstatement, (3) the method of sample selection, (4) a list of misstatements identified in the sample, (5) an evaluation of the result of the sampling application, and (6) conclusions reached by the auditor.

Determining Extent of Testing in a Small Business Without Sampling

.10 Small businesses have certain characteristics that may influence the auditor's decision to use audit sampling. Because of the limited segregation of duties common in small businesses, auditors frequently choose to assess control risk at the maximum level, so generally the auditor of a small business will not have to consider tests of controls, including sampling of documentary evidence, to determine if controls are working as prescribed.

.11 For substantive testing, small businesses frequently have small populations of accounting data in both account balances and classes of transactions. Consequently, sampling may not be as useful since there may be large populations of data.

.12 SAS No. 39, paragraph 1 (AU section 350.01), defines audit sampling: "The application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class." This definition allows some alternative approaches to sampling to determine the extent of testing in a small business engagement. These alternatives, by not using audit sampling and thus eliminating the requirements of SAS No. 39, may provide a more effective and efficient audit approach for a small business engagement.

.13 These alternative approaches include:

a. Procedures applied to 100 percent of a certain group (strata) of transactions or balances.

b. Testing unusual items without applying procedures to the remainder of the population.

c. Other tests that involve application of procedures to less than 100 percent of the items in the population without drawing a conclusion about the entire account or class of transactions.

.14 The auditor should decide what audit procedures to perform to meet the established audit objectives. Once this decision is made, the auditor needs to determine the extent of testing.

.15 An effective and efficient approach to determining the extent of testing in a small business engagement is shown in flowchart 1. This approach involves four important steps.

Identification of Individual Items to Be Examined

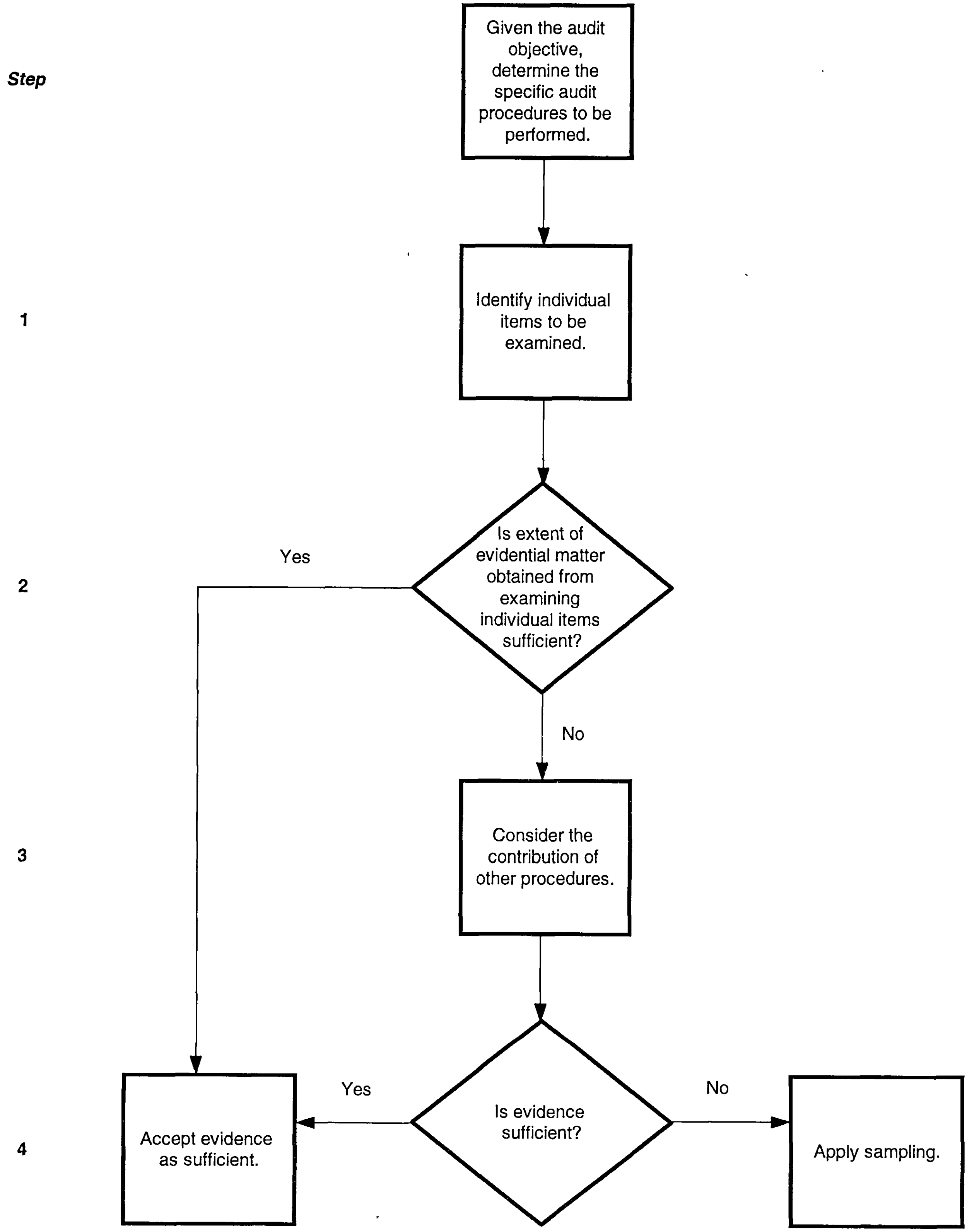
.16 An auditor should apply professional judgment in determining which individual items in an account balance or class of transactions need to be examined. In evaluating individual items, the auditor should consider factors such as size of the item, whether the item is unusual, prior experience with the client, and whether the item involves a related party.

.17 For example, consider the following information for accounts receivable of a small business.

Number of Accounts	*Balances*	*Total Accounts*
4	$100,000 or more	$ 625,000
7	$25,000–99,999	375,000
62	$1–24,999	300,000
73		$1,300,000

In this case, if the eleven largest accounts are confirmed by the auditor, most of the accounts receivable balance is supported ($1,000,000 out of $1,300,000, or 77 percent). Also, the auditor may decide to confirm the receivables that have unusual characteristics (for example, receivables with either large credit balances or those that are very delinquent).

Flowchart 1
An Audit Sampling Approach for a Small Business



Is Extent of Evidential Matter Obtained Sufficient?

.18 Some factors which have been identified in SAS No. 39 in evaluating the sufficiency of evidential matter obtained in tests of details for a particular account balance or class of transactions are:

a. The individual importance of the items examined. If the items examined, account for a high percentage of the total population, then the auditor may be reasonably assured that there is an acceptably low risk of an undetected misstatement.

b. The nature and cause of misstatements. If during the course of the audit, misstatements are discovered, those misstatements should be evaluated to determine if they are due to differences in principle or in application, are errors or irregularities or are due to misunderstanding of instructions or carelessness.

c. Possible relationship of the misstatement to other phases of the audit. If it is determined that the misstatement is an irregularity this would require a broader consideration of the possible implications than would the discovery of an error.

d. The characteristics of the sample to the population. The auditor may obtain some knowledge of the types of items in the population if the characteristics in the sample are similar in nature and the same controls are followed for processing the transactions.

.19 If an auditor has examined a substantial number of individual amounts and found no evidence of problems from the other procedures performed—and the remaining population totals less than an amount that would be material to the financial statements—there is often no need to sample the remaining population. Otherwise, the auditor should extend tests to the remaining population unless an alternative approach can be justified.

Consider Contribution of Other Procedures

.20 The auditor should also consider whether other evidence obtained contributes to conclusions regarding the account balance or class of transactions. The auditor often considers the contribution of other procedures at the same time the extent of evidential matter obtained from examining individual items is considered.

.21 The auditor may use a combination of analytical procedures and substantive tests of details to support an opinion on the financial statements. A small business audit does not typically include assessing control risk at less than the maximum level, so the auditor would rely primarily on analytical procedures and other substantive tests of details. In deciding whether other audit procedures make a contribution, the auditor should consider whether they support the audit objectives in the area, whether they indicate potential problems, and whether the evidence is consistent with the previous evidence obtained.

.22 In considering the contribution of other procedures, the auditor should use professional judgment in determining whether an unqualified opinion can be given without performing additional tests in the form of audit sampling.

Evaluation of Sufficiency of Evidence

.23 There are three factors that the auditor may consider in evaluating the sufficiency of audit evidence obtained from examining individual items and contributed by other procedures, and in determining whether the remaining items in the population should be tested.

.24 First, the auditor should consider whether the dollar amount of the remaining population is equal to or greater than an amount that would be material to the financial statements. If the remaining population is less than material, the auditor may decide that no additional testing by sampling is necessary. Second, the auditor should consider the degree of risk involved (that is, how susceptible the account is to misstatement, and whether there have been problems with this area in prior audits). Third, the auditor should consider the sufficiency of all the audit evidence obtained so far (the extent of evidential matter obtained by testing individual items along with the contribution of other procedures).

Audit Sampling for Tests of Controls

.25 SAS No. 39 indicates that an auditor may use nonstatistical or statistical sampling in performing tests of controls. This section provides guidance for both approaches. Regardless of whether nonstatistical or statistical sampling is being used, audit sampling for tests of controls involves the following steps:

a. Determine the objective of the test. The objective of a test of control is to determine whether particular controls are being applied as prescribed. Audit sampling for tests of controls is generally appropriate when application of the controls leaves documentary evidence of performance. Normally, audit sampling for tests of controls will involve selecting a sample of documents and examining them for evidence that the relevant controls were applied. Tests of controls involving observation of performance of procedures or inquiries of the client are not normally subject to audit sampling.

b. Define the deviation conditions. A deviation condition is a situation that indicates that the controls were not performed. For example, if the auditor is examining purchase invoices for evidence of approval of an expenditure (e.g., the initials of the approving individual), a deviation condition would be an invoice that is not initialed by the appropriate individual. Adequate performance of controls consists of all the steps the auditor believes are necessary to support the assessed level of control risk. For example, assume that a prescribed procedure requires that support for every disbursement should include an invoice, a voucher, a receiving report, and a purchase order, all stamped "Paid." The auditor believes that the existence of an invoice and a receiving report, both stamped "Paid," is necessary to indicate adequate performance of the procedure for purposes of supporting the assessed level of control risk. Therefore, a deviation may be defined as "a disbursement not supported by an invoice and a receiving report that have been stamped 'Paid.'"

c. Define the population. The population selected must be appropriate for the objective being tested. For example, if the auditor is testing the operating effectiveness of control activities designed to determine if all shipments were billed, the auditor would not detect deviations by sampling from billed items. An appropriate population for detecting such deviations usually includes the record of all items shipped.

For samples to be representative of the period under audit, the population generally should include all transactions processed during the period. However, sometimes the results of tests performed at an interim date may be sufficient to generalize about the population for the entire period. In determining whether interim tests are sufficient, the auditor should consider the results of the tests, responses to inquiries concerning the remaining period, the length of the remaining period, the nature and amounts of the transactions or balances involved, and related evidence obtained from the tests of balances. If controls have been changed during the year, the auditor will often decide that it is efficient to only test the new controls.

For sample results to be reliable, the sample must be selected from the complete population. Completeness of the population can be determined by either physical or numerical control. Normally, the auditor can establish the completeness of the population by inspecting the documents to see that it appears that they have all been accounted for.

d. Determine the method of selecting the sample. Any sample that is selected should be representative of the population and all items should have an opportunity to be selected. Random-number selection should generally be used when statistical sampling is being applied. When nonstatistical sampling is applied, random-number sampling, systematic sampling, and haphazard sampling are methods that might be used to obtain a representative sample. Methods of selecting samples are discussed beginning at AAM section 5300.61.

e. *Determine the sample size.* Sample sizes for tests of controls are affected by (*a*) the risk of assessing control risk too low, (*b*) the tolerable deviation rate, (*c*) the expected population deviation rate, and (*d*) any effects of small population sizes.

Guidance for determining sample size when performing nonstatistical sampling begins with AAM section 5300.28. A description of statistical sampling begins with AAM section 5300.31.

f. *Perform the sampling plan.* Once the sample has been selected, the auditor should examine each item for evidence of performance of the controls. If the auditor selects an item that is unused (e.g., a voided document), the auditor should select another item, at random. However, the auditor should make sure that the item really represents an unused item. If the document is valid, but cannot be found, the item should be treated as a deviation in evaluating the sample results.

g. *Evaluate the sample results.* Guidance for evaluating nonstatistical sampling results begins with AAM section 5300.30 and guidance for evaluating statistical sampling results begins with AAM section 5300.32.

h. *Document the sampling procedure.* The audit working papers should document the following matters:

- The objectives of the test.
- A description of the deviation conditions.
- The acceptable risk of assessing control risk too low.
- The tolerable deviation rate. .
- The expected deviation rate.
- The sample results, including the disposition of any deviations found.
- The effect of the results on the auditors assessed level of control risk.

.26 ***Factors Affecting Sample Sizes for Tests of Controls.*** Sample sizes for tests of controls are affected by the following factors:

a. *Acceptable risk of assessing control risk too low.* The risk of assessing control risk too low is the risk that the sample supports a lower level of control risk than is in fact the case. Decreasing the risk of assessing control risk too low will increase the sample size.

b. *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. As the expected population deviation rate increases, the sample size will increase.

c. *Tolerable deviation rate.* Tolerable deviation rate is the maximum rate (%) of deviations from a control procedure that the auditor is willing to accept without increasing the assessed level of control risk. Higher tolerable deviation rates will permit smaller sample sizes.

d. *Population size.* Populations over 500 items have little or no effect on sample size. For populations under 500 in size, the auditor may slightly reduce the size of the sample.

.27 The effects of these factors may be summarized as follows:

Factor	*Effect on Sample Size*
Acceptable risk of assessing control risk too low—increase (decrease)	Smaller (larger)
Tolerable deviation rate—increase (decrease)	Smaller (larger)
Expected population deviation rate—increase (decrease)	Larger (smaller)
Population size	Populations less than 500 items should be adjusted to slightly smaller sample sizes

.28 ***Sample Sizes Using Nonstatistical Sampling.*** Nonstatistical sample sizes for tests of controls may be determined using the sample size selection tables in AAM section 5300.29, or they may be selected on a purely judgmental basis. For each method of selection, the auditor should document consideration of the relevant factors. For example, the rationale for selecting tests of controls sample sizes of 30 from the first table in AAM section 5300.29 may be:

a. Control risk will be assessed at a moderate level, and

b. The expected population deviation rate is at or near zero.

.29 The following tables should be used for a nonstatistical approach to determine sample sizes for tests of controls:

Controls Testing Nonstatistical Sample Size Selection Table

Assessed Level of Control Risk	*Sample Size*
Maximum	0
Slightly below the maximum	15
Moderate	30
Low	40

The numbers in the table were determined using a risk of assessing control risk too low of 10 percent and an expected population deviation rate of 0 percent. When deviations are expected or found in a sample, the following table may be used to determine the sample size or evaluate the sample results:

Deviations (Expected or Actual)	*Assessment of Control Risk*		
	Slightly Below Maximum	*Moderate*	*Low*
0	15	30	40
1	25	50	65
2	34	67	90
3	43	85	115

.30 In evaluating the results of the sample, the auditor should consider the number of deviations found and the nature of the deviations. If the auditor uses the first table in AAM section 5300.29 to determine sample size, the discovery of one or more deviations will require the auditor to reassess the planned level of control risk. In these cases, the second table in AAM section 5300.29 may be used to evaluate the assessed level of control risk that is supported by the sample results. When looking at the nature of the deviations, the auditor is concerned with the following questions:

- Was the cause of the deviation an error or does it indicate an intentional violation of the control?
- Are there implications for other audit areas?

.31 ***Sample Sizes Using Statistical Sampling.*** The appropriate statistical method for tests of controls is attributes sampling, which is a technique designed to estimate qualitative characteristics of a population. Attributes sampling results may be used to estimate the frequency of deviations from performance of controls.

.32 Applying attributes sampling involves performing the following steps:

a. *Decide on the attributes to test.* The tests of controls may include the testing of one or more attributes. Proper evaluation of the results may require testing and evaluating each attribute separately.

b. *Define the population from which the sample items should be selected.* The auditor should make sure that the population is appropriate for the audit objective as described in AAM section 5300.25.

c. Specify the following factors:

- *Acceptable risk of assessing control risk too low.* The risk of assessing control risk too low is the risk the sample supports a lower level of control risk than is the case. Since sample evidence represents the only evidence typically obtained about the operating effectiveness of a particular control, the risk of assessing control risk too low is usually set at 5 percent or 10 percent.

- *Tolerable deviation rate.* Tolerable deviation rate is the maximum rate (%) of deviations from a control procedure the auditor is willing to accept without increasing the assessed level of control risk. Higher assessments of control risk will permit higher tolerable deviation rates as shown in the following table:

Planned Assessed Level of Control Risk	*Tolerable Rate*
Low	2%–7%
Moderate	6%–12%
Slightly below the maximum	11%– 20%
Maximum	Omit test

- *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. The auditor's expectations may be based on prior years' experience with the client, or experience with similar clients. Sample sizes will increase significantly as the expected population deviation rate increases from zero. If the deviation rate in the sample turns out to be higher than the rate specified by the auditor in determining the sample size, the sample results will not support the auditor's planned assessed level of control risk.

d. *Determine the appropriate sample size.* Sample sizes are found in the tables in AAM section 5300.33 and .34. The table in AAM section 5300.35 is designed for a risk of assessing control risk too low of 5 percent, and the table in AAM section 5300.36 is designed for a 10 percent risk of assessing control risk too low. With the tolerable deviation rate and the expected deviation rate, the auditor may find the sample size from the table. The numbers in parentheses are the number of deviations that may be found in the sample and still support the auditor's planned assessed level of control risk.

e. *Randomly select the sample from the population.* The section beginning at AAM section 5300.61 describes the methods that may be used to select a random sample.

f. *Perform the audit procedures to identify deviations in the sample.*

g. *Calculate the statistical results.* Using the tables in AAM section 5300.35 and .36 or the appropriate risk of assessing control risk too low, determine the actual tolerable deviation rate from the sample size and the actual number of deviations found in the sample.

h. Reassess the level of control risk. If the actual deviation rate in the sample is higher than that specified in determining the sample, the sample results will not support the auditor's planned assessed level of control risk. In these situations, the auditor should increase the assessed level of control risk. The auditor should also consider the causes of the deviations found, and whether they have implications for other audit areas.

i. Document the Sampling Procedures. The audit working papers should document the matters set forth in AAM section 5300.25 (Item No. 8).

.33

Statistical Sample Sizes for Testing Controls
Five Percent Risk of Assessing Control Risk Too Low
(with number of expected deviations in parentheses)

Expected Population Deviation Rate	Tolerable Rate 2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	149(0)	99(0)	74(0)	59(0)	49(0)	42(0)	36(0)	32(0)	29(0)	19(0)	14(0)
.25	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.50	*	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.75	*	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.00	*	*	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.25	*	*	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.50	*	*	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.75	*	*	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)	46(1)	30(1)	22(1)
2.00	*	*	*	181(4)	127(3)	88(2)	77(2)	68(2)	46(1)	30(1)	22(1)
2.25	*	*	*	208(5)	127(3)	88(2)	77(2)	68(2)	61(2)	30(1)	22(1)
2.50	*	*	*	*	150(4)	109(3)	77(2)	68(2)	61(2)	30(1)	22(1)
2.75	*	*	*	*	173(5)	109(3)	95(3)	68(2)	61(2)	30(1)	22(1)
3.00	*	*	*	*	195(6)	129(4)	95(3)	84(3)	61(2)	30(1)	22(1)
3.25	*	*	*	*	*	148(5)	112(4)	84(3)	61(2)	30(1)	22(1)
3.50	*	*	*	*	*	167(6)	112(4)	84(3)	76(3)	40(2)	22(1)
3.75	*	*	*	*	*	185(7)	129(5)	100(4)	76(3)	40(2)	22(1)
4.00	*	*	*	*	*	*	146(6)	100(4)	89(4)	40(2)	22(1)
5.00	*	*	*	*	*	*	*	158(8)	116(6)	40(2)	30(2)
6.00	*	*	*	*	*	*	*	*	179(11)	50(3)	30(2)
7.00	*	*	*	*	*	*	*	*	*	68(5)	37(3)

*Sample size is too large to be cost effective for most audit applications.
Derived from AICPA Audit and Accounting Guide *Audit Sampling*.
Note: This table assumes a large population.

.34

Statistical Sample Sizes for Testing Controls
Ten Percent Risk of Assessing Control Risk Too Low
(with number of expected deviations in parentheses)

Expected Population Deviation Rate	Tolerable Rate 2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	144(0)	76(0)	57(0)	45(0)	38(0)	32(0)	28(0)	25(0)	22(0)	15(0)	11(0)
.25	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.50	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.75	265(2)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.00	*	176(2)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.25	*	221(3)	132(2)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.50	*	*	132(2)	105(2)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.75	*	*	166(3)	105(2)	88(2)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
2.00	*	*	198(4)	132(3)	88(2)	75(2)	48(1)	42(1)	38(1)	25(1)	18(1)
2.25	*	*	*	132(3)	88(2)	75(2)	65(2)	42(1)	38(1)	25(1)	18(1)
2.50	*	*	*	158(4)	110(3)	75(2)	65(2)	58(2)	38(1)	25(1)	18(1)
2.75	*	*	*	209(6)	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.00	*	*	*	*	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.25	*	*	*	*	153(5)	113(4)	82(3)	58(2)	52(2)	25(1)	18(1)
3.50	*	*	*	*	194(7)	113(4)	82(3)	73(3)	52(2)	25(1)	18(1)
3.75	*	*	*	*	*	131(5)	98(4)	73(3)	52(2)	25(1)	18(1)
4.00	*	*	*	*	*	149(6)	98(4)	73(3)	65(3)	25(1)	18(1)
5.00	*	*	*	*	*	*	160(8)	115(6)	78(4)	34(2)	18(1)
6.00	*	*	*	*	*	*	*	182(11)	116(7)	43(3)	25(2)
7.00	*	*	*	*	*	*	*	*	199(14)	52(4)	25(2)

*Sample size is too large to be cost effective for most audit applications.
Derived from AICPA Audit and Accounting Guide *Audit Sampling.*
Note: This table assumes a large population.

.35

Statistical Sample Results Evaluation Table for Tests of Controls Tolerable Deviation Rate at Five Percent Risk of Assessing Control Risk Too Low

Sample Size	Actual Number of Deviations Found 0	1	2	3	4	5	6	7	8	9	10
25	11.3	17.6	*	*	*	*	*	*	*	*	*
30	9.5	14.9	19.6	*	*	*	*	*	*	*	*
35	8.3	12.9	17.0	*	*	*	*	*	*	*	*
40	7.3	11.4	15.0	18.8	*	*	*	*	*	*	*
45	6.5	10.2	5.4	16.4	19.2	*	*	*	*	*	*
50	5.9	9.2	12.1	14.8	17.4	19.9	*	*	*	*	*
55	5.4	8.4	11.1	5.5	15.9	18.2	*	*	*	*	*
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	*	*	*	*
65	4.6	7.1	9.4	11.5	5.6	15.5	17.4	19.3	*	*	*
70	4.2	6.6	8.8	10.8	12.6	14.5	16.3	18.0	19.7	*	*
75	4.0	6.2	8.2	10.1	11.8	5.6	15.2	16.9	18.5	20.0	*
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9	17.4	18.9	*
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2	15.5	16.8	18.2
100	3.0	4.7	6.2	7.6	9.0	10.3	11.5	12.8	14.0	15.2	16.4
125	2.4	3.8	5.0	6.1	7.2	8.3	9.3	10.3	11.3	12.3	5.2
150	2.0	3.2	4.2	5.1	6.0	6.9	7.8	8.6	9.5	10.3	11.1
200	1.5	2.4	3.2	3.9	4.6	5.2	5.9	6.5	7.2	7.8	8.4

*Over 20 percent.

Derived from AICPA Audit and Accounting Guide *Audit Sampling*.

Note: This table presents upper limits as percentages. This table assumes a large population.

.36

Statistical Sample Results Evaluation Table for Tests of Controls Tolerable Deviation Rate at Ten Percent Risk of Assessing Control Risk Too Low

Sample	Actual Number of Deviations Found										
Size	0	1	2	3	4	5	6	7	8	9	10
20	10.9	18.1	*	*	*	*	*	*	*	*	*
25	8.8	14.7	19.9	*	*	*	*	*	*	*	*
30	7.4	12.4	16.8	*	*	*	*	*	*	*	*
35	6.4	10.7	14.5	18.1	*	*	*	*	*	*	*
40	5.6	9.4	12.8	16.0	19.0	*	*	*	*	*	*
45	5.0	8.4	11.4	14.3	17.0	19.7	*	*	*	*	*
50	4.6	7.6	10.3	12.9	15.4	17.8	*	*	*	*	*
55	4.1	6.9	9.4	11.8	14.1	16.3	18.4	*	*	*	*
60	3.8	6.4	8.7	10.8	12.9	15.0	16.9	18.9	*	*	*
70	3.3	5.5	7.5	9.3	11.1	12.9	14.6	16.3	17.9	19.6	*
80	2.9	4.8	6.6	8.2	9.8	11.3	12.8	14.3	15.8	17.2	18.6
90	2.6	4.3	5.9	7.3	8.7	10.1	11.5	12.8	14.1	15.4	16.6
100	2.3	3.9	5.3	6.6	7.9	9.1	10.3	11.5	12.7	5.9	15.0
120	2.0	3.3	4.4	5.5	6.6	7.6	8.7	9.7	10.7	11.6	12.6
160	1.5	2.5	3.3	4.2	5.0	5.8	6.5	7.3	8.0	8.8	9.5
200	1.2	2.0	2.7	3.4	4.0	4.6	5.3	5.9	6.5	7.1	7.6

*Over 20 percent.

Derived from AICPA Audit and Accounting Guide *Audit Sampling.*

Note: This table presents upper limits as percentages. This table assumes a large population.

Audit Sampling for Tests of Balances

.37 In planning tests of balances, the auditor should decide on the most efficient approach to performing the tests. For some recorded populations, instead of sampling, it may be more efficient to examine individually significant items comprising a majority, or near majority, of the recorded population. Audit assurance about the remaining balance may then be obtained by (1) performing analytical procedures, or (2) concluding that the risk of material misstatement of the remaining balance is low. For example, confirmation of 50 percent to 80 percent of the dollar amount of accounts receivable may be necessary when risk is high; 40 percent to 60 percent may be sufficient when risk is low.

.38 Obviously, when the remaining balance, after auditing the individually significantly items, is immaterial, no testing of the remaining balance is necessary.

.39 The decision to sample, or not to sample, should be documented in the *working papers*.

.40 Selecting all individually significant items is not considered a sampling application. Items such as large receivables are usually examined individually. Procedures used for examining such items should ordinarily be the most reliable under the circumstances, such as positive confirmation requests.

.41 When planning a sampling application for tests of balances, the in-charge should consider the financial statement assertions and audit objectives and their relationship to populations selected. For example, understatements cannot be detected by sampling recorded amounts; instead, units from populations of all existing transactions must be selected.

.42 The following is an approach to nonstatistical sampling for tests of balances.

a. Determine the sampling population by identifying and deducting the individually significant items.

b. Determine the sample size by considering the following factors:

- The amount of tolerable misstatement.
- The assessed level of inherent and control risk for the assertions being tested.
- The risk that other substantive procedures (e.g., analytical procedures) will fail to detect a material misstatement.
- Variations within the population.

c. Select the sample.

d. Perform the test procedure.

e. Evaluate the results.

- Project the misstatement.
- Consider sampling risk.
- Consider qualitative aspects of the test results.

.43 Sample selection methods should produce representative samples and may include random selection, systematic selection, or haphazard selection methods. Care should be taken to avoid bias, however, when a haphazard selection method is used. AAM section 5300.61 describes these sample selection methods.

.44 *Determine the Sample Size for Tests of Balances.* Sample sizes for tests of balances are affected by the following factors:

- *Tolerable misstatement.* As the amount of tolerable misstatement increases, the sample size decreases. Conversely, larger sample sizes are required to compensate for a smaller amount of tolerable misstatement.
- *Assessed level of inherent and control risk.* As the combined level of inherent and control risk increases, the sample size increases.
- *The risk that other substantive procedures will fail to detect a material misstatement.* As the risk that other substantive procedures will fail to detect a material misstatement increases, the sample size increases. This risk is determined by considering the effectiveness of these procedures.
- *Variations within the population.* Sample sizes are smaller when the sampling population is stratified into homogeneous groups. Larger sample sizes are usually required to obtain a representative sample from sampling populations with high variations.

.45 Illustration 1 summarizes the impact of the factors above on sample size planning.

.46 *Nonstatistical Sampling Approaches.* At the direction of the engagement partner, either of the following nonstatistical approaches can be used for selecting tests of balances sample sizes:

a. Judgmental method.

b. Model approach.

Illustration 1

Factors Influencing Sample Sizes for Substantive Tests of Balances

		Conditions Leading to:	
	Factor	*Smaller Sample Size*	*Larger Sample Size*
a.	Tolerable misstatement.	Larger amount	Smaller amount
b.	Assessed level of inherent and control risk	Lower	Higher
c.	Risk that other procedures will fail to detect a material misstatement.	Lower	Higher
d.	Variation within the population.	Less variation	More variation

.47 *Judgmental Method.* Sample sizes can be selected judgmentally after considering the influence of the factors described above. The in-charge should describe the factors that influence the sample sizes selected for substantive tests of balances. The engagement partner should approve the planned sample sizes before the substantive tests of balances work is begun.

.48 Judgmentally selected samples are considered in terms of audit coverage of a total population. Large dollar coverage generally includes individually significant items, and units from the sampling population that cover more than 50 percent of the dollar amount of the total population.

.49 The coverage of the total population will also be affected by the nature of the population and the degree of the engagement risks. For example, a large coverage of accounts receivable for confirmation in high-risk circumstances may be from 50 percent to 80 percent of the total dollar population. A large coverage for an inventory price test in the same circumstances may only be 30 percent to 40 percent of total inventory because the risk of inventory price misstatement is generally less. In low-risk circumstances, a large coverage of accounts receivable may be 40 percent to 60 percent, a large inventory coverage may be 20 percent to 30 percent. These percentages are not presented as specific guidelines for decision making, but as illustrations of the factors influencing nonsampling decisions. Since the auditor's opinion is expressed on the financial statements taken as a whole, evidence should be designed to include tests of a majority of the dollars in the financial statements, but should also be, overall, the most efficient in the circumstances.

.50 *The Model Approach.* The model approach is a nonstatistical sampling method that is based on Probability Proportional To-Size (PPS) Sampling. Because the approach is based on PPS theory, the overall materiality limit does not have to be allocated to each account to determine tolerable misstatements. Instead, the basic allowance for unknown misstatement, i.e., overall materiality limit minus estimates for unadjusted misstatement from nonsampling tests, expected projected misstatement from sampling tests and related allowances for imprecision, may be used in place of tolerable misstatement for each sampling application. An acceptable approach would be to use 66⅔ percent, or a smaller percentage, of the overall materiality limit for the basic allowance. Under PPS theory, the overall materiality limit does not have to be allocated to accounts because the financial statements may be viewed as one population and the basic allowance for unknown error applies to the financial statements taken as a whole. The basic allowance must also be considered, however, when measuring misstatements.

.51 It is important to recognize that when sample sizes are selected nonstatistically based on some statistical theory such as PPS, it is assumed that the population will be stratified. A simple method of stratification is as follows:

- Determine the mean of the population to be sampled.
- Select 2/3 of the sample items from those items equal to or greater than the mean.
- Select 1/3 of the sample items from those items less than the mean.

.52 If it is not practical to stratify the sampling population, the sample size should be increased by a factor of 20 percent, or multiplied by 1.2.

.53 A more time consuming, yet more accurate method would, of course, be a PPS statistical selection method. For the sake of time, however, this statistical method ordinarily is not used. When populations are unusually large and engagement risks are high, however, a PPS statistical method may be appropriate. Guidance for PPS statistical sampling may be found in the AICPA Audit and Accounting Guide *Audit Sampling**.

.54 Developed from the model in the AICPA Audit and Accounting Guide *Audit Sampling* (paragraphs 4.57 through 4.60), the Model Approach follows:

Sampling Population Tolerable Misstatement	×	Assurance Factor	=	Preliminary Sample Size (units)
Preliminary Sample Size (units)	×	Marginal Risk Factors (1.2 to 1.5)	=	Adjusted Sample Size (Units)

.55 The assurance factors, also based on PPS statistical theory, are as follows:

Assessment of Inherent and Control Risk	*Risk That Other Substantive Procedures (e.g., analytical procedures) Will Fail to Detect a Material Misstatement*		
	Maximum	*Moderate*	*Low*
Maximum	3.0	2.3	1.9
Slightly below maximum	2.7	2.0	1.6
Moderate	2.3	1.6	1.2
Low	1.9	1.2	1.0

* The Audit and Attest Standards Division of the AICPA is developing an Auditing Procedure Study (APS) to replace the AICPA Audit and Accounting Guide *Audit Sampling*. The APS is expected to be issued in the fourth quarter of 1996.

.56 The steps to be taken in determining the sample size using the Model Approach are as follows:

a. Assess the combination of inherent and control risk:

(1) Maximum—Control and inherent risk are assessed at the maximum for the particular assertions. No tests of controls are required to support this assessment.

(2) Slightly below the maximum—Control and inherent risk are assessed at slightly below the maximum for the particular assertions. Minimal tests of controls are required for this assessment.

(3) Moderate—Control and inherent risk are assessed at a moderate level for this particular assertion. Moderately effective tests of controls are required for this assessment.

(4) Low—Control and inherent risk are assessed at a low level for the particular assertions. Very effective tests of controls are required for this assessment.

b. Determine the basic allowance for unknown misstatements (tolerable misstatement). This is related to preliminary estimates of materiality for the engagement.

c. Assess the risk that other substantive procedures (such as analytical procedures) designed to test the same assertions will fail to detect a material misstatement in a particular assertion as follows:

(1) Maximum—No other substantive procedures are performed that are designed to test the same assertions.

(2) Moderate—Other substantive procedures to test the assertions are expected to be moderately effective in detecting material misstatements.

(3) Low—Other substantive procedures to test the assertions are expected to be highly effective in detecting material misstatements.

d. Determine the population's recorded amount after deducting any items that will be audited 100 percent (all items that are more than 1/3 of tolerable misstatement).

e. Use the appropriate assurance factor from the table in AAM section 5300.55 and the formula below to determine the initial sample size.

Calculate the initial sample size with the following formula:

Sampling Population		*Basic Allowance (Tolerable Misstatement)**		*Assurance Factor*		*Initial Sample Size*
$ ____________	÷	$ ____________	×	____________	=	$____________

.57 Depending on the amount of the basic allowance for unknown misstatements, sample sizes computed with this model may approximate those sizes selected judgmentally. Because the model is based on a highly stratified approach, and this approach usually will include minimal or no stratification, the sample should be somewhat larger than the preliminary size if there are significant variations in the population. If stratification is necessary and is not practical, an acceptable approach would be to multiply the preliminary sample size by a marginal risk factor of 1.2 to compensate for the sampling risk associated with not stratifying. The marginal risk factor should *not* be used when the population is stratified or when stratification is not necessary.

.58 ***Evaluating the Sample Results.*** The misstatement in the sample must be projected to the population. One method of projecting the amount of misstatement found in a sample is to divide the amount of misstatement by the fraction of total dollars in the population to total dollars included in the sample. For example, if a $1,000 misstatement is found in a sample of 10 percent of the population, the projected misstatement would be $10,000 ($1,000/.10).

* Amount should be two-thirds of overall materiality limit.

.59 A second method for projecting the misstatement uses the average difference between the audited and the recorded amounts of each item included in the sample. For example, if $200 of misstatement is found in a sample of 100 items, the average difference between audited and recorded amounts for items in the sample is $2 ($200/100). An estimate of the amount of misstatement in the population may be calculated by multiplying the total number of items in the population (in this case 25,000 items) by the average difference of $2 for each sample item. The estimate of misstatement in the population is $50,000 (25,000 × 2).

.60 If the projected misstatement is less than tolerable misstatement for the account balance, consideration must be given to the risk that actual misstatement exceeds the amount of tolerable misstatement. If the projected misstatement is less than 1/3 of tolerable misstatement, it is generally safe to conclude that sampling risk is sufficiently low. If it is greater than 1/3, consideration should be given to performing additional tests of the account.

Selecting Samples

.61 SAS No. 39 permits random number selection, systematic selection with or without random starts and haphazard selection methods for nonstatistical sampling. Block sampling is not acceptable. A random number selection method should be used for statistical sampling.

.62 Random-based selection methods can be applied using random number tables or computer or calculator programs.

.63 To use a random number table:

a. Assign each element in the population a unique address that corresponds to the random number table.

b. Decide how to read the table, i.e., the number of digits and location, and if top to bottom, left to right.

c. Place a pencil on a page to determine a random starting point.

d. Modify the population numbers to the smallest possible number of digits to reduce discards.

.64 The procedure for using a program or calculator to generate random numbers varies with the programs. However, these techniques generally require the auditor to provide the smallest and largest item numbers, and the number of sample items needed.

.65 Systematic sampling requires the calculation of an interval. An interval is determined by dividing the population size by the number of sample units desired. For example:

$$\begin{aligned} N &= \text{Sample Size} = 4{,}000 \\ n &= \text{Desired Units} = 50 \\ I &= \text{Interval} \\ I &= \frac{N}{n} = \frac{4{,}000}{50} = 80 \end{aligned}$$

.66 After selecting a random number within the interval as a starting point, each 80th unit would be selected.

.67 Haphazard sampling involves selecting items on a purely judgmental basis, without any bias towards the selection of particular items.

[*The next page is 5401.*]

AAM Section 5400
Illustrative Audit Program for Corporations

.010 The audit programs contained in this section have been designed to provide substantive evidence (when combined with appropriate planning and with appropriate tests of controls) that is sufficient to support the assertions in the client's financial statements. The programs should be modified to reflect overall engagement risk, risks of potential misstatements, the results of analytical procedures, and the selection of the most cost-beneficial audit approaches and procedures.

.011 The programs address the financial statement assertions discussed in SAS No. 31, *Evidential Matter* (AU section 326):

- *Existence or occurrence.* Whether the assets or liabilities exist at a given date and whether recorded transactions have occurred during a given period.
- *Completeness.* Whether all transactions and accounts that should be presented in the financial statements are so included.
- *Rights and obligations.* Whether assets are the rights of the entity and liabilities are obligations of the entity at a given date.
- *Valuation or allocation.* Whether asset, liability, revenue, and expense components of the financial statements have been included in the financial statements at appropriate amounts.
- *Presentation and disclosure.* Whether particular components of the financial statements are properly classified, described, and disclosed.

.012 Most of the audit programs contain analytical procedures. The right mix of tests of details and analytical procedures should be made for each major audit area, based on the respective risk assessment, the internal control environment, and upon the results of the tests of controls. In most cases, analytical procedures should be relied upon to the maximum extent possible, because they are often more efficient to perform than tests of balances (detailed tests). Accordingly, all of the substantive detailed tests listed in a program may not necessarily need to be performed.

.013 The auditor's professional judgment must be applied in deciding whether the program includes all of the procedures required in the particular circumstances. The program serves solely as a timesaver. Users of manuscript aids must remain alert to needs such as the following:

- Developing steps for required procedures which are not covered by the program.
- Excluding extraneous and unnecessary procedures which are covered by the program.
- Editing or modifying the program to suit the needs and preferences of the auditor in the circumstances.

.014 The programs that follow contain illustrative audit objectives and procedures which are numbered merely to organize the materials; the numbers are not intended to imply completeness or a prescribed sequence. This list is merely illustrative. Some auditors may find the items too wordy, others may find them too terse, and still others may prefer a different set of items organized in a different manner. Users of this material must use professional judgment and be alert for the important matters in a particular set of circumstances which may not be covered in the illustrative material.

.015 The illustrative audit program permits the auditor to select audit procedures to be performed based on the assessed level of risk. If the auditor assesses control risk at the maximum level, it may be necessary to extend such tests to compensate for assessing control risk at that level. See AAM section 3165 for an illustrative audit planning checklist.

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

.020

	Done by	*Date*	*W/P Ref.*
I. General Procedures			
Financial Statement Assertions:			
1. Existence or occurrence.			
2. Completeness.			
3. Rights and obligations.			
4. Valuation or allocation.			
5. Presentation and disclosure.			
Procedures:			
A. Planning			
1. Has the illustrative checklist been completed? (See AAM section 3165.)	____	____	____
2. Determine that decision to accept engagement (in case of new client) or to retain client has been documented. (See AAM section 11,500.18.)	____	____	____
3. If this is a new client, ascertain that required communications with predecessor auditors, if any, have been made.	____	____	____
4. If other auditors are performing parts of the audit, ascertain that appropriate communications have been made.	____	____	____
5. Obtain an initial understanding of the client's operations:			
a. Review most recent management letter.	____	____	____
b. Obtain and review copies or abstracts of minutes of meetings of the Board of Directors, Shareholders, and/or relevant committees.	____	____	____
c. Obtain a list of all related parties.	____	____	____
6. Review correspondence files, prior year audit working papers, permanent files, financial statements and auditor's reports. Also review any current year interim financial statements.	____	____	____
7. If client has internal audit staff, read reports and related correspondence, and consider possible effect of internal audit work and findings on scope of the audit.	____	____	____

	Done by	Date	W/P Ref.
8. Perform analytical procedures focusing on:			
a. Enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date.	____	____	____
b. Identifying areas that may represent specific risks relevant to the audit.	____	____	____
9. Discuss the type, scope and timing of audit with the owner/manager or board of directors or audit committee. Also discuss the adequacy of working space for the audit team, access to client records and assistance, if any, to be furnished by client.	____	____	____
10. Determine that a signed engagement letter covering the current engagement is on file. Read letter for any special provisions. List any special provisions and determine that the audit program addresses the provisions.	____	____	____
11. Prepare a preliminary time budget by audit area and determine the staffing assignments of audit personnel, as well as other auditors, consultants and/or specialists.	____	____	____
12. Discuss the audit plan with the engagement personnel. If considered necessary, prepare a planning memorandum for review by engagement staff.	____	____	____
13. Discuss the following (and other appropriate) matters with appropriate client personnel (including the audit committee of the company, if applicable):			
a. Changes in operations, including pending/planned changes.	____	____	____
b. Changes in accounting methods or accounting principles applied.	____	____	____
c. Changes in key personnel (accounting and data processing).	____	____	____
d. Significant accounting or reporting problems.	____	____	____
e. Principal findings of internal auditors, if applicable.	____	____	____
f. Changes in data processing methods or equipment.	____	____	____
g. Significant legal matters and contingencies.	____	____	____
h. Disposition of prior year's management letter points.	____	____	____
i. Extent of client assistance to be provided.	____	____	____
j. Timing of preliminary audit work, inventory observation, confirmation procedures, final audit work, etc.	____	____	____
k. Closing information to be prepared (check applicable items):			
(1) Closing journal entries	____	____	____
(2) Post closing trial balance	____	____	____

	Done by	Date	W/P Ref.
(3) Audit adjusting entries	____	____	____
(4) Reversing journal entries	____	____	____
l. Other matters (prepare list and attach to program).	____	____	____
14. Ascertain that notes regarding matters to be discussed with audit partner, manager and/or in-charge auditor have been prepared by staff members with specific concerns.	____	____	____
15. Obtain an understanding of the effect of laws, regulations, and ordinances having a direct and material effect on the financial statements, and prepare a list of such laws and regulations and attach to audit program.	____	____	____
16. Obtain an understanding of the client's internal control:			
a. *Control environment*—including such factors as:			
(1) Integrity and ethical values	____	____	____
(2) Commitment to competence	____	____	____
(3) Functioning of the board of directors and its committee, particularly the audit committee	____	____	____
(4) Management philosophy and operating style	____	____	____
(5) Entity's organizational structure	____	____	____
(6) Methods of assigning authority and responsibility	____	____	____
(7) Human resources policies and practices	____	____	____
b. *Risk assessment* to identify, analyze, and manage risks relevant to the preparation of financial statements prepared in conformity with GAAP. Risks can arise or change due to circumstances such as:			
(1) Changes in operating environment	____	____	____
(2) New personnel	____	____	____
(3) New or revamped information systems	____	____	____
(4) Rapid growth	____	____	____
(5) New technology	____	____	____
(6) New lines, products, or activities	____	____	____
(7) Corporate restructurings	____	____	____
(8) Foreign operations	____	____	____
(9) Accounting pronouncements	____	____	____
c. *Control activities* to determine that management directives are carried out—categorized as policies and procedures that pertain to:			
(1) Performance reviews	____	____	____

	Done by	Date	W/P Ref.
(2) Information processing	____	____	____
(3) Physical controls	____	____	____
(4) Segregation of duties	____	____	____
d. *Information and communication* in order to understand:			
(1) Classes of transactions in the entity's operations that are significant to the financial statements	____	____	____
(2) How those transactions are initiated	____	____	____
(3) The accounting records, supporting information, and specific accounts in the financial statements involved in the processing and reporting of transactions	____	____	____
(4) The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including electronic means (such as computers and electronic data interchange) used to transmit, process, maintain, and access information	____	____	____
(5) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures	____	____	____
e. *Monitoring* to assess the quality of internal control performance over time to determine if controls are operating as intended and that they are modified as appropriate for changes in conditions. Such monitoring activities may include:			
(1) Communications from external parties such as customer complaints	____	____	____
(2) Regulator comments	____	____	____
(3) Presence of internal audit function	____	____	____
(4) Communication from external auditors relating to internal control	____	____	____
17. Use the understanding obtained of the internal control and consider factors influencing audit risk to evaluate the risk of material misstatements arising from errors, irregularities, and/or illegal acts, including the risk of management misrepresentation. Document conclusions in the working papers and their effects on engagement staffing, extent of supervision, and overall strategy for the conduct and scope of audit in the working papers.	____	____	____
18. Use the information obtained or developed concerning materiality levels, the internal control and the related assessments of control risk, the results of analytical procedures, and the evaluation of other factors impacting on audit risk to plan:			
a. The nature, timing, and extent of substantive tests;	____	____	____

	Done by	Date	W/P Ref.
b. Staffing requirements and related levels of supervision;	____	____	____
c. The overall strategy for the conduct and scope of audit. (This audit program is prepared based on financial statement captions. Dependent upon the client, it may be cost-effective to combine audit program sections, i.e., revenue and accounts receivable, payables and expenses, etc.)	____	____	____
19. Prepare listing of schedules/analyses to be prepared by client (and working paper set-ups, if considered necessary) and deliver to client.	____	____	____
20. Update the permanent file(s) for new agreements, copies or extracts of minutes and other important documents.	____	____	____
21. For trial balances and other schedules and analyses prepared by the client, document and perform the following:			
a. Trace amounts to the general ledger	____	____	____
b. Re-perform the footings and crossfootings (test basis may be appropriate)	____	____	____
c. Trace opening balances to final balances per the working papers for the preceding year (period).	____	____	____
d. Determine that working papers are marked "Prepared by Client" or "PBC."	____	____	____
22. Review journal and general ledger entries made during the period for propriety and accuracy.	____	____	____
23. Communicate with audit committee or other parties that have the responsibility for oversight of the financial reporting process, the following matters:			
a. The auditor's responsibility under generally accepted auditing standards (i.e., matters relating to the internal control, whether the financial statements are free of material misstatement, etc.)	____	____	____
b. Significant accounting policies (i.e., initial selection of and changes in significant accounting policies, or their application)	____	____	____
c. Management judgments and accounting estimates (i.e., the process followed by management in formulating sensitive accounting estimates, the basis for the auditor's conclusions regarding the reasonableness of management's estimates)	____	____	____
d. Significant audit adjustments (whether recorded or not, it is a proposed correction of the financial statements, correction would not have been detected except through the auditing process)	____	____	____
e. Other information in documents containing audited financial statements (i.e., the auditor's responsibility for other information included with the audited financial statements)	____	____	____

	Done by	Date	W/P Ref.
f. Disagreements with management (i.e., whether satisfactorily resolved or not, any matters that could be significant individually, or in the aggregate, to the entity's financial statements or the auditor's report)			
g. Consultation with other accountants (i.e., any accounting or auditing matters which management had discussed with other accountants)			
h. Major issues discussed with management prior to retention (i.e., issues relating to the application of accounting principles and auditing standards)			
i. Difficulties encountered in performing the audit (i.e., unreasonable delays in commencement of the audit, providing information, client personnel, etc.)			

B. Conclusion of Audit

1. Communicate internal control related matters noted (SAS No. 60 [AU section 325]).
2. Obtain written representation from management of the client (SAS No. 19 [AU section 333]) and the company's legal representatives.
3. Determine that required communications, proper as to form and content, have been made as necessary to disclose irregularities and/or illegal acts noted during the course of the audit. (SAS No. 53 [AU section 316] and SAS No. 54 [AU section 317])
4. Determine that any required communications in accordance with SAS No. 61, *Communication With Audit Committees* (AU section 380), have been made.
5. Perform the following analytical procedures:
   a. Re-examine the comparison of current-period amounts with amounts from prior periods, after correction of the amounts for any adjustments and reclassifications.
   b. Perform any additional analytical procedures, such as ratio analysis, that were not performed during the planning stage because preliminary amounts were unreliable.
   c. Identify significant or unexpected fluctuations and other unusual items.
   d. Based on the knowledge of the client's operations and the results of audit procedures, evaluate whether all significant or unexpected fluctuations have been adequately explained.
   e. Based on the results on the audit procedures performed, evaluate whether there is substantial doubt about the entity's ability to continue as a going concern:
      (1) Ascertain if any of the following negative trends exist:
         (a) Recurring operating losses

	Done by	Date	W/P Ref.
(b) Working capital deficiencies			
(c) Negative cash flows from operations			
(d) Adverse key financial ratios			
(e) Calculate the Altman Z Score (the formula can be found in the AAM section 2300.16)			
(2) Ascertain if any of the following have occurred:			
(a) Default on loans or similar agreements			
(b) Arrearages in dividends			
(c) Denial of usual trade credit			
(d) Restructuring of debt			
(e) Noncompliance with statutory or contractual capital arrangements			
(f) Need for new sources or methods of financing			
(g) Need to dispose of substantial assets			
(3) Ascertain if the following internal matters have occurred:			
(a) Work stoppages			
(b) Other labor difficulties			
(c) Substantial dependence on a particular project or customer			
(d) Uneconomic long-term commitments			
(e) Need to revise operations significantly			
(4) Ascertain if the following external matters have occurred:			
(a) Legal proceedings			
(b) Adverse legislation			
(c) Loss of key franchise, license or plant			
(d) Loss or principal customer or supplier			
(e) Uninsured or underinsured catastrophe			
6. Determine whether the audit work performed indicates that a substantial doubt exists with regard to the company's ability to continue as a going concern for a reasonable period of time. If a substantial doubt exists:			
a. Obtain information about management's plans, assess the expected effectiveness of the plans, and gather evidence to evaluate pertinent provisions of those plans and to support audit conclusions concerning the company's ability or inability to continue as a going concern;			
b. Evaluate the adequacy of the related financial statement disclosures; and			
c. Consider the effects on the audit report.			

	Done by	*Date*	*W/P Ref.*
7. Read the financial statements and related notes and consider the following:			
a. The adequacy of the evidence gathered in response to unusual or unexpected balances identified in planning the audit or in the course of the audit	____	____	____
b. Unusual or unexpected balances or relationships that were not previously identified	____	____	____
8. Determine that all applicable disclosure checklists and review programs have been completed. (See Financial Statement Preparation Manual and AAM sections 9200-9500.)	____	____	____
9. Complete a subsequent events review. (See AAM section 5400.180.)	____	____	____
10. Evaluate the effects of unadjusted misstatements on the financial statements.	____	____	____
11. Ensure that all work performed has been properly reviewed to determine whether it was adequately performed and to determine whether the results of the work are consistent with the conclusions to be presented in the auditor's report.	____	____	____
12. Ascertain that all working papers have been headed, indexed, cross-referenced, initialed, and dated.	____	____	____
13. Accumulate all pending items in one listing, and dispose of all other follow-up or "TO DO" sheets and any other similar notations in the files.	____	____	____
14. Ascertain that all time has been posted to the daily time control records, and record totals on the engagement time summary. Write explanations for any significant variations between budgeted and actual time.	____	____	____

Note: Many firms include other matters in the general section of programs, such as disposition of proposed adjustments, report preparation and review, reconciliation of actual and estimated time, preparation of fee estimate, evaluation of staff, etc.

C. Section Completion

1. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

Done by	____	____	____
Reviewed by	____	____	____

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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	Done by	*Date*	*W/P Ref.*

II. Controls

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Procedures:

A. Revenues, Receivables, and Receipts—Audit Objectives

1. Obtain a sufficient understanding of the design of the relevant controls that relate to the revenues and receivables account balances and transactions and whether they have been placed in operation. (This will include sales, sales return, sales discounts, etc.) ____ ____ ____

B. Revenues, Receivables, and Receipts—Assessment of Risk

1. Document the understanding of internal control (the form and extent of documentation is influenced by the size, complexity, and nature of internal control). (Review AAM section 4000 for sample internal control questionnaires.) ____ ____ ____

2. Assess the level of control risk:

   a. If the control risk is assessed at the maximum level, document this assessment (the basis for the assessment need not be documented) and go to section E. If the control risk is assessed at this level, the auditor will have to expand substantive tests to compensate for this level of control risk. Some examples of substantive tests which may be affected are shown in step 3 below. ____ ____ ____

   b. If control risk is assessed at less than the maximum level, document the basis for this conclusion and obtain sufficient

	Done by	Date	W/P Ref.

evidential matter to support this assessed level of control risk. Some examples of evidential matter which can be used to support this assessed level are shown in section C, below—Tests of Controls. ____ ____ ____

c. Remember that the choice of an audit strategy is made at the assertion level, not a global level. A primarily substantive testing approach may be chosen for some assertions, while less rigorous substantive tests may be performed for other assertions due to a less than maximum control risk assessment. ____ ____ ____

3. Based on the assessed level of control risk the timing and extent of substantive tests may be affected in, for example, the following aspects:

a. The use of confirmations. ____ ____ ____

b. If confirmations are used:

(1) Extent and method of selection of accounts for confirmation. ____ ____ ____

(2) Use of positive or negative forms of confirmation request, or a combination of both. ____ ____ ____

(3) Timing of confirmation procedures. ____ ____ ____

(4) Type of information needed on the confirmation request. ____ ____ ____

(5) Anticipated scope of alternative procedures as to significant accounts which do not respond to confirmation requests. ____ ____ ____

c. Nature and extent of tests to substantiate sales cut-off. ____ ____ ____

d. Nature and extent of tests to substantiate deferral and realization of revenue in such situations as unearned subscription income or unearned finance charges on installment receivables. ____ ____ ____

e. Approach to reviewing and evaluating adequacy of the allowance provided for doubtful accounts (review of allowances for specific accounts, comparison of experience relating to write-offs with sales and receivables, and the client's past and present credit policies and practices, etc.). ____ ____ ____

C. Revenues, Receivables, and Receipts—Tests of Controls

Note: Tests directed toward the effectiveness of the operation of a control are concerned with how the control was applied, the consistency with which it was applied during the audit period, and by whom it was applied. The examples that follow assume that the client has controls in place which can be either inspected, observed or reperformed.

	Done by	Date	W/P Ref.
1. Obtain the sales journal and for a selected period(s):			
a. Trace totals from the sales journal to the general ledger control accounts for revenues, receivables, and such other accounts as salesmen's commissions, provisions, and allowances for product warranties, etc.	____	____	____
b. Trace selected individual items from the sales journal to such other subsidiary records as the salesmen's commissions detail, and entries to charge cost.	____	____	____
c. Reconcile the sales journal to the entries to charge cost of sales and credit inventory.	____	____	____
d. Test the arithmetic accuracy of the footings and crossfootings of the journals.	____	____	____
2. Obtain the cash receipts journal and perform the following on a test basis for a selected period(s):			
a. Trace totals to the general ledger for both the cash account and applicable account distributions such as accounts receivable, cash sales, investment income, and additions to notes payable (re: proceeds).	____	____	____
b. Test the arithmetic accuracy of the footings and crossfootings of the cash receipts journal; reconcile total receipts to total deposits per the bank statement.	____	____	____
3. Select ____ entries from the sales journal made at various times throughout the year, obtain the supporting documents, and perform the following tests:			
a. Compare the sales invoices with the entries in the sales journal for invoice date, invoice number, identity of customer, dollar amount, and any related items such as sales tax, salesmen's commissions, etc.	____	____	____
b. Trace the sales invoice to the accounts receivable subsidiary (customers) ledger and to evidence of subsequent payment (remittance advice and cash receipts records).	____	____	____
c. If the client charges cost of sales and credits inventory as items are sold, trace detail per the sales invoice to subsidiary records for cost of sales and inventory.	____	____	____
d. Compare the sales invoice for customer identity, description of product, price, quantities, and amounts, to the applicable sales order, and customer's purchase order or job contract. Note evidence of approval of prices and credit as prescribed by management.	____	____	____
e. Compare customer identity, description of product, and quantities per the sales invoice to the documents evidencing shipment; test computations of related freight and insurance charges. Ascertain whether sales are recorded in the proper months.	____	____	____

	Done by	Date	W/P Ref.
f. Trace prices, discount, and payment terms to such sources as price lists, job quotations, and job contracts.	____	____	____
g. Test arithmetic accuracy of extensions, footings, and computation of discounts. Note evidence of performance of a clerical check by client staff, where applicable.	____	____	____
4. Review the numerical sequence file of shipping orders for a selected period and account for missing numbers.	____	____	____
5. Select ____ shipping orders prepared at various times during the year:	____	____	____
a. Obtain related sales invoices and trace them to the sales journal.	____	____	____
b. Note whether billings are timely for shipments made.	____	____	____
6. Select ____ credit memorandums issued at various times during the year.	____	____	____
a. Ascertain whether credits were authorized in accordance with prescribed procedures.	____	____	____
b. Review available supporting documentation.	____	____	____
c. Trace the memorandums to the sales journal or other appropriate journal and to the accounts receivable subsidiary ledger.	____	____	____
d. If the credit is granted for return of goods, inspect evidence of return and ascertain whether accounting for the returned goods is consistent with reported condition of the returned goods.	____	____	____
7. From the cash receipts journal, select ____ cash receipts entered during the year; obtain the supporting remittance advices and perform the following:			
a. Compare the remittance advices with applicable entries per the cash receipts journal and trace to deposits per the bank statement(s). Ascertain the promptness of the deposit and recording of the entries.	____	____	____
b. Trace detail posting of cash receipts to the accounts receivable, notes receivable, or other appropriate subsidiary ledgers. Ascertain whether cash receipts and related credits to accounts receivable are recorded consistently in the proper period.	____	____	____

D. Revenue, Receivables, and Receipts—Evaluation of Tests of Controls

1. Evaluate whether the assessed level of risk was appropriate based on the results of the tests of control and:

   a. Document matters considered and conclusions reached in making the control risk assessment in accordance with firm

	Done by	*Date*	*W/P Ref.*
policy (completion of questionnaires, checklists, preparation or required memoranda, etc.).	____	____	____
b. Based on the control risk assessment, make necessary modifications to applicable sections of the program for substantive tests.	____	____	____
c. Identify and note reportable conditions in internal control to be brought to the client's attention.	____	____	____
d. Identify and note other internal control matters to be brought to the client's attention.	____	____	____

Practice Tip

When performing tests of controls, caution is necessary. The tests cannot support an assessment of control risk below the maximum unless they provide evidence to evaluate the effectiveness of design and operation of controls. See AAM section 4600.15.

	Done by	*Date*	*W/P Ref.*
E. Purchases, Accounts Payable, and Disbursements—Audit Objectives			
1. Obtain a sufficient understanding of the design of relevant controls which relate to classifications of costs or expenses and charges to accounts such as property and equipment and prepaid expenses and whether they have been placed in operation.	____	____	____
F. Purchases, Accounts Payable, and Disbursements—Assessment of Risk			
1. Document the understanding of internal control (the form and extent of documentation is influenced by the size and complexity and nature of internal control). (Review AAM section 4000 for sample internal control questionnaires.)	____	____	____
2. Assess the level of control risk:			
a. If the assessment of control risk is at the maximum level, document this assessment (the basis for the assessment need not be documented) and go to section I. If the control risk is assessed at this level, the auditor will have to expand substantive tests to compensate for this level of control risk. Some examples of substantive tests which may be affected are shown in step 3 below.	____	____	____
b. If control risk is assessed at less than the maximum level, document the basis for this conclusion and obtain sufficient evidential matter to support this assessed level of control risk. Some examples of evidential matter which can be used to support this assessed level are shown in section G below—Tests of Controls.	____	____	____
c. Remember that the choice of an audit strategy is made at the assertion level, not a global level. A primarily substantive			

	Done by	Date	W/P Ref.
testing approach may be chosen for some assertions, while less rigorous substantive tests may be performed for other assertions due to a less than maximum control risk assessment.	____	____	____
3. Based on the assessed level of control risk the timing and extent of substantive tests may be affected in, for example, the following aspects:			
a. Extent of analytical procedures and tests of details of transactions and balances regarding classification of costs or expenses and charges to accounts such as property and equipment and prepaid expenses.	____	____	____
b. Extent of testing of details of transactions and balances to substantiate recorded payables and search for unrecorded liabilities as of the balance-sheet date.	____	____	____
c. Need for and extent of confirmation of payables from vendors.	____	____	____
d. The number of days following the balance-sheet date for which cut-off bank statements should be obtained.	____	____	____
e. The extent to which (if any) tests of cash balances can be performed at interim dates.	____	____	____
f. The extent to which testing of outstanding checks, deposits in transit, and other reconciling items can be restricted.	____	____	____
g. The number of days before and after the balance-sheet date which should be used for the testing of bank transfers.	____	____	____
h. Whether all bank transfers during the selected period or only those over a selected dollar amount should be tested.	____	____	____
i. Whether petty cash funds should be counted or confirmed with the custodian as of the balance-sheet date.	____	____	____
j. Whether petty cash funds should be counted on a surprise basis.	____	____	____
k. The need for coordination of cash counts with inspection of marketable securities and other investments.	____	____	____

G. Purchases, Accounts Payable, and Disbursements—Tests of Controls

Note: Tests directed toward the effectiveness of the operation of a control are concerned with how the control was applied, the consistency with which it was applied during the audit period, and by whom it was applied. The examples that follow assume that the client has controls in place which can be either inspected, observed or reperformed.

	Done by	Date	W/P Ref.
1. Obtain the voucher register and for a selected period(s):			
a. Trace postings to other subsidiary registers, if used (for example, property tax register).	____	____	____

	Done by	Date	W/P Ref.
b. Test the arithmetic accuracy of the footings and crossfootings of the voucher register for a test period(s).	____	____	____
c. Trace totals to the general ledger for both accounts (vouchers) payable and the various account distributions.	____	____	____
2. Select ____ entries from the voucher register for various months throughout the year, obtain supporting documents and perform the following tests:			
a. Compare the entry in the voucher register to the vendor's invoice as to date, payee, description, and amount and test the clerical accuracy of the invoice.	____	____	____
b. Determine that the invoice is supported by (i) an approved purchase order or payment request form and, if applicable, a properly executed purchase requisition and (ii) a signed receiving report or other evidence of receipt of services or goods, or otherwise authorized in accordance with prescribed procedures.	____	____	____
c. Determine that the account distribution in the voucher register is reasonable and in agreement with the purchase order.	____	____	____
d. Determine that purchase discounts have been properly recorded.	____	____	____
e. Determine that freight has been billed in conformity with the purchase order.	____	____	____
f. Examine the canceled check issued to payment of the invoice for date, payee, amount, signature, and endorsement. Trace to cash disbursements journal.	____	____	____
g. Inspect the voucher for evidence of clerical check, approval of payment as prescribed by management, and appropriate cancellation.	____	____	____
3. Review the numerical sequence files of receiving reports and of purchase orders and determine whether missing numbers are accounted for. (Failure by the client to do so increase the risk that unrecorded liabilities may exist.)	____	____	____
4. Obtain the cash disbursements journal and perform the following on a test basis:			
a. Trace postings for a selected period(s) to the general ledger for both the cash accounts and applicable account distributions.	____	____	____
b. Trace postings for a selected period(s) to other applicable subsidiary records, if present (for example, voucher or purchase journal, insurance and property tax registers, plant ledger, etc.).	____	____	____
c. For a selected period(s), foot and crossfoot the cash disbursements journal; reconcile total disbursements to the bank statement.	____	____	____

	Done by	Date	W/P Ref.
5. Review the numerical sequence of checks issued for a selected period and account for missing numbers as void or included on the list of outstanding checks. Select ____ checks drawn at various times during the year from the disbursements journal and obtain the paid checks and supporting detail for the disbursements:			
a. Examine the paid checks and trace identity of signatures to the list of authorized check signers. (Consider requesting confirmations from banks of authorized check signers.)	____	____	____
b. Compare identity of payee to endorsement; review checks for unusual endorsements and schedule those found for further investigation.	____	____	____
c. Compare paid check and supporting detail to the cash disbursements journal for check number, date drawn, payee, amount, and account distribution.	____	____	____
6. Review the client's bank reconciliations; for a selected period(s) perform the following tests of the bank reconciliation(s) and related listings of outstanding checks:			
a. Prove the arithmetic accuracy of the bank reconciliation, including the list of outstanding checks.	____	____	____
b. Trace the bank balance to the bank statement and the book balance to the general ledger account.	____	____	____
c. Trace the paid checks accompanying the bank statement to the cash disbursements journal and outstanding check list for the preceding month-end.	____	____	____
d. Trace deposits per the bank statement to the cash receipts journal and deposits in transit per bank reconciliations of the preceding month-end.	____	____	____
e. Trace deposits in transit to the bank statement for the following month; note whether the time interval between the dates per book and bank appear reasonable.	____	____	____
f. Trace outstanding checks to paid checks which accompany the bank statement for the month(s) subsequent to the reconciliation tested; compare paid checks to the cash disbursements journal and inspect signature(s) and endorsements.	____	____	____
g. Trace other reconciling items to supporting documents and check subsequent disposition.	____	____	____
7. Consider preparing a proof of cash for a test period including the tests described in step 6 above and the following:			
a. Trace totals per the cash receipts and disbursements journals to the general ledger cash accounts; identify and obtain explanations for significant and unusual cash entries in the general ledger during the test period. Foot the receipts and			

	Done by	Date	W/P Ref.
disbursements journals and prove the arithmetic between the opening and closing general ledger cash balances for the test period.	____	____	____
b. Prove the arithmetic accuracy of the bank statement by footing the deposits and disbursements, adding the opening balance and deducting the closing balance and ascertaining that the resulting differences equal total disbursements.	____	____	____
c. Account for all deposits per books as deposits per bank or deposits in transit. Determine that deposits are made on a timely basis.	____	____	____
d. Review the numerical sequence of checks issued during the period, accounting for them as paid during the period, included on the list of outstanding checks, or void. Determine that void checks have been properly mutilated.	____	____	____

Note: The working paper format for this step would present reconciliations of total receipts and disbursements per cash books to the respective total credits and charges per the bank statement(s) in addition to reconciliations of the bank and book balances at the beginning and end of the selected period. This working paper format may be used to reconcile total activity per the cash books and bank statements for various time periods such as a month or several months.

	Done by	Date	W/P Ref.
8. Select the paid check(s) to reimburse the petty cash fund(s) from the cash disbursements journal; examine the voucher and paid check for consistency with the disbursements journal and prescribed approval and account distribution, and perform the following tests:			
a. Foot supporting evidence by account distribution and trace total to reimbursement voucher.	____	____	____
b. Trace reimbursement voucher to cash disbursements journal and petty cash book.	____	____	____
c. Examine petty cash vouchers for the following:			
(1) Prepared in ink	____	____	____
(2) Approved	____	____	____
(3) Canceled after reimbursement	____	____	____
(4) Dated	____	____	____
(5) Payee	____	____	____
(6) Amount	____	____	____
(7) Signature	____	____	____
(8) Account charged	____	____	____
(9) Numbered consecutively	____	____	____
(10) Reasonableness of amount and business purpose	____	____	____

	Done by	Date	W/P Ref.

H. Purchases, Accounts Payable, and Disbursements—Evaluation of Tests of Controls

1. Evaluate whether the assessed level of risk was appropriate based on the results of the tests of controls and:

   a. Document matters considered and conclusions reached in making the control risk assessment in accordance with firm policy (completion of questionnaires, checklists, preparation of required memoranda, etc.). ____ ____ ____

   b. Based on the control risk assessment, make necessary modifications to applicable sections of the program for substantive tests. ____ ____ ____

   c. Identify and note reportable conditions in internal control to be brought to the client's attention. ____ ____ ____

   d. Identify and note other internal control matters to be brought to the client's attention. ____ ____ ____

Practice Tip

When performing tests of controls, caution is necessary. The tests cannot support an assessment of control risk below the maximum unless they provide evidence to evaluate the effectiveness of design and operation of controls. See AAM section 4600.15.

I. Payroll—Audit Objectives

1. Obtain a sufficient understanding of the design of relevant controls which relate to the payroll account balances and transactions and whether they have been placed in operation. ____ ____ ____

J. Payroll—Assessment of Risk

1. Document the understanding of internal control (the form and extent of documentation is influenced by the size and complexity and nature of internal control). (Review AAM section 4000 for sample internal control questionnaires.) ____ ____ ____

2. Assess the level of control risk:

   a. If control risk is assessed at the maximum level, document this conclusion (the basis for the conclusion need not be documented) and go to section M. If the control risk is assessed at this level the auditor will have to expand substantive tests to compensate for this level of risk. Some examples of substantive tests which may be affected are shown in step 3 below. ____ ____ ____

   b. If control risk is assessed at less than the maximum level, document the basis for this conclusion and obtain sufficient evidential matter to support this assessed level. Some examples of evidential matter which can be used to support this assessed level are shown in section K—Tests of Controls. ____ ____ ____

	Done by	Date	W/P Ref.

c. Remember that the choice of an audit strategy is made at the assertion level, not a global level. A primarily substantive testing approach may be chosen for some assertions, while less rigorous substantive tests may be performed for other assertions due to a less than maximum control risk assessment. ____ ____ ____

3. Based on the assessed level of control risk the timing and extent of substantive tests may be affected in, for example, the following aspects:

   a. The extent to which analytical procedures are applied to payroll costs and expenses and the extent to which fluctuations are investigated. ____ ____ ____

   b. Whether, and to what extent, gross pay is reconciled to individual earnings records. ____ ____ ____

   c. Whether, and to what extent, a payoff is made. ____ ____ ____

   d. The extent to which labor charges to property and equipment and to inventory are tested. ____ ____ ____

   e. The extent to which payroll taxes withheld and accrued are tested. ____ ____ ____

K. Payroll—Tests of Controls

Note: Tests directed toward the effectiveness of the operation of a control are concerned with how the control was applied, the consistency with which it was applied during the audit period, and by whom it was applied. The examples that follow assume that the client had controls in place which can be either inspected, observed or reperformed.

1. Obtain the payroll register for a selected period(s):

   a. Trace totals per the register through applicable payroll summaries to the paid check used to transfer cash for net pay to the payroll bank account, and to postings in the general ledger (and cost accounting records, if applicable) for wage and salary cost and expense distributions, and liabilities for payroll withheld and deducted. ____ ____ ____

   b. Trace payroll withheld through applicable subsidiary records to the payroll tax returns. Review the payroll tax returns; examine the check remitting withholdings to the governments (federal and state) and trace to the general ledger liability accounts. ____ ____ ____

   c. Determine whether payroll was approved in accordance with prescribed procedures. (For example, approval might be a signature on a payroll summary and request for the de-

	Done by	Date	W/P Ref.
posit of net pay to the payroll bank account; the signature on the check used to transfer money to the payroll bank account; approvals directly on the registers; etc.)	_____	_____	_____
d. Test the arithmetical accuracy of the footings and crossfootings of the payroll register.	_____	_____	_____
2. Select _____ entries from the payroll register made at various times throughout the year, and perform the following procedures:			
a. Examine authorization for rate of pay and evidence in support of payment (for example, time records, piece-work production reports or other documentation which has been approved as prescribed by management) and on a test basis recompute gross pay.	_____	_____	_____
b. Examine proper authorizations for payroll withholdings such as signed W-4 forms and on a test basis recompute amounts withheld.	_____	_____	_____
c. Test arithmetical accuracy of net pay based on gross pay less deductions.	_____	_____	_____
d. Examine canceled checks noting date, check number, name of payee and comparing net pay to the payroll register, signature to list of authorized check signers, and endorsement to the signed W-4 forms.	_____	_____	_____
e. Examine signed receipt for employees paid by cash, compare amount on the receipt with the payroll register and compare signature to the signed W-4 form.	_____	_____	_____
f. Compare the individual payroll entry on the payroll register to the records used to accumulate year-to-date employee compensation for such purposes as preparation of payroll tax returns and W-2 forms.	_____	_____	_____
3. Authorization of rate of pay. (For example, memoranda in the personnel files evidencing approval as prescribed by management, union contracts, approved rate or salary schedules, authorization of officer's salaries per minutes of board of director's meetings.)	_____	_____	_____
4. Evidence in support of payment. For example:			
a. Time cards or records, which have been approved as prescribed, for employees paid on an hourly basis and for employees paid for overtime.	_____	_____	_____
b. Production reports, which have been approved as prescribed, for employees paid on a piece-work basis.	_____	_____	_____
c. Sales and commission registers, and evidence that advance drawings for commission salesmen had been approved as prescribed.	_____	_____	_____

	Done by	Date	W/P Ref.
5. Evidence in support of payroll withholdings. (For example, signed W-4 forms or other proper authorization.)	____	____	____
6. Evidence of review of payroll for clerical accuracy, reasonableness, and account distribution, as prescribed by management.	____	____	____
7. Evidence of individual payroll records. (For example, the individual payroll entry to the records used to accumulate year to date employee compensation for such purposes as preparation of payroll, tax returns and W-2 forms.)	____	____	____
8. Consider, based on the preliminary evaluation, whether to:			
a. Observe the distribution of payroll checks or cash, including control of unclaimed wages.	____	____	____
b. Physically observe selected employees in the performance of their duties.	____	____	____
L. Payroll—Evaluation of Tests of Controls			
1. Evaluate whether the assessed level of risk was appropriate based on the results of the tests of control and:			
a. Document matters considered and conclusions reached in making the control risk assessment in accordance with firm policy (completion of questionnaires, checklists, preparation of required memoranda, etc.).	____	____	____
b. Based on the control risk assessment, propose necessary modifications to applicable sections of the program for substantive tests.	____	____	____
c. Identify and note reportable conditions in internal control to be brought to the client's attention (SAS No. 55 [AU section 319]).	____	____	____
d. Identify and note other internal control matters to be brought to the client's attention.	____	____	____

Practice Tip

When performing tests of controls, caution is necessary. The tests cannot support an assessment of control risk below the maximum unless they provide evidence to evaluate the effectiveness of design and operation of controls. See AAM section 4600.15.

	Done by	Date	W/P Ref.
M. Inventories and Cost of Sales—Audit Objectives			
1. The auditor must obtain a sufficient understanding of the design of relevant controls which relate to the inventory, costs of sales account balances and transactions and whether they have been placed in operation.	____	____	____
N. Inventories and Cost of Sales—Assessment of Risk			
1. Document the understanding of internal control (the form and extent of documentation is influenced by the size, complexity,			

	Done by	Date	W/P Ref.
and nature of internal control). (Review AAM section 4000 for sample internal control questionnaires.)	____	____	____
2. Assess the level of control risk:			
a. If control risk is assessed at the maximum level, document this conclusion (the basis for the conclusion need not be documented). If the control risk is assessed at this level the auditor will have to expand substantive tests to compensate for this level of risk. Some examples of the substantive tests which may be affected are shown in step 3 below.	____	____	____
b. If control risk is assessed at less than the maximum level, document the basis for this conclusion and obtain sufficient evidential matter to support this assessed level. Some examples of evidential matter which can be used to support this assessed level are shown in section O—Tests of Controls.	____	____	____
c. Remember that the choice of an audit strategy is made at the assertion level, not a global level. A primarily substantive testing approach may be chosen for some assertions, while less rigorous substantive tests may be performed for other assertions due to a less than maximum control risk assessment.	____	____	____
3. Based on the assessed level of control risk the timing and extent of substantive tests may be affected in, for example, the following aspects:			
a. The extent to which physical inventories are observed and/or perpetual records tested.	____	____	____
b. Whether physical inventories are taken at a preliminary date or at the balance-sheet date.	____	____	____
c. The extent to which consigned inventories are confirmed.	____	____	____
d. The extent to which inventory prices are tested to supporting documentation.	____	____	____
e. The extent to which analytical procedures are applied to cost of sales and the extent to which fluctuations are investigated.	____	____	____
f. The extent to which cutoffs are tested.	____	____	____
g. The extent to which inventories are tested for obsolete or excess stock.	____	____	____

O. Inventories and Cost of Sales—Tests of Controls

Note: Tests directed toward the effectiveness of the operation of a control are concerned with how the control was applied, the consistency with which it was applied during the audit period, and by whom it was applied. The examples that follow assume that the client has controls in place which can be either inspected, observed or reperformed.

	Done by	Date	W/P Ref.
1. Tour the client's manufacturing or production facilities with a member of the client's organization familiar with production.	____	____	____
2. Select a sample of transactions for additions and deletions of inventory from such sources as receiving reports, requisitions to place materials into production, and shipping documents. Note the reference or control number, date, description, quantity and dollar amount for each transaction selected. Trace the transactions to the perpetual inventory record and the cost accounting records, if any, used to determine unit or job costs. Perform similar tests selecting the transactions from the perpetual inventory records and/or cost accounting records and trace the transactions to receiving reports, requisitions and shipping documents.	____	____	____

Note: This testing may be coordinated with tests of controls for purchases, payables, and disbursements, and for revenues, receivables, and receipts.

	Done by	Date	W/P Ref.
3. Obtain an analysis of overhead costs charged to inventories and over- or under-absorbed overhead. Review the amounts included in the overhead pool for propriety and perform the following:			
a. Determine that overhead costs are being charged to inventory in accordance with an appropriate policy (for example, as a percent, as a percent of direct labor).	____	____	____
b. Identify disposition of variances, if any, between actual overhead costs incurred and overhead costs applied to production and inventory. Determine that variances are reasonable. Determine that no excessive costs for idle plant are being charged to inventory.	____	____	____
4. If a job order cost system is used, obtain the job order ledger (or tabulation), select a period(s) and perform the following:			
a. Trace total costs incurred to the voucher register (or cash disbursements journal), the payroll distribution, and support for overhead applied.	____	____	____
b. Test the footings of the job order ledger by refooting the detail for selected subtotals and refooting the subtotals.	____	____	____
c. Select ____ job orders for jobs in process and completed jobs and perform the following:			
(1) Examine authorization for the job order.	____	____	____
(2) Trace materials used on a test basis at various times since inception of the job order to such supporting details as requisitions, purchase orders, receiving reports, and processed invoices. (Consider coordination with compliance tests for purchases.)	____	____	____

	Done by	Date	W/P Ref.
(3) Trace direct labor costs to account distributions of the payroll registers and on a test basis to individual time reports or time cards. (Consider coordination with tests of controls for payroll.)	____	____	____
(4) Trace application of overhead costs to analyses used to accumulate overhead costs; test computations and review for reasonableness.	____	____	____
(5) Identify the status of the job (work in process, finished goods, or goods shipped) and trace through necessary summarization to the applicable general ledger account. Obtain explanation for any unreasonable time lag between completion and shipping dates for job orders performed for specific customers.	____	____	____
5. For process cost systems, obtain the cost of production reports for each department within the production process for a selected period(s) and:			
a. Trace quantities and dollar amounts for units received for selected departments to the quantities and dollar amounts transferred out per the preceding department in the sequence of production.	____	____	____
b. For each selected department, review the computations of total and unit costs for production transferred to the next department; on a test basis recompute unit costs and ascertain that costs for units lost in process are properly reallocated to surviving units.	____	____	____
c. Trace materials costs charged to the selected departments to appropriate journals and on a test basis to individual requisitions.	____	____	____
d. Trace labor costs incurred to account distribution analyses of the payroll registers.	____	____	____
e. Review the allocation of overhead.	____	____	____

P. Inventories and Cost of Sales—Evaluation of Tests of Controls

	Done by	Date	W/P Ref.
1. Evaluate whether the assessed level of risk was appropriate based on the results of the tests of controls and:			
a. Document matters considered and conclusions reached in making the control risk assessment in accordance with firm policy (completion of questionnaires, checklists, preparation of required memoranda, etc.).	____	____	____
b. Based on the control risk assessment, make necessary modifications to applicable sections of the program for substantive tests.	____	____	____

	Done by	Date	W/P Ref.
c. Identify and note reportable conditions in internal control to be brought to the client's attention.			
d. Identify and note other internal control matters to be brought to the client's attention.			

Practice Tip

When performing tests of controls, caution is necessary. The tests cannot support an assessment of control risk below the maximum unless they provide evidence to evaluate the effectiveness of design and operation of controls. See AAM section 4600.15.

Q. Section Completion

This audit program section has been completed in accordance with firm policy.

Done by

Reviewed by

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

III. Cash

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Existence of cash—To determine that cash exists and is owned by the entity. (Assertions 1 and 3)

B. Proper cut-off—To determine that cash balances reflect a proper cut-off of cash receipts and disbursements. (Assertions 1, 2, and 4)

C. Cash complete—To determine that cash balances as presented in the balance-sheet properly reflect all cash and cash items on hand, in transit, or on deposit with third parties. (Assertions 1, 2, and 5)

D. Proper classification—To determine that cash balances are properly classified in the financial statements and any restrictions on the availability of funds are properly disclosed. (Assertions 3 and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Preliminary Procedures

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:

   a. Preliminary analytical review ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	b. Planning documents	____	____	____
	c. Internal control documentation and test results	____	____	____
[A]	**B. Substantive Analytical Procedures**			
[B] [C] [D]	1. Compare account balances with preceding year's balances (or expected balances) and investigate any significant deviations from expected balances.	____	____	____
	2. Compute quick current ratios (cash, and net receivables) and compare with preceding year's ratios or expected ratios. Investigate any significant deviations from the expected ratios.	____	____	____
	C. Cash in Banks—Detailed Tests			
A C D	1. Confirm bank balances (using standard forms to confirm account balance information with financial institutions) as of the balance-sheet date for ____ bank accounts used during the year. (Confirmation of and information about certificates of deposit and compensating balances arrangements should also be requested.)	____	____	____
B [C]	2. Arrange to obtain cut-off bank statements and related paid checks directly from the banks for ____ days following the balance-sheet date.	____	____	____
C	3. Obtain or prepare a comparative listing of the component bank account(s) and petty cash fund balances as of the closing and opening balance-sheet dates for the year (period) being audited:			
	a. Refoot the schedule and trace totals to the financial statement assembly sheets.	____	____	____
	b. Trace closing balances to the general ledger and working papers on bank reconciliations and petty cash funds.	____	____	____
	c. Trace opening balances to the working papers for the preceding audit.	____	____	____
	d. For bank accounts opened and closed during the year (period) trace to authorization in the minutes of the board of directors meetings.	____	____	____
A B C [D]	4. Obtain copies of the bank reconciliations as of the balance sheet date and perform the following:			
	a. Trace the book balance to the balance per the general ledger control account and to the working lead schedule or trial balance.	____	____	____
	b. Compare the bank balance to the cut-off bank statement and to the confirmation received from the respective bank.	____	____	____
	c. Test the clerical accuracy of the reconciliation.	____	____	____

Obj.		Done By	Date	W/P Ref.
	d. Review and explain unusual reconciling items and trace to appropriate subsequent disposition.	____	____	____
	e. Trace deposits in transit to the cut-off bank statement(s) and ascertain whether the time lag is reasonable.	____	____	____
	f. Inspect selected paid checks returned with the cut-off bank statement. Examine the cancellation date on the paid checks to identify any checks that were not recorded in the period under audit. Trace checks drawn prior to the end of the period under audit to the list of outstanding checks and to the cash disbursements journal and agree items such as date, payee, and amount.	____	____	____
	g. List and investigate any unusual checks including checks drawn to "bearer" or "cash."	____	____	____
	h. List and investigate any outstanding checks of $ ____ or over, which did not clear the banks within a reasonable period to ascertain that the disbursements are proper.	____	____	____
B C	5. Prepare a bank transfer schedule providing column headings for the following:			
	a. Name of disbursing bank	____	____	____
	b. Check number or other reference	____	____	____
	c. Amount	____	____	____
	d. Date disbursed per books	____	____	____
	e. Date disbursed per bank	____	____	____
	f. Name of receiving bank	____	____	____
	g. Date deposited per books	____	____	____
	h. Date deposited per bank	____	____	____
	i. Perform the following:			
	(1) Review the cash receipts and disbursements journals, bank statements and related paid checks (including the cut-off bank statements) for the last ____ days before the first ____ days after the closing date of the year (period) and list all bank transfers (or each transfer of $ ____ or over) on the transfer schedule.	____	____	____
	(2) Review the schedule to determine that the deposit and disbursement side of each transfer is recorded in the proper period and that any time lag between book and bank entries appears reasonable. Trace incompleted transfers to the schedule of outstanding checks and/or deposits in transit.	____	____	____
B	6. If cut-off statements and related paid checks are not independently received by the auditor directly from the bank, obtain			

Obj.		Done By	Date	W/P Ref.
	the bank statements and related paid checks for the month following the balance-sheet date and perform the following:			
	a. Inspect bank statements for erasures and prove arithmetic accuracy of the statements (opening balance plus total deposits and other credits, less the closing balance equals total disbursements and other charges).	____	____	____
	b. Examine paid date of each check and debit memo to ascertain it was paid by the bank during the period covered by the bank statements.	____	____	____
	c. Foot the paid checks and debit memos to ascertain that the total agrees with total charges per the bank statements.	____	____	____
	d. Request banks to confirm the balance at the end of the statement period.	____	____	____
A B C D	7. On receiving the bank confirmation relies:			
	a. Ascertain that all of the inquiries have been answered. If any inquires have not been answered, telephone or correspond with the bank to obtain the missing information (in writing).	____	____	____
	b. Review bank confirmations for details applicable to other areas of the financial statements such as liabilities, debt, commitments, and contingencies.	____	____	____
	c. Determine whether there are any restrictions on the account balances, including minimum balance requirements.	____	____	____
	d. Determine whether there are any guarantee arrangements.	____	____	____
	D. Cash Funds and Petty Cash—Detailed Tests			
	1. The auditor should consider performing the following procedures if cash balances on hand are deemed significant:			
A B C D	*a.* Identify all funds, including locations, custodians, amounts and purpose and decide:			
	(1) Which funds are to be counted and, if so, whether to count them simultaneously and whether simultaneous control and inspection of other assets, such as negotiable securities, is also necessary.	____	____	____
	(2) Timing of counts to be at a preliminary date, the balance-sheet date or subsequent to the balance-sheet date.	____	____	____
A B C D	*b.* Count all (or on a test basis, depending upon risk assessment) undeposited cash, petty cash, unclaimed wages, stamps, etc., in the presence of the custodian (A client's representative should be present at all times during the count.) and:			
	(1) List currency and coins counted by denomination.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	(2) List other items such as stamps, checks, and vouchers; examine vouchers as to date, amount, payer, authorization, signature, account charged, and documentation. Identify large or unusual amounts for possible follow-up.	____	____	____
	(3) Trace the fund balance per the count to the balance per the general ledger.	____	____	____
	(4) List all unusual items such as postdated checks or vouchers prepared in pencil for discussion with a responsible member of the client's staff.	____	____	____
	(5) If petty cash reimbursement checks are included in the fund, trace the amounts to cash book entries dated prior to the count.	____	____	____
	(6) Have the custodian sign a receipt at the conclusion of the count.	____	____	____

Practice Tip

It is often a good idea to scan petty cash vouchers to determine types of expenses that are paid out of petty cash. Be on the lookout for items that might need to be capitalized.

A B C D	3. Consider whether to confirm funds at branch offices and other locations which are not scheduled for a physical count.	____	____	____

E. **Section Completion**

1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for cash balances, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for cash balances.	____	____	____
2. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________ ____ ____ ____
Done by

______________________________ ____ ____ ____
Reviewed by

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

IV. Investments and Derivatives

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Existence of investment—To determine that the entity owns the investments at the balance-sheet date and has physical evidence of ownership (securities, receipts from responsible custodians, etc.). (Assertions 1, 2, and 3)

B. Proper valuation—To determine that the market or other fair value of the investments has been determined as objectively as practicable. (Assertion 4)

C. Income recognition—To determine that related income from the investments is properly recorded and received. (Assertions 2, 3, and 4)

D. Restrictions identified—To determine that restrictions, pledges or liens on any of the investments and related liabilities are identified and adequately disclosed in the financial statements. (Assertions 1, 2, 3, and 5)

E. GAAP conformity—To determine that the financial statement presentation and disclosure investments, including off-balance-sheet items such as options and other derivative instruments, and related income is in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Obj.		*Done By*	*Date*	*W/P Ref.*
	Procedures:			
	A. Preliminary Procedures			
	1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
	a. Preliminary analytical review	____	____	____
	b. Planning documents	____	____	____
	c. Internal control documentation and test results	____	____	____
[A]	**B. Substantive Analytical Procedures**			
[B][C][D]	1. Compare investment account balances with preceding year's balances (or expected balances) and investigate any significant deviations from the expected balances.	____	____	____
	2. Compute the following ratios and compare with prior years:			
	a. Investments divided by total assets (indication of earning asset mix).	____	____	____
	b. Major categories of investments divided by total investments (measure of investments and risk portfolio mix).	____	____	____
	c. Investment income divided by average total investments, by category (measure of investment portfolio yield).	____	____	____
	C. Detailed Tests			
A B C E	1. (Some of the following information may not be necessary, depending upon the judgment of the auditor.) Obtain or prepare detailed analyses of investments showing:			
	a. Classification between held-to-maturity, available-for-sale, or trading securities, and securities accounted for under the equity method.	____	____	____
	b. Classification between current and noncurrent portfolios of held-to-maturity securities and available-for-sale securities.	____	____	____
	c. Description of the security, including any interest rate and maturity of debt, the dividend rate on cumulative preference shares, etc.	____	____	____
	d. Number of shares, par value, or face amount held at the end of the preceding period, and the balance at cost and at market or equity, if applicable, together with any unamortized premium or discount on bonds.	____	____	____
	e. Additions including date, number of shares, par values or face amounts, and cost.	____	____	____
	f. Sales and dispositions including date, number of shares, par value or face amounts, cost, proceeds, and realized gain or loss.	____	____	____

Obj.			Done By	Date	W/P Ref.
		g. Number of shares, par values, or face amounts held at the end of the period, and the balance at cost and at fair value or equity, if applicable, together with any unamortized premium or discount on bonds.	____	____	____
		h. Related holding gains and losses at the beginning and the end of the period and changes therein.	____	____	____
		i. Investment income (dividends, interest, etc.) for individual investments—accrued at the end of the previous period, earned during the current period, collected during the period and accrued at the end of the current period.	____	____	____
B	2.	Foot and croosfoot the analyses.	____	____	____
[E]	3.	Trace ending totals to the general ledger and trace opening balances to the prior period audit working papers.	____	____	____
A B [D] [E]	4.	Inspect securities on hand in the presence of the custodian (including treasury stock and securities held as collateral) at the balance-sheet date or at a date shortly before or after, and examine supporting evidence (for example, bank and broker advices) for transactions between the inspection date and balance-sheet date:			
		a. Ascertain that certificates issued in nominee names are owned by the client.	____	____	____
		b. Note certificate or serial numbers, if useful.	____	____	____
		c. If the investment is in the debt or equity of a nonpublic entity, consider obtaining confirmation from the issuer or trustee.	____	____	____
		d. Obtain a signed receipt.	____	____	____
A	5.	Obtain positive confirmation as of the balance-sheet date for investments held by independent custodian; consider whether inspection of investments held by custodians is necessary.	____	____	____
C D E	6.	Examine contractual terms of debt securities and preferred stocks.	____	____	____
E	7.	Determine that all debt and equity securities are properly classified as held-to-maturity, available-for-sale, or trading by reference to the nature of the security and management's ability and intention to hold.	____	____	____
	8.	For debt securities classified as held-to-maturity:			
B		*a.* Determine that they are valued at amortized cost.	____	____	____
A B E		*b.* Recalculate the amortized cost.	____	____	____
	9.	For debt and equity securities classified as available-for-sale:			
A B E		*a.* Determine that they are valued at fair value and, on a test basis, agree to third-party market value quotations.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
B E	*b.* Recalculate unrealized gains and losses and determine whether they are properly included as a separate component of stockholders' equity.	____	____	____
	10. For debt and equity securities classified as trading securities:			
A B E	*a.* Determine that they are valued at fair value and, on a test basis, agree to third-party market value quotations.	____	____	____
B E	*b.* Recalculate unrealized gains and losses and determine whether they are properly included in earnings.	____	____	____
[A]	11. Determine that sales and purchases were properly approved; trace transactions to minutes of the Board of Directors or Finance Committee meetings.	____	____	____
A C E	12. Examine bank or broker's advices and custodian's reports in support of purchases and sales.	____	____	____
C E	13. Determine that gain or loss on disposition of a security has been computed and accounted for properly.	____	____	____
A C E	14. Trace payments for purchases to canceled checks and proceeds from sales to entries in cash book.	____	____	____
	15. Test accrued interest on investment securities as follows:			
	a. Obtain or prepare a trial balance of accrued interest receivable on investment securities and agree to the general ledger.	____	____	____
	b. Recalculate accrued interest for selected securities.	____	____	____
	c. Review the client's procedures for calculating monthly accruals and:			
	(1) Test the posting of monthly accruals by tracing to applicable accounts in the general ledger.	____	____	____
	(2) Test detail calculations supporting the monthly entries.	____	____	____
B C E	16. Determine that the amortization of premium and discount on debt securities, where applicable, has been properly computed and accounted for.	____	____	____
B E	17. For investments in nonpublic entities and investments carried on the equity method, compare carrying value to information in the most recently available audited financial statements. If necessary, use financial reports and statements issued later than the most recently available audited financial statements.	____	____	____
E	18. Determine that any transfers between categories of investments have been properly recorded.	____	____	____
	19. Obtain a list of all derivative transactions.			
A D	*a.* Examine evidence of the transactions and directors' approval of the transactions.	____	____	____

Obj.		Done By	Date	W/P Ref.
E	*b.* Obtain confirmations of outstanding transactions as of year end.	____	____	____
A	*c.* Review subsequent transactions to determine completeness of the list.	____	____	____
E	*d.* For disclosure purposes obtain and evaluate information concerning significant individual or group concentrations of credit risk.	____	____	____
B E	*e.* Determine that any gains or losses have been properly recorded.	____	____	____
D	20. Determine if any securities are pledged or restricted.	____	____	____
A	21. Evaluate the credit quality of the investments and determine whether purchases and sales conform to policy.	____	____	____
E	22. Ensure that all information needed for financial statement disclosures has been accumulated and documented in the working papers.	____	____	____
E	23. In accordance with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), obtain information about the fair value of investments, and perform the following:			
	a. Determine that the fair value amounts are determined in accordance with FASB Statement No. 107 (AC F25).	____	____	____
	b. Determine that the valuation principles are being consistently applied.	____	____	____
	c. Determine that the fair value amounts are supported by the underlying documentation.	____	____	____
	d. Determine that the method of estimation and significant assumptions used are properly disclosed.	____	____	____

Note: FASB Statement No. 107 (AC F25) does not apply to investments accounted for under the equity method.

D. Section Completion

	Done By	Date	W/P Ref.
1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for investments, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for investments.	____	____	____
2. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________ Done by	____	____	____
______________________________ Reviewed by	____	____	____

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

V. Trade Accounts and Notes Receivable

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Existence of accounts receivable—To determine that the receivables exist, are authentic obligations owed to the entity, contain no significant amounts that should be written off, and that allowances for doubtful accounts are adequate and not excessive. (Assertions 1, 3, and 4)

B. Proper disclosure—To determine that proper disclosure is made of any pledged, discounted or assigned receivables. (Assertions 3 and 5)

C. Revenue recognition—To determine that interest on accounts and notes receivable has been properly recorded. (Assertions 2, 3, and 4)

D. GAAP conformity—To determine that presentation and disclosure of receivables is in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Preliminary Procedures

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:

   a. Preliminary analytical review ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	b. Planning documents	____	____	____
	c. Internal control documentation and test results	____	____	____
[A]	**B. Substantive Analytical Procedures**			
[B] [C] [D]	1. Compare receivable account balances with preceding year's balances (or expected balances) and investigate any significant deviations from the expected balances.	____	____	____
	2. Analyze the relationship of receivables and sales (day's sales in accounts receivable) and compare with relationships for the preceding period(s). Investigate results as deemed necessary.	____	____	____
	3. Compute the ratio of interest earned to the average notes receivable outstanding and compare with preceding year's ratio (or expected ratio). Investigate results as deemed necessary.	____	____	____
	4. Compare balances in allowance for doubtful accounts, bad debts, sales returns and allowances with the preceding year's balances (or expected balances). Investigate any significant deviations from the expected balances.	____	____	____
	5. Compute the following ratios and compare with the preceding year's ratios (or expected ratios). Investigate results as deemed necessary.			
	a. Sales returns and allowances as a percentage of gross sales.	____	____	____
	b. Sales returns and allowances as a percentage of gross sales by product/service line.	____	____	____
	c. Bad debts expense as a percentage of gross sales.	____	____	____
	d. Allowance for doubtful accounts as a percentage of trade accounts receivable.	____	____	____
	e. Aging categories as a percentage of total accounts receivable compared to prior year's.	____	____	____
	C. Detailed Tests			
[A]	1. Review activity in the general ledger control accounts for trade accounts receivable for the period being audited and:			
	a. Note and investigate any significant entries which appear unusual in amount or source.	____	____	____
	b. Compare the opening balance for the period with the final closing balances per the working papers and reports for the preceding period.	____	____	____
[A]	2. Obtain or prepare an aged trial balance of trade receivables as of the date selected for confirmation procedures. (Note: In some situations, it may not be practicable to obtain an aged trial balance until after the mailing of confirmation requests, especi-			

Obj.		Done By	Date	W/P Ref.

ally when confirmation procedures are coordinated with the client's regular billing cycle. In such instances obtain a trial balance (which may be an annotated tape) of trade receivables as of the confirmation date.) Perform the following:

a. Test the clerical accuracy of the trial balance. ____ ____ ____

b. Reconcile the total per the aged trial balance to the general ledger control account and, if as of the balance-sheet date, to the lead schedule or working trial balance. ____ ____ ____

Note: When the aged trial balance and the general ledger do not agree, a monthly accounts receivable reconciliation between the two reports is an essential internal control feature.

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c. On a test basis, trace entries for individual customers on the aging analysis (totals and aging detail) to the individual accounts in the accounts receivable subsidiary ledger and select individual accounts from the subsidiary ledger and trace totals and aging detail to the aged trial balance. Test footings of individual customer accounts in the subsidiary ledger. ____ ____ ____

[A] 3. Select individual customer accounts for confirmation procedures from the aged trial balance (or trial balance) and arrange for the preparation of confirmation requests to be mailed under the auditor's control and tested as follows:

a. Positive requests on individually significant accounts with balances in excess of $ _____ . ____ ____ ____

b. Positive requests on accounts from the sampling population as follows:

____
____
____
____
____

____ ____ ____

Note: Due to risk assessment and planning decisions, confirmation of receivables may not be part of the audit approach. If so, complete alternative procedures as described in this program.

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c. Trace individual confirmation requests as to balances and addresses to the subsidiary accounts receivable records. Send confirmations (using envelopes with the auditor's return address) and prepare confirmation statistics. ____ ____ ____

d. If client requests that any accounts be excluded from the confirmation process, obtain explanations and determine if such a restriction will have a significant affect on your ability to meet the audit objectives. (Consider reviewing such records as correspondence files to substantiate the explanation.) Perform appropriate alternative procedures with respect to the amounts. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	e. Trace confirmation replies to the trial balance and investigate and reconcile replies with differences.	____	____	____

Note: The auditor may prepare a control of exceptions such as copies of replies or a list and arrange for the client's staff to investigate the differences and accumulate supporting documentation for the auditor's review. Be alert to explanations that may be evidence of overall conditions affecting the financial statements. Follow up on such conditions.

Obj.		Done By	Date	W/P Ref.
	f. Obtain new addresses for all confirmations returned by the post office and remail.	____	____	____
	g. Send second requests for all unanswered positive confirmation requests. Consider sending third requests by registered or certified mail, and performing alternative auditing procedures.	____	____	____
	h. Perform alternative auditing procedures for unanswered positive confirmation requests.	____	____	____

Practice Tip

Be alert to large credits claimed by customers (especially close to the balance-sheet date). These credits may represent goods which were never shipped.

Obj.		Done By	Date	W/P Ref.
[A]	4. For positive confirmation requests to which no reply was received, accounts which declined to provide confirmation information and accounts which the client requested not be confirmed:			
	a. Test balances subsequently paid to remittance advices which identify the specific invoices paid.	____	____	____
	b. For balances on which no payment has yet been received, examine customer's purchase orders, related invoices and shipping documents.	____	____	____
	c. Establish the existence of the customer by reference to such sources as Dun and Bradstreet Reference Book.	____	____	____
[A]	5. If accounts receivable were confirmed as of a date other than the balance-sheet date, obtain an analysis of transactions between the confirmation and balance-sheet dates, trace amounts to books of original entry, and review the analysis and books for significant unusual entries.	____	____	____
	6. Summarize the results of the confirmation procedures.	____	____	____
A B C	7. Obtain or prepare an analysis of notes receivable including the following information:			
	a. Maker	____	____	____
	b. Date made/date due	____	____	____
	c. Original terms of repayment	____	____	____
	d. Collateral, if any	____	____	____

Obj.		Done By	Date	W/P Ref.
	e. Interest rate			
	f. Balance at the end of last period			
	g. Principal—additions, payments			
	h. Interest income—at the end of the preceding period, earned during the current period, received during the current period, and accrued at the end of the current period.			
A B C	8. Foot schedule and trace totals to applicable general ledger accounts.			
A B C	9. Physically inspect all notes in possession of the client.			
A B C	10. As deemed necessary, request positive confirmation of the terms and balances of notes with makers (as of the balance-sheet date or other date). Investigate any differences.			
A B C	11. Confirm notes out for collection with collection agents as deemed necessary.			
A B C	12. Examine evidence of periodic or subsequent payments on notes not responding to confirmation requests.			
A B C	13. Reconcile any confirmation exceptions received.			
A B C	14. Inspect collateral for notes, if any, making sure that items were not included in corresponding asset accounts of the company.			
A B C	15. Recompute interest income, accrued interest and unearned discount; trace interest collections, if any, to the cash receipts journal. Ascertain that computations of interest and recognition of interest income is in conformity with APB Opinion No. 21. (AC I69)			
A B [D]	16. Ascertain whether any accounts or notes have been assigned, pledged, guaranteed, sold or discounted by reference to minutes, review of agreements, confirmation with banks, etc.			
A [D]	17. Ascertain whether any accounts or notes receivable are owed by employees or related parties such as officers, directors, shareholders and affiliates, and:			
	a. Obtain an understanding of the business purpose for the transactions which resulted in balances.			
	b. Ascertain that transactions were properly authorized.			
	c. Obtain positive confirmations of the balances (as the balance-sheet date or some other date) except for intercompany accounts with affiliated companies which the firm is concurrently examining.			
	d. Determine if any notes repaid prior to the balance-sheet date have since been renewed.			

Obj.		Done By	Date	W/P Ref.
A B C [D]	18. Obtain or prepare an analysis of the allowance for doubtful accounts for the period, and:			
	a. Review accounts written off during the period and determine that significant write-offs have been properly authorized. Examine supporting documentation, including correspondence with the customer. (Such correspondence may indicate a broader problem.)	____	____	____
	b. Review adequacy of the allowance and related provision:			
	(1) Review the aged trial balance as of the balance-sheet date with the client's credit manager or other responsible individual to identify accounts of a doubtful nature and allowances required; review correspondence files and other relevant data in support of client's representations. Items reviewed should include past due amounts and significant amounts whether or not past due.	____	____	____
	(2) Examine credit reports for delinquent and large accounts.	____	____	____
	(3) Review confirmation exceptions for indication of amounts in dispute.	____	____	____
	(4) Consider whether accounts receivable that have been connected to notes receivable pose any unusual credit risk.	____	____	____
	c. Identify differences, if any, between the book and tax basis for the allowance for doubtful accounts and related expense provision; summarize information required for determining income taxes currently payable and deferred.	____	____	____
	d. Review revenue, receivable and cash receipts transactions after the balance-sheet date including discounts taken, credits allowed, and write-offs for unusual transactions (especially concerning past-due balances and large accounts).	____	____	____
A	19. Summarize the results of the procedures above and evaluate the adequacy of the allowance for doubtful accounts.	____	____	____
D	20. Determine that accounts and notes receivable have been properly classified between current and noncurrent.	____	____	____
D	21. Determine that the following are properly presented and/or disclosed in the financial statements:			
	a. Related party receivables.	____	____	____
	b. Significant credit balances that should be reclassified.	____	____	____
A C	22. To determine if receivables are recorded in the proper period, test the sales cutoff as follows:			
	a. Trace ____ entries in the sales journal for ____ days before and after the balance-sheet date to shipping documents. Based			

Obj.		Done By	Date	W/P Ref.
	on the information provided by the shipping documents, determine whether the sales/receivables were recorded in the proper period.	____	____	____
	b. Trace ____ shipping documents for ____ days before and after the balance-sheet date to the sales journal. Based on the information provided by the shipping documents, determine whether the sales/receivables were recorded in the proper period.	____	____	____
D	23. In accordance with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), obtain information about the fair value of notes payable and long-term debt, and perform the following:			
	a. Determine that the fair value amounts are determined in accordance with FASB Statement No. 107 (AC F25).	____	____	____
	b. Determine that the valuation principles are being consistently applied.	____	____	____
	c. Determine that the fair value amounts are supported by the underlying documentation.	____	____	____
	d. Determine that the method of estimation and significant assumptions used are properly disclosed.	____	____	____

Practice Tip

Normally, the carrying amount of receivables will approximate their fair values. However, factors such as extended payment terms, creditworthiness, and interest rates significantly different from market rates may lead to situations where the carrying amount of the receivables does not approximate their fair value. See FASB Statement No. 107 (AC F25) and Auditing Interpretation No. 1 of SAS No. 57, *Auditing Accounting Estimates,* titled "Performance and Reporting Guidance Related to Fair Value Disclosures (AU section 9342.01–.10)," for further guidance.

Obj.		Done By	Date	W/P Ref.
A	24. For accounts and notes receivable with terms exceeding one year, if it is probable that all of the amounts due will not be collected according to their contractual terms, determine that impairment of those receivables has been measured by one of the following methods:			
	a. The present value of expected future cash flows discounted at the loan's effective interest rate.	____	____	____
	Or			
	b. The receivable's observable market price.	____	____	____
	Or			
	c. The fair value of the collateral if the receivable is collateral dependent.	____	____	____

Note: See FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* and FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (AC I08), for further guidance.

Obj.		*Done By*	*Date*	*W/P Ref.*
	D. Section Completion			
	1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for receivables, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for receivables.	____	____	____
	2. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

____ ____ ____ ____
Done by

____ ____ ____ ____
Reviewed by

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

VI. Inventories

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Inventory exists—To determine that the inventory exists and is the client's property. (Assertions 1 and 3)

B. Quantity and condition—To determine that the client has taken reasonable care in determining the physical quantities and identifying the condition (normal, slow moving, obsolete) of its inventory. (Assertions 2 and 4)

C. Clerical accuracy—To determine that the inventories are summarized and priced with clerical accuracy, and the records have been adjusted to the physical inventory. (Assertions 2 and 4)

D. GAAP conformity—To determine that inventory classifications and carrying amounts are determined and presented in the financial statements in conformity with generally accepted accounting principles consistently applied (for example, assumptions about the cost flow, such as FIFO and LIFO, and lower of cost or market considerations). (Assertion 5)

E. Encumbrances identified—To determine that any encumbrances such as pledges or liens are identified and adequately disclosed in the financial statements. (Assertion 3, 4, and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Obj.		*Done By*	*Date*	*W/P Ref.*

Procedures:

A. Preliminary Procedures

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:

   a. Preliminary analytical review ____ ____ ____

   b. Planning documents ____ ____ ____

   c. Internal control documentation and test results ____ ____ ____

A B D **B. Substantive Analytical Procedures**

1. Compare inventory balances with preceding year's balances (or expected balances) and investigate any significant deviations from the expected balances. ____ ____ ____

2. Compare inventory classifications (i.e., raw materials, work in process, finished goods) as a percentage of total inventory with the preceding year's percentages and investigate any significant fluctuations. ____ ____ ____

3. Compute gross margin and compare with preceding year's (or expected) gross margin. Investigate any significant fluctuation. ____ ____ ____

4. Compute gross margin by product line or division and compare with preceding year's (or expected) gross margins. Investigate any significant fluctuations. ____ ____ ____

5. Compute inventory turnover and compare with preceding year's (or expected) turnover. Investigate any significant fluctuation. ____ ____ ____

6. Compute inventory turnover by major product or division and compare with preceding year's (or expected) turnover. Investigate any significant fluctuations. ____ ____ ____

C. Detailed Tests—General

1. Identify the locations of the physical inventories and their relative materiality by location. ____ ____ ____

2. Review the client's plans and instructions for taking the physical inventory and accumulating, pricing, and summarizing the results. Also review the client's plans for controlling tags and count sheets, identifying obsolete items, identifying and handling consigned and customer's goods, and for controlling the movement of inventory during the count and controlling shipping and receiving during the count. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	3. Determine whether involvement of specialists is required. If a specialist is to be involved, review and evaluate the professional qualifications and reputation of the specialist; obtain an understanding of the nature of the work to be performed by the specialist.	____	____	____
A B C D E	4. For significant amounts of inventory stored at outside locations, consider performing the following procedures:			
	a. Review and test the owner's control procedures for investigating the warehouseman and evaluating the warehouseman's performance.	____	____	____
	b. Obtain an independent auditor's report on the warehouseman's system of internal accounting control relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that the information received from the warehouseman is reliable.	____	____	____
	c. Observe physical counts of the goods, if practicable and reasonable.	____	____	____
	d. If warehouse receipts have been pledged as collateral, confirm with lenders pertinent details of the pledged receipts (on a test basis, if appropriate).	____	____	____
	e. Confirm goods out on consignment or at outside warehouses.	____	____	____
[B] [C] [D] [E]	5. Discuss with the client and assess the impact of any changes in accounting policies regarding inventory, such as the manner in which costs are accumulated and the pricing methods used.	____	____	____

D. Before Observation of the Physical Inventory

Note: Some auditing procedures may serve to accomplish the purpose of both tests of controls and substantive tests. Certain steps that are listed here as illustrative substantive tests are also listed among illustrative tests of controls for inventory. They are listed as tests of controls because they may serve to clarify and confirm the auditor's understanding of internal control for inventory and cost of sales.

Obj.		Done By	Date	W/P Ref.
	1. Tour the client's manufacturing or production facilities with a member of the client's organization familiar with production.	____	____	____
A B [D]	2. On a test basis, select transactions for additions and deletions of inventory from such sources as receiving reports, requisitions to place materials into production, and shipping advices. Note the reference or control number, date, description, quantity, and dollar amount for each transaction selected. Trace the transactions to the perpetual inventory record and the cost accounting records, if any, used to determine unit or job costs. Perform simi-			

Obj.		*Done By*	*Date*	*W/P Ref.*
	lar tests selecting the transactions from the perpetual inventory records and/or cost accounting records and trace the transactions to receiving reports, requisitions, and shipping advices.	____	____	____

Note: This test may be coordinated with tests of controls for purchases, payables, and disbursements, and for revenues, receivables, and receipts.

D	3. Obtain an analysis of overhead costs charged to inventories and over- and under-absorbed overhead. Review the amounts included in the overhead pool for propriety and perform the following:			
	a. Determine that overhead costs are being charged to inventory in accordance with an appropriate policy (for example, as a percent of direct labor).	____	____	____
	b. Identify disposition of variances, if any, between actual overhead costs incurred and overhead costs applied to production and inventory. Determine that variances are reasonable. Determine that no excessive costs for idle plant are being charged to inventory.	____	____	____
C D	4. If a job order cost system is used, obtain the job order ledger (or tabulation), select a period(s) and perform the following:			
	a. Trace total costs incurred to the voucher register (or cash disbursements journal), the payroll distribution, and support for overhead applied.	____	____	____
	b. Test the footings of the job order ledger by refooting the detail for selected subtotals and refooting the subtotals.	____	____	____
	c. Select _____ job orders for jobs in process and completed jobs and perform the following:			
	(1) Examine authorization for the job order.	____	____	____
	(2) Trace materials used on a test basis at various times since inception of the job order to such supporting details as requisitions, purchase orders, receiving reports, and processed invoices. (Consider coordination with tests of controls for purchases.)	____	____	____
	(3) Trace direct labor costs to account distributions of the payroll registers and on a test basis to individual time reports or time cards. (Consider coordination with tests of controls for payroll.)	____	____	____
	(4) Trace application of overhead costs to analyses used to accumulate overhead costs; test computations and review for reasonableness.	____	____	____
	(5) Identify the status of the job (work in process, finished goods, or goods shipped) and trace through necessary			

Obj.		Done By	Date	W/P Ref.
	summarization to the applicable general ledger account. Obtain explanation for any unreasonable time lag between completion and shipping dates for job orders performed for specific customers.	____	____	____
C D	5. For process cost systems, obtain the cost of production reports for each department within the production process for a selected period(s) and:			
	a. Trace quantities and dollar amounts for units received for selected departments to the quantities and dollar amount transferred out per the preceding department in the sequence of production.	____	____	____
	b. For each selected department, review the computations of total and unit costs for production transferred to the next department; on a test basis recompute unit costs and ascertain that costs for units lost in process are properly reallocated to surviving units.	____	____	____
	c. Trace material costs charged to the selected departments to appropriate journals and on a test basis to individual requisitions.	____	____	____
	d. Trace labor costs incurred to account distribution analyses of the payroll registers.	____	____	____
	e. Review the allocation of overhead.	____	____	____
	E. Observation of the Physical Inventory			
	1. Tour the premises on arrival and ascertain whether the inventory arrangement is conducive to a satisfactory count; if the arrangement appears obviously unsatisfactory, recommend rearrangement.	____	____	____
A	2. Ascertain that items on hand which are not the property of the client are clearly identified, segregated, and excluded from the count. Note such references as descriptions, quantities, serial numbers, and shipping advice numbers so that in subsequent tests of inventory summarization the auditor may determine whether the items were excluded from the physical count.	____	____	____
[A]	3. Visit the shipping and receiving departments and record the control numbers for the last shipping advice and receiving report prepared prior to the physical count for subsequent tracing to accounting department records. Consider recording a few additional shipping advice and receiving report numbers for subsequent tracing.	____	____	____
A B	4. Ascertain that receiving and shipping departments are informed that receipts after and shipments before the inventory cut-off are to be excluded from the count. Ascertain that receiving reports for items not included in the count are prominently marked "after inventory."	____	____	____

Obj.		Done By	Date	W/P Ref.
B	5. Observe and note client's provision for segregation and/or clear identification of slow-moving, obsolete and/or damaged items; also be alert for such items among regular stock and if present, bring to the client's attention and note for subsequent consideration.	____	____	____
[A] [B]	6. Inspect representative items of inventory and ascertain the source of their identification, description, status (work in process, finished goods, etc.), basis for count or measure (volume, weight, item tally, etc.). Inquire of both production personnel and personnel involved in the count about such items.	____	____	____
[A] [B]	7. Observe and ascertain that the client's inventory instructions and procedures are being followed.	____	____	____
[A] [B]	8. Ascertain that prenumbered inventory tickets on count sheets are properly controlled including:			
	a. Accounting for all tickets or sheets issued to count personnel.	____	____	____
	b. Accounting for return of all tickets or sheets issued including those unused and spoiled as well as those used, at completion of the inventory.	____	____	____
	c. Note series of tickets or count sheet numbers used and those unused or spoiled for subsequent tracing in tests of summarization.	____	____	____
[A] [B]	9. Observe the count process and make test counts ascertaining that the identifications, descriptions, and quantities are being properly noted on the inventory tickets or count sheets. If inventory count sheets are used, select some items from the floor, make test counts and trace them to the sheets; select some entries from the sheets (include some items of greater dollar value) and trace them to items on the floor.	____	____	____
[C]	10. Prepare a worksheet listing some items (include some items of greater dollar value) test counted, for subsequent tracing into the client's inventory summarization. Include on the worksheet for each item the inventory ticket or count sheet number, location, description, quantity per client, quantity per your test count, and other particulars essential for subsequent tracing to the inventory summarization. Bring test count differences to the client's attention during the count so they may be resolved in a timely manner. If test count differences are not isolated, it may be necessary to request a recount of a particular area or department.	____	____	____
B C	11. Observe that all items of inventory are clearly ticketed or marked when counted to avoid omissions and/or duplications of counts.	____	____	____
B C	12. Observe whether any items are not being counted and obtain an adequate explanation for their omission.	____	____	____

Obj.		Done By	Date	W/P Ref.
A B	13. Note any movement of inventory during the count; obtain an explanation for the movement and record details from the applicable authorizing documents for consideration in review of the cut off.	____	____	____
	14. Prepare a memorandum on the observation of the physical inventory including:			
	a. Comment on the physical inventory arrangements.	____	____	____
	b. Implementation of the client's inventory instructions.	____	____	____
F.	**Summarization—Physical Quantities**			
A B C	1. Relate and trace information, noted during observations of the physical, about control number for count tickets or count sheets used, to the client's summarization of the physical for reasonable assurance that only tickets or sheets used for the physical are included in the summarization of quantities. (Summarization of quantities may consist of the quantities per the final priced inventory or an intermediate tabulation of count tickets. In some instances the original count sheets may provide for entry of prices, extensions, and summarization of dollar amounts.)	____	____	____
B C	2. Trace test counts noted during the physical to the client's summarization of quantities.	____	____	____
A	3. Trace quantities confirmed by third parties to the summarization of quantities.	____	____	____
B C	4. Depending on the extent of the work in step 2 above and on internal control over inventory summarization, select quantities for particular items from the summarization and trace them to the count tickets or count sheets; select quantities for particular items from the count tickets or sheets and trace them to the summarization of quantities.	____	____	____
A B C	5. If the client uses perpetual inventory records and the perpetuals are to be used to determine the year-end balance, trace items on a test basis to and from the physical inventory summaries; ascertain that the perpetuals were adjusted to the physical.	____	____	____
B C	6. Trace notes made at the observation for slow moving, obsolete, and/or damaged items to the client's summarization of quantities and determine if they are clearly identified as such.	____	____	____
B C	7. Test the cut-off information noted at the observation of the physical inventory as follows:			
	a. Select the last few shipping advices used before the count to the sales register; determine that the shipments were recorded as sales and charges to cost of sales as the dates shipped.	____	____	____

Obj.		Done By	Date	W/P Ref.
	b. Select a few shipping advices used after the count to the sales register and determine that the shipments were recorded as sales in the period after the date of the inventory.	____	____	____
	c. Select the last few receiving reports used before the count and determine that the related liability was recorded prior to or as of the count date.	____	____	____
B C	8. If the client uses a process cost system, trace selected quantities per the physical inventory to the departmental cost of production reports and determine that quantities have been adjusted to the physical inventory as of the date of the physical count.	____	____	____

G. Prices and Summarization—Monetary Units

Note: Judgment should be used in determining which of the following steps should be used when testing the cost of inventory. Depending on the system used by the client to assign costs to their inventory items, certain steps may not be applicable.

Obj.		Done By	Date	W/P Ref.
D	1. Ascertain the methods followed concerning the flow of costs (FIFO, LIFO, moving average, etc.) and compare with working papers of the preceding year to ascertain whether the methods have been consistently applied.	____	____	____
CD	2. Determine client's pricing method for raw materials and purchased finished goods per the final inventory summary and make a selection of items for price testing from the sampling population as follows: ________ ________ ________ ________	____	____	____
C D	3. Compare prices to vendor invoices or price lists. If client uses LIFO method, additional procedures for testing base prices and computations should be designed and performed. Determine that the method is consistent.	____	____	____
C D	4. Perform price tests for all individually significant items of raw materials and purchased finished goods that were included in test counts.	____	____	____
C D	5. Determine client's pricing method for work-in-process and finished goods per the final inventory summary and make a selection of items for price testing from the sampling population as follows: ________ ________ ________ ________	____	____	____

Obj.		Done By	Date	W/P Ref.
C D	6. Trace unit costs of work-in-process and finished goods to the cost accounting records and perform the following:			
	Note: Cost accounting records will differ depending upon the cost accounting system (e.g., process cost system, job order system, etc.). For the finished good item or work-in-process item selected for testing, cost accounting records should be obtained which present the various costs associated with the item selected.			
	a. Agree raw material quantities used in producing the finished goods or work-in-process items to supporting documents, such as bills of material.	____	____	____
	b. Agree the cost of raw materials used in producing the finished goods or work-in-process items to vendor invoices and the final inventory summary.	____	____	____
	c. Agree labor used in producing the finished goods or work-in-process items to supporting documents, such as time cards.	____	____	____
	d. Agree labor rates to payroll records.	____	____	____
	e. Recalculate the client's overhead rate and ascertain the reasonableness of the assumptions and methods used.	____	____	____
	f. Obtain and review trial balances or tabulations of detailed components of production costs incurred for the year (period) and compare with the equivalent for the preceding year (period).	____	____	____
	(1) Obtain and note explanations for apparent inconsistencies in classification and significant fluctuations in amounts.	____	____	____
	(2) Ascertain that the cost classifications accumulated as production costs and absorbed in inventory are in conformity with generally accepted accounting principles.	____	____	____
	g. Review activity in the general ledger control accounts for raw materials, supplies, work in process, and finished goods inventories; investigate any significant unusual entries or fluctuations.	____	____	____
	h. Review labor and overhead allocations to inventory and cost of sales; compare to actual labor and overhead costs incurred and ascertain that variances appear reasonable in amount and have been properly accounted for.	____	____	____
C	7. Perform the following tests for clerical accuracy of the final summarized inventory:			
	a. Recompute extensions of quantities and unit costs on a test basis.	____	____	____
	b. Refoot accumulation of dollar subtotals on a test basis.	____	____	____

Obj.		Done By	Date	W/P Ref.
	c. Refoot dollar subtotals to test total dollar amounts per the physical inventory listing for the major classifications (i.e., raw materials, work in process, finished goods, supplies, etc.).	____	____	____
	d. Review the inventory listings for significant quantities and amounts that appear unusual.	____	____	____
	e. Ascertain that the general ledger control accounts have been adjusted to include the findings of the physical inventory. (This may consist of tracing the totals per the physical to an analysis which supports journal entries, or an involved trail of tracing through the cost accounting records to the general ledger control accounts.)	____	____	____
C	8. Review the pricing, extensions, and summarization of the physical inventory summary for items identified as slow-moving, damaged, and/or obsolete to ascertain that the items are carried at dollar amounts in conformity with the lower of cost or market principle:			
	a. Examine documentation for the proceeds of recent scrap or salvage sales.	____	____	____
	b. Review client's criteria for considering items as slow-moving or obsolete and evaluate whether criteria appear reasonable and realistic. (For example, are a certain number of months used to determine when an item becomes slow-moving? Are predetermined quantities used to determine that quantities on hand are not in excess of reasonable economic need?)	____	____	____
	H. Lower of Cost or Market Considerations			
B D	1. Determine whether adequate allowances have been recorded for obsolete and slow-moving inventory.	____	____	____
C	2. On a test basis select items of raw materials and purchased finished goods inventory including some items with relatively significant carrying amounts (because of high unit costs or large quantities on hand) and:			
	a. Compare the inventory unit prices with prices per recent (prior to year end) vendors' invoices, vendor quotations, vendor price lists, and published market quotations.	____	____	____
	b. Review purchase records and production requisitions for indications of whether items may be on hand in excess quantities, slow moving, or obsolete.	____	____	____
[A] [B] C	3. On a test basis select items or classifications of finished goods and work-in-process inventories including some items with relatively significant carrying amounts (because of high unit costs or large quantities on hand) and:			
	a. Review and note current selling prices and quantities sold for the items or classifications by reference to recent sales in-			

Obj.		*Done By*	*Date*	*W/P Ref.*
	voices, customer orders, and published market quotations, and supplementary discussion with the client's marketing and sales executives.	____	____	____
	b. Compare inventory carrying amounts and recent selling prices for the selected finished goods items or classifications noted in terms of current relationships of sales to gross profit, selling and shipping expenses; ascertain that the carrying amounts of the selected finished goods items are not in excess of net realizable value.	____	____	____
	c. For the selected work-in-process items, ascertain their stage of completion and estimated cost to complete by reference to the cost accounting records, production reports, and inquiry of the client's production supervisors. Apply the estimated costs to complete to the selected work-in-process items and apply steps *a.* and *b.* above.	____	____	____
	d. Compare quantities on hand for selected items with quantities noted per recent sales invoices and customer orders; be alert that quantities on hand are not in excess of the client's requirements.	____	____	____
B D	4. Review the prior year working papers on obsolete inventory and compare to the current year's inventory summary and obsolete inventory listing. Determine the reasonableness of any changes in prior year valuations.	____	____	____
B D	5. Based on the procedures performed, determine the results of the audit procedures as they relate to the inventory valuation.	____	____	____
	I. Other			
[A]	1. If the physical count was not taken as of the balance-sheet date, analyze and reconcile the balance per the physically counted inventory to inventory per the balance sheet:			
	a. Review and analyze the general ledger control accounts for inventory from the date counted to the balance-sheet date; trace additions to such sources as the purchase journal or voucher register, the cost accounting records, and charges to cost of sales.	____	____	____
	b. Compare the current activity between the count date and balance-sheet date to activity of the equivalent period in the preceding year. Investigate unusual fluctuations.	____	____	____
E	2. Determine whether any inventory is pledged as collateral or subject to any liens; coordinate with work on debt payable.	____	____	____
D	3. Inspect open purchase order file at the balance-sheet date for significant commitments that should be considered for disclosure.	____	____	____

Obj.		Done By	Date	W/P Ref.
D	4. Determine that any intercompany or interdepartmental profit in inventory is eliminated in consolidation.	____	____	____
	J. Section Completion			
	1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level risk for inventory, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for inventory.	____	____	____
	2. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________ ____ ____ ____

Done by

______________________________ ____ ____ ____

Reviewed by

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

VII. Property, Plant, and Equipment, and Related Depreciation

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Property exists—To determine that the property exists and is owned by the entity. (Assertion 1)

B. Additions appropriate—To determine that additions to property are authentic, recorded at cost, and properly distinguished from maintenance and repairs expense. (Assertions 1, 2, and 3)

C. Retirements recorded—To determine that retirements of property together with the proceeds from salvage and related cost to remove are properly recognized. (Assertions 1, 2, and 4)

D. Depreciation appropriate—To determine that a proper amount of depreciation expense is allocated to the period based on the asset cost, estimated life and salvage, and use of acceptable methods consistently applied, and adequately presented in the financial statements. (Assertions 4 and 5)

E. Recoverable value—To determine that the net carrying value as presented in the financial statements is expected to be recoverable through the ordinary course of business. (Assertion 4)

F. Encumbrances identified—To determine that any encumbrances and liens are identified and adequately disclosed in the financial statements. (Assertion 5)

G. Proper classification—To determine that significant amounts of idle property, plant, and equipment are properly stated, classified and described. (Assertion 5)

H. Proper disclosure—To determine that significant amounts of fully depreciated assets are considered for disclosure. (Assertion 5)

Obj.		*Done By*	*Date*	*W/P Ref.*

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e. [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Preliminary Procedures

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:
   a. Preliminary analytical review ____ ____ ____
   b. Planning documents ____ ____ ____
   c. Internal control documentation and test results ____ ____ ____

B. Substantive Analytical Procedures

A B C D E — 1. Compare balances in fixed assets, capitalized leased assets, accumulated depreciation, accumulated amortization, depreciation, repairs and maintenance, rents, supplies, and similar expense accounts with prior year balances or expected balances. Investigate significant deviations from expected amounts.

[A] [B] [C] [D] [E] — 2. Compute the following ratios to help conclude upon the reasonableness of fixed asset balances. Investigate any unusual ratio results. ____ ____ ____
   a. Fixed assets divided by total assets (indication of nonearning asset trend). ____ ____ ____
   b. Fixed assets divided by equity (indication of funding source for fixed assets). ____ ____ ____

C. Detailed Tests

1. Obtain (or update) an understanding of the client's policies concerning capitalization of assets and related depreciation methods and depreciable lives. ____ ____ ____

2. Consider a tour of the client's facilities for new staff assigned to the engagement, or for the entire audit team if significant changes have occurred. ____ ____ ____

3. Consider the extent to which it may be practicable to perform substantive tests prior to the balance-sheet date. ____ ____ ____

[A] [B] [C] [D] — 4. Obtain or prepare the following schedules:
   a. Summary schedule of property, plant and equipment, and related depreciation (by major asset classification) including the following:
      (1) Beginning and ending asset balances at cost. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	(2) Asset additions at cost.	____	____	____
	(3) Asset retirements and dispositions.	____	____	____
	(4) Other changes.	____	____	____
	(5) Depreciation method and life.	____	____	____
	(6) Beginning and ending balances of the allowances for depreciation.	____	____	____
	(7) Additions to the allowances for depreciation accompanied by an analysis of amounts expensed, absorbed in inventory, and capitalized.	____	____	____
	(8) Reductions of the allowances for depreciation for retirements and dispositions.	____	____	____
	b. Additions at cost showing the description, date acquired, transaction reference (purchase order number, check number, work order number, etc.), estimated useful life, and cost for all additions of $______ or over.	____	____	____
	c. Retirements and dispositions showing the description, date of acquisition, date of retirement or disposition, cost, accumulated depreciation, net carrying value, proceeds of disposition, and gain or loss on disposition.	____	____	____
	d. Analysis of maintenance expense showing each transaction of $______ or greater (or all transactions) for the year or period.	____	____	____
[A] [B] [C]	5. Trace opening balances per the summary schedules to closing balances per the prior year's working papers.	____	____	____
B C	6. Trace amounts per the summary schedule to the general ledger, the detailed asset records, and to the schedules of additions, and retirements and dispositions; recompute the footings and cross-footings of the schedules.	____	____	____
A B [C] F	7. Perform the following tests of selected additions:			
	a. Determine the addition has been authorized by reference to such sources as minutes of the meetings of the Board of Directors or Finance Committee and/or capital asset budgets reviewed by the Board of Directors or Finance Committee or by evidence of approval by appropriate, responsible personnel, in accordance with prescribed policies.	____	____	____
	b. Examine such supporting documents as purchase contracts, paid checks, vendors' invoices, purchase orders, receiving reports, work orders, engineers' reports, etc.	____	____	____
	c. Trace transactions to appropriate entries in the detailed records.	____	____	____
	d. For construction in progress examine supporting work orders, documentation in support of costs incurred such as contractors' invoices, reports and correspondence from en-			

Obj.			Done By	Date	W/P Ref.
		gineers and/or architects regarding completion and trace transfers from the construction in progress accounts to other property accounts.	____	____	____
	e.	Physically inspect selected (or all) major additions.	____	____	____
	f.	Inquire about related dispositions.	____	____	____
	g.	Determine whether additions conform with the company's capitalization policy.	____	____	____
	h.	Determine that installment purchases, if any, are properly recorded.	____	____	____
	i.	By reference to purchase contracts and contractors billings identify related liabilities to be recorded in connection with debt or other payables.	____	____	____
	j.	Examine deeds and title insurance policies, as necessary.	____	____	____
	k.	Review insurance policies, coinsurance clauses and coverage limits versus replacement costs, as necessary.	____	____	____
	l.	Identify any indications of employees' involvement in ownership or sales interest in the asset. Ascertain the propriety of any identified employee involvement.	____	____	____
A C [D]	8.	Perform the following tests of dispositions:			
	a.	Determine disposition has been properly authorized.	____	____	____
	b.	Examine such supporting documents as bills of sale, contracts, delivery memoranda, etc.	____	____	____
	c.	Trace retirements to the detailed property records.	____	____	____
	d.	Determine that deductions from the asset accounts and related accumulated depreciation are correct.	____	____	____
	e.	Determine that gain or loss on disposition has been correctly classified and recorded.	____	____	____
A C G H	9.	For fully depreciated assets, determine whether the assets are still used and not retired from service. Determine whether disclosure in the financial statements is necessary.	____	____	____
A C G H	10.	Determine that assets retired from service, if material, have been removed from the property, plant, equipment accounts and related accumulated depreciation accounts, and are carried at amounts which are not in excess of realizable value.	____	____	____
D [E]	11.	Review provisions for depreciation and amortization, and:			
	a.	Determine whether the methods and depreciable lives used in the current year are consistent with the preceding year and are reasonable.	____	____	____
	b.	Perform a reasonableness test of depreciation and amortization by using average rates and lives and one-half year for additions and disposals.	____	____	____

Obj.		Done By	Date	W/P Ref.
	c. Test computations of depreciation and amortization. Consider deleting this step if step *b* results are acceptable.	____	____	____
	d. Determine that amounts of depreciation capitalized in construction in progress are reasonable and appropriate.	____	____	____
	e. Ascertain that obsolescence, if any, is being properly recognized by adjustments of depreciable lives.	____	____	____
	f. Trace additions to the depreciation allowance to the applicable general ledger expense accounts.	____	____	____
D E G H	12. Based on all of the procedures performed above, ascertain the reasonableness of the remaining useful lives of assets and ascertain the recoverability of the net carrying values of the client's fixed assets.	____	____	____
B	13. Review maintenance and repairs expense, supplies, small tools and other appropriate accounts for any assets that should be capitalized.	____	____	____
E H	14. Determine the investment credit and recapture on disposals. Summarize for tax return and provision computation.	____	____	____
H	15. Determine the carrying amount of assets pledged on notes or other indebtedness for possible financial statement disclosure.	____	____	____
H	16. Inquire as to any significant expansion plans and determine any need for disclosure.	____	____	____
H	17. Review rental income and expense accounts to determine leased and subleased assets.	____	____	____
A D E G H	18. In accordance with FASB Statement No. 121 (AC I08), if any events or changes in circumstances have occurred indicating that the carrying amount of a long-lived asset may not be recoverable:			
	a. Determine if an impairment loss should be recognized. [An impairment loss should be recognized if the carrying amount of an asset exceeds estimated future cash flows (undiscounted and without interest charges).]	____	____	____
	(1) Review the estimate of future cash flows for mathematical accuracy and, through discussion with management and review of any supporting documentation, determine whether assumptions used are reasonable.	____	____	____
	b. If an impairment loss should be recognized, test the calculation of the loss. [The impairment loss is measured as the amount by which the carrying amount of an asset exceeds its fair value.]	____	____	____
	(1) Test the fair value calculation by vouching to quoted market prices in active markets or by reviewing the valuation technique used.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	(2) If the fair value is based on the present value of estimated future cash flows, test for mathematical accuracy and ensure that the assumptions used in the present value calculation, including the discount rate, are reasonable.	____	____	____
	D. Leases			
A E	1. Review the permanent file to determine whether updated copies of lease agreements and other data of continuing application are included and that changes made during the year are appropriately noted.	____	____	____
A B D F H	2. Examine new lease agreements and significant amendments to existing lease agreements to determine whether they are accounted for in accordance with the appropriate accounting standards (properly capitalized, appropriate depreciation, etc.), determine whether they are in accordance with established policies and procedures and document the conclusions in the permanent file.	____	____	____
A F	3. *Consider the advisability* of obtaining from the lessor confirmation of compliance with restrictive covenants and other pertinent details of significant lease agreements.	____	____	____

Practice Tip

Items to be considered for leases:
- Facilities.
- Authorization and approval of terms.
- Parties.
- Location and description of premises.
- Period covered.
- Rentals.
- Contingent payments and escalator clauses.
- Payment of ownership expenses.
- Restrictions.
- Options and renewal provisions.
- Methods and terms of cancellation.
- Subleases.
- Nature and amount of related guarantees made or obligations assumed.
- Other contractual arrangements which have the economic characteristics of a lease.
- Investment tax credit.
- Criteria for lease capitalization as set forth in appropriate accounting standards (principles).

Obj.		*Done By*	*Date*	*W/P Ref.*
A B C D E F G H	4. Obtain an analysis of capitalized lease obligations, including related lease rights and interest, and:			
	a. Compare beginning balances to prior period audit work papers.	____	____	____
	b. Test the clerical accuracy of the analysis.	____	____	____
	c. Compare balances to the general ledger accounts.	____	____	____

Obj.		Done By	Date	W/P Ref.
	d. Review the general ledger accounts for the period, investigate unusual entries, and document the results of such investigation.	____	____	____
	e. Examine the lease agreements to verify the terms used in the computations.	____	____	____
	f. Test payments and examine other supporting data, where appropriate.	____	____	____
	g. Test the computations of current maturities.	____	____	____
	h. Determine whether the accounting method for lease cancellations has been applied in accordance with applicable accounting standards and that the method has been consistently applied.	____	____	____
	i. Test new leases or significant changes to existing leases as follows:			
	(1) Determine whether the accounting method has been applied in accordance with GAAP and that the method has been consistently applied.	____	____	____
	(2) Review the reasonableness of the interest rate used to discount the lease obligation. Consider the following:			
	(a) Interest rates implicit in the lease terms.	____	____	____
	(b) Interest rates applicable to the financing of purchases of similar property by the lessee at the times of entering into the lease agreements.	____	____	____
	(c) Fair value of the leased property as compared to the discounted amount of the lease obligation.	____	____	____
	(3) Determine whether proper consideration was given to noncapitalizable costs (such as taxes, insurance, maintenance) in computing the amount of lease cost capitalized.	____	____	____
	(4) Review the reasonableness of the method and period for amortization of capitalized lease rights.	____	____	____
A B C D E F G H	5. Select work paper formats that will facilitate grouping information regarding operating leases that may require disclosure in the financial statements and:			
	a. Obtain the appropriate analyses above and proceed as follows:			
	(1) Compare pertinent information to the lease agreements.	____	____	____
	(2) Test the clerical accuracy of the analyses.	____	____	____
	(3) Determine whether the calculations have been made in accordance with the lease agreements.	____	____	____
	(4) Compare prepaid and accrued rentals and rental expenses to the respective general ledger accounts.	____	____	____

Obj.		Done By	Date	W/P Ref.
	(5) Review the general ledger accounts for the period, investigate unusual entries and document the results of such investigation.	____	____	____
	(6) Test the computations of minimum rental commitments applicable to succeeding periods.	____	____	____

Practice Tip

Refer to the applicable accounting standards for a description of disclosure information, such as, rental expenses, minimum future rental payments, noncancelable sublease rentals to be received in the future, contingent rentals, sublease rentals, and general description of leasing arrangements.

	b. Review lease agreement covenants that relate to limitations and default provisions as follows:			
	(1) Review the client's correspondence file for information related to leases, such as modifications, waivers and notification of significant events.	____	____	____
	(2) Review confirmation replies for notations of known matters of noncompliance.	____	____	____
	(3) Cross-reference factors entering into the computations and compute amounts.	____	____	____
	(4) If a default appears to exist with respect to any lease agreement, determine its effect on such agreement, other agreements, the financial statements and our report thereon.	____	____	____
	c. Gather and document information for financial statement disclosure and tax return preparation.	____	____	____
	d. Consider and compute any capitalized interest.	____	____	____

Practice Tip

Consider preparing a schedule for inclusion in the permanent file that sets forth, by section and paragraph number, the limitations and each computation or item involved in the determination of whether the client is in compliance with lease covenants.

E. Section Completion

	1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for property, plant, and equipment, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for property, plant, and equipment.	____	____	____
	2. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________ ____ ____ ____
Done by

______________________________ ____ ____ ____
Reviewed by

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

VIII. Prepaid Expenses, Deferred Charges, Intangibles, and Other Assets

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Properly recorded—To determine that the balances represent costs which are properly allocable to future periods in conformity with generally accepted accounting principles. (Assertions 1, 2, 3, and 4)

B. Additions supported—To determine that additions are adequately supported. (Assertions 1, 2, 3, and 5)

C. Amortization appropriate—To determine that amortization is determined by a rational and systematic method consistently applied. (Assertions 4 and 5)

D. Impairment recognized—To determine that any permanent impairment of balance is recognized by write-downs charged to operations. (Assertions 1, 2, 4, and 5)

E. Proper classification—To determine that balances and related expenses are properly described and classified in the financial statements. (Assertion 5)

F. Contingencies disclosed—To determine whether there are uninsured risks that should be considered for disclosure.. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e. [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Obj.		*Done By*	*Date*	*W/P Ref.*
	Procedures:			
	A. Preliminary Procedures			
	1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
	a. Preliminary analytical review	____	____	____
	b. Planning documents	____	____	____
	c. Internal control documentation and test results	____	____	____
	B. Substantive Analytical Procedures			
A B C D	1. Compare balances in prepaid expense, deferred charges, intangibles, other assets, and accumulated amortization accounts to the preceding year's balances or expected balances. Investigate any significant deviations from the expected amounts.	____	____	____
	C. Detailed Tests			
A B C E	1. Obtain or prepare an analysis for each significant classification of prepaid expenses, deferred charges, other assets or intangibles. The analysis should include adequate description of significant components and the following:			
	a. Balance at the beginning of the year (or period).	____	____	____
	b. Additions at cost.	____	____	____
	c. Deductions charged to expense, and to other accounts.	____	____	____
	d. Balance at the end of the year (or period).	____	____	____

Practice Tip

Ordinarily, extensive detailed schedules showing computations of prepaid balances or analyses of transactions for the period are not necessary, particularly in cases where the balances are not significant. A brief summary of limited reviews and comparisons of balances with prior period amounts or tests of the client's detailed records may be satisfactory.

	2. Foot analysis and trace totals to general ledger; trace opening balance to the audit working papers for the preceding year (or period).	____	____	____
A B [C] D E	3. Examine supporting documents for material charges during the year.	____	____	____
[A] C [D]	4. Review and recompute amortization; determine that the amortization period and method is reasonable.	____	____	____
A C [D]	5. Determine that the carrying amount of the item does not exceed amounts properly allocable to future periods.	____	____	____
C	6. Trace amounts amortized during the period to the related general ledger expense accounts.	____	____	____
A	7. Confirm significant deposits and assets held by others.	____	____	____

Obj.		Done By	Date	W/P Ref.
A F	8. For prepaid insurance accounts (including life insurance) with balances of $____ or more at ____, obtain or prepare a prepaid insurance schedule and agree prepaids and expense to the general ledger; perform the following additional tests:			
	a. Examine selected policies noting identity of insurer, descriptions and amounts of coverage, premiums, and period covered; compare particulars with the analysis.	____	____	____
	b. Ascertain by review of the policy and related billing advices for the insurance premiums whether the premiums are being financed and/or the policy or cash surrender value has been pledged; determine that related liabilities and finance cost have been properly recorded.	____	____	____
	c. Obtain confirmation of cash surrender values; consider confirmation of policies especially if premium financing is involved to determine that payments are current and coverage is still in force.	____	____	____
	d. Ascertain whether all significant insurable risks have been considered.	____	____	____
	e. Recompute amortization and trace amounts to the applicable expense accounts.	____	____	____

Practice Tip

Be alert to insurance confirmations indicating locations of inventory. Trace locations listed to inventory totals to determine all locations listed as covered by insurance have been included in the inventory summary.

	f. Vouch premiums of $____ or more to premium notices.	____	____	____
	g. Ascertain propriety of accounting treatment for premium deposits and dividends.	____	____	____
	h. Examine latest audit reports, when applicable, made by insurance companies.	____	____	____
	i. For life insurance, reconcile prepaid premiums at beginning of period, premiums paid and increase in cash surrender value with life insurance expense.	____	____	____
A	9. For property taxes, where significant, obtain or prepare an analysis which relates both repayments and accruals as of the beginning and end of the period with tax expense. Examine tax billings and determine whether the timing of the period covered by the tax and the payment due dates result in prepayment or an accrual as of the balance-sheet date. Trace charges to expense to the proper expense account.	____	____	____
A D	10. Obtain a list of the detail of all suspense accounts and follow-up on the clearance of all items. (Note: suspense accounts should clear in one day). Investigate any large or unusual uncleared items.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
A B C	11. For intangible assets:			
	a. Trace authorization for major transactions to minutes of Board of Directors meetings.	____	____	____
	b. Examine supporting documents.	____	____	____
	c. Ascertain whether amortization has been properly computed in conformity with generally accepted accounting principles, and trace charges to related expense accounts.	____	____	____
A D	12. Determine that there has been no permanent impairment of value for prepaid expenses, deferred charges, intangible assets, etc.	____	____	____
E	13. Determine that balances are properly classified in the balance sheet (current v. noncurrent, etc.)	____	____	____
F	14. Determine that there have been no uninsured events which would affect the value of other assets.	____	____	____
E	15. Determine any required disclosures.	____	____	____

D. Section Completion

1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for prepaid expenses, deferred charges, intangibles and other assets, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for those accounts.	____	____	____
2. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

Done by	____	____	____
Reviewed by	____	____	____

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

IX. Accounts Payable

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Payables exist—To determine that accounts payable represent authorized current obligations. (Assertions 1 and 2)

B. Proper classification—To determine that amounts included in accounts payable are properly classified. (Assertion 5)

C. Obligations complete—To determine that accounts payable include all significant current obligations. (Assertions 2, 3, and 4)

D. Proper disclosure—To determine that adequate disclosure has been made of any pledged assets. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e. [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Preliminary Procedures

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:

   a. Preliminary analytical review ____ ____ ____

   b. Planning documents ____ ____ ____

   c. Internal control documentation and test results ____ ____ ____

Obj.		Done By	Date	W/P Ref.

B. Substantive Analytical Procedures

A B C 1. Compare balances in trade accounts payable and purchases with the preceding year's balances or expected balances. Investigate any significant deviations from the expected amounts. ____ ____ ____

C. Detailed Tests

1. Were the following items considered:

   a. Whether to request positive confirmation from vendors and, if so, when and to what extent. ____ ____ ____

Note: Some auditors send confirmations to major vendors to obtain independent outside evidence that all liabilities have been recorded. Other auditors believe that evidential matter can be obtained more efficiently through other procedures.

   b. Potential efficiencies to be gained from coordination of accounts payable work with substantive tests of inventory when the physical is taken at the balance-sheet date. (For example, tests of cut off, and using vouchers obtained from client's files in substantiating recent inventory prices as well as accounts payable work.) ____ ____ ____

A B C D 2. Obtain or prepare a schedule of accounts payable (subsidiary ledger) as of the balance-sheet date.

   a. Foot schedule/subsidiary ledger and reconcile to the general ledger control account. ____ ____ ____

   b. Segregate amounts due to officers, employees, stockholders, affiliates and other related parties. ____ ____ ____

   c. Discuss with client old or disputed payables. ____ ____ ____

   d. Investigate debit balances and, if significant, consider requesting positive confirmations and propose reclassification of the amounts. ____ ____ ____

   e. Ascertain by review of minutes, agreements and by inquiry whether any assets are pledged to collateralize payables. ____ ____ ____

   f. Identify intercompany accounts and:

      (1) Arrange to have balances traced to corresponding receivables in the affiliate's books if affiliate is being currently audited by the firm. ____ ____ ____

      (2) Obtain confirmation from the affiliate. ____ ____ ____

      (3) Investigate and reconcile differences. ____ ____ ____

A B C [D] 3. Consider confirmation procedures such as the following:

   a. Obtain and review a list of major vendors, or identify major vendors by reviewing voucher registers or subsidiary accounts payable records. ____ ____ ____

Obj.			*Done By*	*Date*	*W/P Ref.*
		b. Request vendors to provide a statement of the account balance as of the date selected (ordinarily, the physical inventory date and/or balance-sheet date).	____	____	____
		c. Investigate and reconcile differences.	____	____	____

Practice Tip

Vendors should be instructed to mail confirmation replies directly to the auditor. The auditor should control the mailing of all confirmations.

Obj.			*Done By*	*Date*	*W/P Ref.*
A B [D]	4.	Confirm balances due to officers and employees; ascertain business purpose of the transactions and, if significant, trace to authorization in the minutes of the Board of Directors meetings.	____	____	____
A C	5.	Test selected unconfirmed balances by examination of vouchers, invoices, and receiving reports.	____	____	____
A B C	6.	Obtain the purchases journal and trace all entries over $____ for a period of ____ days after the balance-sheet date to supporting documents to determine recording in the proper period.	____	____	____
A B C	7.	Obtain the cash disbursements journal and trace all entries over $____ for a period of ____ days after the balance-sheet date to supporting documents to determine recording in the proper period.	____	____	____
A B C	8.	Review the open receiving report, open purchase order and open purchase requisition files for ____ days after the balance-sheet date for unrecorded liabilities.	____	____	____
A B C	9.	Review the open vendor invoice files for ____ days after the balance-sheet date to determine recording in the proper period and for unrecorded liabilities.	____	____	____
A C	10.	Inquire of responsible client staff about their knowledge of additional sources of unprocessed invoices, unrecorded commitments, or contingent liabilities.	____	____	____
A B C	11.	Liabilities for payroll taxes withheld:			
		a. Trace liabilities to payments made subsequent to the balance-sheet date; examine the payroll tax deposit receipts.	____	____	____
		b. Compare liability to accrued payroll taxes for reasonableness.	____	____	____
		c. Trace liabilities to summaries of the applicable payroll registers.	____	____	____
A B C	12.	Determine that credit memos received ____ days after the balance-sheet date have been recorded in the proper period.	____	____	____
B C D	13.	Identify any payables due after one year and consider the imputation of interest.	____	____	____
D	14.	Consider the need for any disclosures.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	D. Section Completion			
	1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for accounts payable, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for accounts payable.	____	____	____
	2. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

Done by	____	____	____
Reviewed by	____	____	____

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Obj.		*Done By*	*Date*	*W/P Ref.*

X. Accrued Liabilities Other Than Income Taxes and Deferred Credits

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Liabilities complete—To determine that expense accounts include costs and expenses applicable to the period. (Assertions 1, 2, and 5)

B. GAAP conformity—To determine that all contingencies and estimated future expenses that should be accrued in the period have been accrued, classified, and described in accordance with generally accepted accounting principles consistently applied. (Assertion 1, 2, 3, 4, and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e. [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Preliminary Procedures

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:

Obj.	Procedure	Done By	Date	W/P Ref.
	a. Preliminary analytical review	____	____	____
	b. Planning documents	____	____	____
	c. Internal control documentation and test results	____	____	____

Obj.		Done By	Date	W/P Ref.
	B. Substantive Analytical Procedures			
A B	1. Compare balances in accrued expense and other liability accounts with the preceding year's balances or expected balances. Investigate any significant deviations from the expected amounts.	____	____	____
	C. Detailed Tests			
[A]	1. Obtain or prepare analysis of accrued liability accounts and agree to the general ledger.	____	____	____
A B	2. For accrued salaries, wages, vacation pay and bonus accounts:			
	a. Test the clerical accuracy of the analyses.	____	____	____
	b. Determine whether the calculations have been made in accordance with related agreements and the corporate policies established by the board of directors or other appropriate executive groups.	____	____	____
	c. Trace bonuses and similar accruals to the board of directors minutes or other proper authorizations.	____	____	____
	d. Compare amounts to subsequent payments.	____	____	____
A B	3. Test computations of accrued salaries and wages by tracing last payment date to payroll journals and estimating the accrual by reference to subsequent payrolls.	____	____	____
A B	4. Review compensation agreements for possible additional liabilities.	____	____	____
A B	5. Determine whether a liability should be accrued for employees' compensation for future absences.	____	____	____

Practice Tips

Ordinarily, a liability is accrued when all of the following conditions are met:

- The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered,
- The obligation relates to rights that vest or accumulate,
- Payment of the compensation is probable, and
- The amount can be reasonably estimated.

The fact that an accrual has not been made because of an inability to meet the last condition ordinarily should be disclosed.

Obj.		Done By	Date	W/P Ref.
A B	6. Review deferred compensation agreements and the method of accounting:			
	a. Determine whether the method of accounting recognizes deferred compensation costs in accordance with FASB Statement No. 106 (AC P40).	____	____	____
	b. Consider whether individual contracts, if taken together, constitute a pension plan.	____	____	____

Obj.		Done By	Date	W/P Ref.
A B	7. Obtain an analysis of deferred compensation and:			
	a. Test the clerical accuracy of the analysis and compare balances to the general ledger.	____	____	____
	b. Verify the computations by reference to provisions of the agreements.	____	____	____
	c. Test current payments by examining appropriate supporting data.	____	____	____
	d. *Consider the advisability* of confirming unpaid balances and the terms of payment.	____	____	____
A B	8. Review the general ledger liability accounts for other accruals that may exist and proceed as follows:			
	a. Inquire into the nature and purpose of such accounts and document the results of the inquiry.	____	____	____
	b. Identify the accounts selected for further analysis. *(To be done by the in-charge.)*	____	____	____
	________ ________ ________ ________ ________ ________			
	c. Verify the year-end balance of the accounts selected by computation, examination of subsequent payments or examination of other data.	____	____	____
	d. Compare recorded transactions to available supporting data on a test basis, *where deemed necessary.*	____	____	____
A B	9. Consider whether there is a need to recognize and disclose environmental remediation liabilities.	____	____	____

Practice Tip

To help identify possible environmental issues, the auditor should consider:
- The industry in which the client operates,
- The types of products or services provided by the client,
- The number and characteristics of the client's locations,
- Applicable governmental regulations and
- The client's production and distribution processes.

		Done By	Date	W/P Ref.
	a. Inquire of management whether the company or any of its subsidiaries has been designated a potentially responsible party by the Environmental Protection Agency or otherwise has a high-risk exposure to environmental liabilities.	____	____	____
	b. Consider other possible indicators of increased risk of environmental liability, such as:			
	(1) Participation in real estate transaction or corporate merger involving properties with environmental risks.	____	____	____
	(2) The purchase of land for a price significantly below local market prices.	____	____	____
	(3) The acquisition of new or increased insurance coverage against environmental risks or liability to third parties.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
A B	10. Review revenue accounts and determine whether income recorded in the current period should be deferred to future periods.	____	____	____
A B	11. Obtain appropriate analyses of other deferred credits:			
	a. Review and document the nature of the account and the policies and method of accounting.	____	____	____
	b. Test computations of current additions and reductions by examination of appropriate supporting data or by analytical review of appropriate revenue and expense accounts.	____	____	____
	c. Determine whether the basis of recording and method of amortization is consistent with the prior year.	____	____	____
	d. Determine if the ending balance is reasonable.	____	____	____
[A] [B]	12. Determine that amounts accrued that are not currently deductible for income tax purposes have been identified for consideration in the computation of income taxes.	____	____	____
A B	13. Determine whether management replies to our inquiries provide adequate explanations for significant fluctuations and consider whether such replies are corroborated by our audit procedures and knowledge of the business or whether additional audit procedures are required.	____	____	____
A B	14. Obtain and verify disclosure information for multi-employer plans and vouch expense for the period.	____	____	____
A B	15. For defined contribution plans:			
	a. If applicable, obtain copy of trustee's fund report. Consider confirming contents of report with trustee.	____	____	____
	b. Determine if there have been any adoptions or amendments of plans during the period and obtain copies. Note for financial statement disclosures and:			
	(1) Agree expense to minutes, when applicable.	____	____	____
	(2) Verify computations, where applicable.	____	____	____
	c. Where applicable, test employee data. Test should consist of analytical procedures, and additional procedures as considered necessary.	____	____	____
[A] [B]	16. For defined benefit plans obtain the following, where applicable:			
	a. Copy of actuarial report as of a date no earlier than three months prior to balance-sheet date.	____	____	____
	b. If applicable, copy of trustee's report.	____	____	____
	c. Form 5500 for prior year and for current year, if already prepared.	____	____	____
	d. Actuary's certificate on Schedule B for Form 5500 for prior year and for current year if already prepared.	____	____	____
	e. Plan document(s).	____	____	____
	f. Census and plan asset date given to actuary.	____	____	____
A B	17. Consider confirming contents of Trustee report with Trustee.	____	____	____

Obj.		Done By	Date	W/P Ref.
A B	18. Reconcile aggregate census data, such as number of employees covered, compensation, to amounts shown in the actuarial valuation report or if not in the report, consider obtaining confirmation of such data from the actuary.	____	____	____
A B	19. For selected employees, check census data (age, sex, marital status, current pay, term of employment, benefit election, etc.) to payroll records. [Check only that data important to the valuation. If analytical review of data and valuation report appear reasonable, a sample of 15 will generally be acceptable. If not, a sample up to 40 may be required.]	____	____	____
A B	20. Based on plan documents, make appropriate tests to determine whether all eligible employees are included in the census data provided to the actuary.	____	____	____
A B	21. Reconcile plan assets per the trustee's report to amounts shown in the actuarial valuation report.	____	____	____
[A] [B]	22. Ascertain that the actuary is professionally qualified. (Membership in the Society of Actuaries, the Conference of Actuaries in Public Practice, American Academy of Actuaries is usually sufficient to indicate that actuary is qualified.)	____	____	____
[A] [B]	23. Inquire as to any relationships between the actuary and the client that would impair independence.	____	____	____
A B	24. Review the actuary's most recent certificate on Schedule B, Form 5500, and determine the reasons for qualifications expressed, if any.	____	____	____
B	25. Determine if there have been any adoptions or amendments of plans during the period. Obtain copies of any and note for financial statement disclosure.	____	____	____
A B	26. Review the latest plan document and compare with key provisions included in the actuarial valuation report. If the report does not include a description of key plan provisions, it may be necessary to confirm the actuary's understanding of such provisions.	____	____	____
A B	27. Vouch the payment of the prior year's accrual to determine that it was paid prior to the filing of the year tax return. (If not paid at the tax return due date, or extended due date, the bank loses its tax deduction.)	____	____	____
A B	28. Trace the authorization for the contribution to the plan to the board of directors' minutes, or obtain the management representation in the representation letter.	____	____	____
B	29. Inquire of the client as to any intent to terminate the plan.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
B	30. Obtain and check disclosure information.	____	____	____
A B	31. If not previously audited, obtain net transition obligation computations and agree amounts to actuarial report, trustees report, or other evidential sources. Recheck compensation.	____	____	____
A B	32. Obtain calculation of pension cost for the current period and agree components to actuarial report or trustee's report.	____	____	____
A B	33. Determine that a liability is recorded for unfunded accrued pension cost whenever the client's contribution is less than its related expense or that prepaid pension costs is recorded when the amount funded exceeds the related expenses.	____	____	____
A B	34. Determine that an additional liability is recorded equal to the excess, if any, of the accumulated benefit obligation over the fair value of plan assets. (Similar assets are not recorded except when the excess follows a business combination treated as a purchase.)	____	____	____
[A] [B]	35. If the work of a specialist is used in performing the audit, has the auditor documented his satisfaction concerning the following:			
	a. Review the professional certification, license, or other recognition of the competence of the specialist.	____	____	____
	b. The reputation and standing of the specialist in view of those familiar with his capability or performance.	____	____	____
	c. The specialist's experience in the type of work under consideration.	____	____	____
	d. Review the relationship, if any, of the specialist to the client.	____	____	____
	e. If the work of a specialist is used in performing the audit, obtain and document the auditor's understanding of the nature of the work to be performed.	____	____	____
[A] [B]	36. Prepare conclusion memo as to whether or not audit objectives have been met and accordingly whether or not the pension and related accounts are fairly stated for inclusion in the (consolidated, if applicable) financial statements in accordance with generally accepted accounting principles. (If not, document details of exception.)	____	____	____

D. Section Completion

		Done By	*Date*	*W/P Ref.*
	1. Accumulate in the working papers all information required to be disclosed in the financial statements (e.g., pension plan data).	____	____	____
	2. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for accrued expenses, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for accrued expenses.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	3. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

Done by	____	____	____
Reviewed by	____	____	____

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Obj.		*Done By*	*Date*	*W/P Ref.*

XI. Income Taxes Accrued and Provided

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Amount reasonable—To determine that the provision for income taxes is reasonable. (Assertions 1, 2, 3, and 4)

B. Amount comparable to amount to be paid—To determine that the liability for accrued income taxes is adequate and not excessive in relation to amounts reasonably expected to be payable. (Assertions 3 and 4)

C. Temporary differences recognized—To determine that deferred income taxes represent the effect of temporary differences. (Assertions 1, 2, and 4)

D. Proper classification—To determine that income tax provisions, accruals and deferrals are properly described and classified in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Preliminary Procedures

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:

   a. Preliminary analytical review ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	b. Planning documents	____	____	____
	c. Internal control documentation and test results	____	____	____

B. Detailed Tests

Obj.		Done By	Date	W/P Ref.
A B C [D]	1. Obtain or prepare analyses of the various current and deferred income tax liabilities and assets and related provisions showing:			
	a. Balances at the beginning of the year (period).	____	____	____
	b. Amounts provided.	____	____	____
	c. Refunds received.	____	____	____
	d. Payments made, indicating date and nature.	____	____	____
	e. Balances at the end of the year (period).	____	____	____
A	2. Compare opening balances to the prior year's working papers.	____	____	____
A B	3. Trace payments to cash books and general ledger; examine canceled checks for evidence of timely payment.	____	____	____
A B	4. Compare payments and refunds to copies of income tax returns.	____	____	____
A B C	5. Ascertain latest year that income tax returns have been examined and which periods, if any, are being contested. Examine recent Revenue Agent Reports; determine that adequate consideration has been given to items challenged in the past. Also consider disclosure of the examination.	____	____	____
A B C	6. Review or prepare a reconciliation of earnings (loss) per books with taxable income for the period.	____	____	____
A B C	7. Review or compute the provisions for federal and other income taxes.	____	____	____
D	8. Determine that the nature of any significant differences between pretax earnings and income tax expense are disclosed.	____	____	____
A B C	9. Determine that the accrual and provision is adequate considering:			
	a. Tax positions taken by the client that might be challenged by the taxing authorities or other tax contingencies.	____	____	____
	b. Possible assessments, penalties or interest indicated by tax return examinations completed during the year or in progress, including similar adjustments applicable to years not yet examined.	____	____	____
A B C	10. Compute or obtain and test the client's computation of deferred tax assets and liabilities to determine conformity with FASB Statement No. 109 (AC I27). Test the reasonableness.	____	____	____
A B C D	11. For deferred tax assets, determine the likelihood that all or part of the recorded amount will not be realized. In making that determination, consider all available evidence, both positive and negative.	____	____	____

Obj.		Done By	Date	W/P Ref.

Practice Tip

For tax benefits to be realized, there must be adequate taxable income in the future when deductible temporary differences reverse and when net operating loss carryfowards are available.

Obj.		Done By	Date	W/P Ref.
A B C D	12. If it is determined that it is more likely than not that all or part of the deferred tax asset will not be realized, evaluate the adequacy of the valuation allowance account by performing the following:			
	a. Review and test the process used by management to develop the estimate, or develop an independent expectation of the estimate, to corroborate the reasonableness of management's estimate.	____	____	____
	b. Determine whether any subsequent events or transactions have occurred prior to the completion of field work that could effect the adequacy of the valuation allowance.	____	____	____

Practice Tip

See FASB Statement No. 109, paragraphs 17–26 (AC I27.116–125), for guidance on valuation allowance computation.

Obj.		Done By	Date	W/P Ref.
D	13. Review a schedule of net operating loss carryovers and unused investment tax credits for propriety.	____	____	____
A B	14. Consider additional tax liabilities to any new states in which the client does business.	____	____	____
A B C	15. If the auditor is to prepare the returns, ascertain that all necessary information is obtained.	____	____	____
D	16. Obtain all necessary information for disclosure in the financial statements (e.g., tax benefits of operating loss carryovers, classification of deferred taxes, etc.).	____	____	____
A B C D	17. Obtain tax department review of the income tax working papers.	____	____	____

C. Section Completion

		Done By	Date	W/P Ref.
	1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for income taxes, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for income taxes.	____	____	____
	2. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________ ____ ____ ____
Done by

______________________________ ____ ____ ____
Reviewed by

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Obj.		*Done By*	*Date*	*W/P Ref.*

XII. Notes Payable and Long-Term Debt

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Payables exist—To determine that notes payable and long-term debt are authorized, properly classified, and described in the financial statements. (Assertions 3 and 5)

B. Period recorded proper—To determine that liabilities are recorded in the proper period at the correct amounts. (Assertions 1, 2, and 4)

C. Expense recognized—To determine that related interest expense (including discount or premium) is accounted for in conformity with generally accepted accounting principles consistently applied. (Assertions 2 and 5)

D. Adequate disclosure—To determine that the financial statements include adequate disclosure of restrictive covenants of loan agreements, pledged assets, etc. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Preliminary Procedures

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:

   a. Preliminary analytical review ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	b. Planning documents	____	____	____
	c. Internal control documentation and test results	____	____	____
A B C	**B. Substantive Analytical Procedures**			
	1. Compare balances in notes payable, long-term debt, and the related interest expense accounts with the preceding year's balances or expected balances. Investigate any significant deviations from the expected amounts.	____	____	____
	2. Compute the following ratios and compare to preceding year's ratios or expected ratios. Investigate any significant deviations from the expected ratios.			
	a. Long-term debt to stockholders' equity.	____	____	____
	b. Interest expense as a percentage of average balance of notes payable and long-term debt outstanding.	____	____	____
	C. Detailed Tests			
[A] [B] [C] [D]	1. Obtain or prepare an analysis of notes payable, long-term debt, lines of credit, and other financing arrangements showing the following:			
	a. Description:			
	(1) Date of origin	____	____	____
	(2) Type of debt and maturity	____	____	____
	(3) Face amount	____	____	____
	(4) Interest rate	____	____	____
	(5) Timing and amount payments	____	____	____
	b. Principal:			
	(1) Balance at the beginning of the year (period)	____	____	____
	(2) Additions	____	____	____
	(3) Payments	____	____	____
	(4) Balance at the end of the year (period)	____	____	____
	c. Related Interest:			
	(1) Accrued interest at the beginning of the year (period)	____	____	____
	(2) Unamortized discount or premium at the beginning of the year (period)	____	____	____
	(3) Expense incurred during the year (period)	____	____	____
	(4) Amount paid during the year (period)	____	____	____
	(5) Accrued at the end of the year (period)	____	____	____
	(6) Unamortized discount of premium at the end of the year (period)	____	____	____

Obj.			*Done By*	*Date*	*W/P Ref.*
[D]	2.	Foot and crossfoot analysis, and trace totals to general ledger and subsidiary ledgers for notes payable and long-term debt.	____	____	____
A [D]	3.	Trace authorization for all new debt to the minutes of the Board of Directors meetings.	____	____	____
A B C D	4.	Examine supporting documentation for all debt and related interest expense (for example, note and loan agreements, bond indentures, correspondence from legal counsel, etc.); obtain copies of debt agreements and highlight restrictive covenants. Note and investigate any apparent violations. Maintain copies of all notes and related agreements in the permanent file.	____	____	____
A D	5.	Confirm outstanding balances, terms, conditions, and compliance with covenants with the credit grantor or independent trustee.	____	____	____

Practice Tip

Confirming responses should be mailed back directly to the auditor. The auditor should always control the mailing of confirmations. Second requests should be mailed as necessary for nonreplies.

Obj.			*Done By*	*Date*	*W/P Ref.*
A B	6.	Examine canceled or paid notes and bonds. Consider confirming large notes paid or canceled during the year (period).	____	____	____
D	7.	Determine if any assets are subject to lien and obtain carrying amount for disclosure.	____	____	____
D	8.	Examine notes for guarantees. Be alert for related-party guarantees. All guarantee relationships should be disclosed.	____	____	____
A B D	9.	Examine notes and debt agreements and review compliance with restrictive loan covenants. Gather information for financial statement disclosures.	____	____	____
D	10.	Separate short-term notes and the current portion of long-term debt for report classification. Categorize by type of lender (related party, banks, loan company, etc.). Determine five year maturities for all long-term obligations.	____	____	____
C	11.	Test interest expense and amortization of debt discount or premium by:			
		a. Performing reasonableness tests. For example, multiplying average balances of debt outstanding by average interest rates.	____	____	____
		Or			
		b. Recomputing the balances.	____	____	____
C	12.	Consider the need to impute interest on noninterest bearing notes.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
A B D	13. Confirm and verify line of credit agreements and gather information for financial statement disclosures.	____	____	____
D	14. In accordance with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), obtain information about the fair value of notes payable and long-term debt, and perform the following:			
	a. Determine that the fair value amounts are determined in accordance with FASB Statement No. 107 (AC F25).	____	____	____
	b. Determine that the valuation principles are being consistently applied.	____	____	____
	c. Determine that the fair value amounts are supported by the underlying documentation.	____	____	____
	d. Determine that the method of estimation and significant assumptions used are properly disclosed.	____	____	____

Practice Tip

Normally, the carrying amount of notes payable and long-term debt will approximate their fair values. However if the interest rate on the debt is significantly different from market rates, the carrying amount of the debt may not approximate their fair value. See FASB Statement No. 107 (AC F25) and Auditing Interpretation No. 1 of SAS No. 57, *Auditing Accounting Estimates,* titled "Performance and Reporting Guidance Related to Fair Value Disclosures (AU section 9342.01–.10)," for further guidance.

D. Section Completion

1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for notes payable and long-term debt, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for notes payable and long-term debt.	____	____	____
2. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________ Done by	____	____	____
______________________ Reviewed by	____	____	____

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Obj.		*Done By*	*Date*	*W/P Ref.*

XIII. Stockholders' Equity

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Proper authorization and classification—To determine that all transactions and commitments (options, warrants, rights, etc.) are properly authorized and classified. (Assertions 1, 2, 3, 4, and 5)

B. Proper recognition and cut-off—To determine that all transactions and commitments are recorded at correct amounts in the proper period. (Assertions 1, 2, and 5)

C. GAAP conformity—To determine that all transactions and balances are presented in the financial statements in conformity with generally accepted accounting principles consistently applied and accompanied by adequate disclosures. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. **Preliminary Procedures**

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:

   a. Preliminary analytical review ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	b. Planning documents	____	____	____
	c. Internal control documentation and test results	____	____	____
	B. Substantive Analytical Procedures			
	1. Compare balances in shareholders' equity accounts with the preceding year's balances or expected balances. Investigate any significant deviations from the expected amounts.	____	____	____
	C. Capital Stock and Additional Paid-In Capital—Detailed Tests			
[C]	1. For each class of stock, identify the number of authorized shares, par or stated value, privileges, and restrictions.	____	____	____
[C]	2. Obtain or prepare an analysis of the activity in the accounts; trace opening balances to the balance sheet as of the close of the year (period) previously audited and trace closing balances to the general ledger.	____	____	____
A B	3. Examine minutes, bylaws, and articles of incorporation for provisions relating to capital stock and support for all changes in the accounts including authorization per minutes of Board of Directors and stockholders meetings, and correspondence from legal counsel.	____	____	____
A B	4. Account for all proceeds from stock issues (including stock issued under stock option and stock purchase plans):			
	a. Recompute sales price and applicable proceeds.	____	____	____
	b. Determine that proceeds have been properly distributed between capital stock and additional paid-in capital.	____	____	____
A B [C]	5. Verify outstanding stock by agreeing open stubs in stock certificate book to the listing or confirm with the transfer agent the total issued shares and the total shares issued in the company's name. Determine that surrendered certificates have been canceled and accounted for.	____	____	____
A B [C]	6. For stock options and stock option plans, trace authorization to the minutes of the Board of Directors meetings, review the plan and the option contracts. Obtain of prepare and test analyses of stock options which include the following information:			
	a. For option plans, the date of the plan, number and class of shares reserved for option, method for determining the option price, period during which options may be granted, and identity of persons to whom options may be granted.	____	____	____
	b. For options granted, identity of persons to whom granted, date of grant, number of shares under option, option price, option period, number of shares as to which options are exercisable, and the market price and value of shares under			

Obj.		Done By	Date	W/P Ref.
	option as of the date of grant or measurement (first date on which are known both (1) the number of shares individual is entitled to receive, and (2) the option of purchase price, if any).	____	____	____
	c. For options outstanding, number of shares subject to option at the beginning of the period, activity during the period (additional shares subjected to option, number of shares exercised under options, number of shares associated with options which expired during the period), and number of shares subject to option at the end of the year (period).	____	____	____
A B C	7. If the client has a stock-based compensation plan (such as a stock option plan mentioned in the step above, or a stock purchase plan or any arrangement by which employees receive shares of stock or other equity instruments), perform the following steps:			
	a. Determine that the appropriate accounting treatment is being applied to all transactions that result from such stock compensation plans:			
	(1) If the client is following the provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation* (AC C36), determine that the fair-value method of accounting is being properly complied with, as described in the applicable sections of FASB Statement No. 123 (AC C36).	____	____	____
	(2) If the client is following the provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees* (AC C47), determine that the intrinsic value method of accounting is being properly complied with, as described in the applicable sections of APB Opinion No. 25 (AC C47).	____	____	____
	b. Summarize in the working papers all information required for disclosure as described in the appropriate accounting guidance.	____	____	____
B C	8. Identify all stock rights and warrants outstanding as of the balance-sheet date including the number of shares involved, period during which exercisable, and exercise price; determine that the rights and warrants were authorized.	____	____	____
A B C	9. Identify any stock subscriptions receivable, and:			
	a. Determine if they were authorized.	____	____	____
	b. Obtain confirmation from subscribers.	____	____	____
	c. Ascertain that subscriptions receivable are classified as a reduction of stockholders' equity on the balance sheet.	____	____	____
A B C	10. Obtain or prepare an analysis of the treasury stock account and:			
	a. Inspect the paid checks and other documentation in support of the treasury stock acquisitions.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	b. Inspect or confirm the treasury stock certificates; ascertain that the certificates are in the company's name or endorsed to the company.	____	____	____
	c. Reconcile treasury stock to the general ledger.	____	____	____
A B C	11. Determine that declared and unpaid dividends are properly recorded. Compare paid dividends to director's minutes.	____	____	____
	D. Retained Earnings—Detailed Tests			
[B]	1. Analyze activity during the period; trace the opening balance to the balance sheet as of the end of the year (period) previously audited; trace net income and other activity to the proper general ledger accounts and cross reference to other working paper analyses.	____	____	____
A B	2. Determine that dividends paid or declared have been authorized by the Board of Directors and:			
	a. Examine paid checks and supporting documents for dividends paid (selected checks to shareholders or to a dividend disbursing agent).	____	____	____
	b. Recompute amounts of dividends paid and/or payable.	____	____	____
B C	3. Investigate any prior period adjustments and determine if they were made in accordance with GAAP.	____	____	____
A B C	4. Examine supporting documents and authorization for all other transactions in the account, considering conformity with generally accepted accounting principles.	____	____	____
	E. Other			
C	1. Determine and document any restrictions on equity accounts.	____	____	____
C	2. Obtain information for each class of stock concerning preferences, dividend requirements and arrearages, redemption, or conversion rights and call provisions for disclosure.	____	____	____
	F. Section Completion			
	1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for shareholders' equity, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for shareholders' equity.	____	____	____
	2. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

____________________ Done by	____	____	____
____________________ Reviewed by	____	____	____

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

XIV. Revenues and Other Income

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Proper recognition—To determine that revenue transactions represent consideration applicable to goods shipped and/or completed services rendered to customers (or clients) in the normal course of business during the year (period). (Assertions 1, 3, 4, and 5)

B. Revenue realized—To determine that revenue transactions have resulted in collections or bona fide receivables. (Assertions 1 and 2)

C. Revenue recorded—To determine that all revenues earned during the year (period) are recorded and included in the financial statements. (Assertions 1, 2, and 5)

D. Proper classification—To determine that revenues are properly classified and described in the financial statements and accompanied by adequate disclosure. (Assertions 4 and 5)

E. Proper classification of other income—To determine that other income has been properly recognized, classified and described in the statement of income. (Assertions 2 and 5)

F. GAAP conformity—To determine that the income statement is prepared in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Obj.		Done By	Date	W/P Ref.

Procedures:

A. **Preliminary Procedures**

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:

   a. Preliminary analytical review ____ ____ ____

   b. Planning documents ____ ____ ____

   c. Internal control documentation and test results ____ ____ ____

B. **Substantive Analytical Procedures**

1. Compare current year sales and other income balances to the preceding year's balances or expected balances. Balances may include gross sales, discounts granted, returns, credits allowed, and net sales. Consider disaggregating the data, such as by product line, division, seasons of the year, etc. Investigate any significant deviations from the expected balances. ____ ____ ____

C. **Detailed Tests**

1. Obtain the sales journal and for a selected period(s):

   a. Trace totals from the sales journal to the general ledger control accounts for revenues, receivables, and such other accounts as salesmen's commissions, provisions, and allowances for product warranties, etc. ____ ____ ____

   b. Trace selected individual items from the sales journal to such other subsidiary records as the salesmen's commissions detail, and entries to charge cost. ____ ____ ____

   c. Reconcile the sales journal to the entries to charge cost of sales and credit inventory. ____ ____ ____

   d. Test the arithmetic accuracy of the footings and crossfootings of the journals. ____ ____ ____

2. Obtain the cash receipts journal and perform the following on a test basis for a selected period(s):

   a. Trace totals to the general ledger for both the cash account and applicable account distributions such as accounts receivable, cash sales, investment income, and additions to notes payable (re: proceeds). ____ ____ ____

   b. Test the arithmetic accuracy of the footings and crossfootings of the cash receipts journal; reconcile total receipts to total deposits per the bank statement. ____ ____ ____

A B C D 3. Select (using appropriate sampling techniques) ____ shipping orders prepared during the year and vouch to related sales invoices and trace into the sales journal. ____ ____ ____

Obj.		*Done By*	*Date*	*W/P Ref.*
[A] [B] [C] [D] [E] [F]	4. Scan source journals for the period for unusual transactions. Determine that they are accounted for properly. Follow up on any unusual or related-party transactions.	____	____	____
A B D	5. Review the source journal for any large or unusual sales transactions, especially near year end. Examine invoice and shipping document.	____	____	____
A F	6. Ascertain whether the entity ships goods to be held on consignment by others, and if so:			
	a. Identify the control accounts, procedures, and entities to whom consignment shipments are made.	____	____	____
	b. Examine consignment agreements.	____	____	____
	c. Review subsidiary accounts for entities to whom consignment shipments are made; examine supporting detail and ascertain that shipments on consignment are properly recorded.	____	____	____
	d. Review shipping advices and trace consignment shipments to the applicable subsidiary records and control accounts; ascertain that consignment shipments are correctly classified and recorded.	____	____	____
	e. Investigate old or significant consignments to determine whether there are any unrecorded sales.	____	____	____
A [F]	7. Identify amounts of sales to affiliates, obtain an understanding of their business purpose, and note for disclosure and/or tracing to consolidation eliminating entries. Identify amounts of sales to other related parties.	____	____	____
A B C	8. For sales cut off as of the closing date for the year (period) and/or the date of the physical inventory:			
	a. Select sales invoices for testing from the sales register for several days before and after the year end (or at the physical inventory date) and examine shipping records and determine that they were recorded in the proper period.	____	____	____
	b. Select credit memos issued after year end and examine underlying documentation (for example, record of receipt of returned goods) to determine period to which credit memo is applicable and whether it was recorded in the proper period.	____	____	____
	c. Inquire of the client if there are unprocessed sales or customer credit memos. Inspect supporting documents to determine whether they should have been recorded prior to year end.	____	____	____
A C E	9. Ascertain that the following income accounts have been traced to the analysis working papers for examination of the related balance-sheet accounts:			
	a. Interest income (notes receivable, debt securities, capitalized leases, etc.).	____	____	____

Obj.			*Done By*	*Date*	*W/P Ref.*
		b. Dividend income and realized gain (investment securities).	____	____	____
		c. Increase in investments accounted for on the equity method (investments).	____	____	____
		d. Gain on sale of property and equipment (property and equipment).	____	____	____
		e. Other miscellaneous revenue amounts, as appropriate.	____	____	____
A E	10.	Obtain (or prepare) an analysis of rent and royalty income and examine supporting agreements (should be related to examination of leases and other agreements). Determine reasonableness of amounts.	____	____	____
A B C D	11.	Determine proper income recognition when the right of return exists.	____	____	____
A B C D F	12.	Determine that any product financing arrangements are accounted for properly.	____	____	____
A B C D	13.	Determine that sales of extended warranty and product maintenance contracts are accounted for properly.	____	____	____

D. Section Completion

1.	Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for revenues and other income, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for revenues and other income.	____	____	____
2.	The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________ ____ ____ ____
Done by

______________________________ ____ ____ ____
Reviewed by

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

XV. Operating and Other Expenses

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Properly recorded—To determine that reported expenses include costs which are properly allocable to the year (period) and are properly matched with revenues. (Assertions 1, 2, and 4)

B. Proper recognition—To determine that recognition has been given to all costs and expenses (including losses) which should be recognized. (Assertions 1, 2, 3, and 4)

C. Taxes properly recorded—To determine that all tax temporary differences have been accounted for. (Assertions 2 and 5)

D. Proper classification—To determine that extraordinary items have been properly classified and disclosed. (Assertions 1 and 5)

E. GAAP conformity—To determine that the income statement is prepared in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

F. Proper classification—To determine that costs and expenses are appropriately classified and described in the statement of income. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Obj.		*Done By*	*Date*	*W/P Ref.*
	Procedures:			
	A. Preliminary Procedures			
	1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:			
	a. Preliminary analytical review	____	____	____
	b. Planning documents	____	____	____
	c. Internal control documentation and test results	____	____	____
	d. SAS No. 70 report on service center processed transactions (payroll)	____	____	____
A B C	**B. Substantive Analytical Procedures**			
D E F	1. Compare cost of sales and expense account balances to the preceding year's balances or expected balances. Investigate any significant deviations from the expected balances.	____	____	____
	2. While completing the procedures in step 1 above, examine the propriety of the balances in the following accounts, as deemed necessary.	____	____	____
	a. Officers' salaries and bonuses. Determine board of directors' authorization.	____	____	____
	b. Officers' expenses (for tax return).	____	____	____
	c. Contributions (eligible for deduction).	____	____	____
	d. Rents (look for potential capitalizable leases).	____	____	____
	e. Legal and professional services (look for any payments that may represent undisclosed legal matters).	____	____	____
	f. Taxes (for tax return).	____	____	____
	g. Repairs and maintenance (look for capitalizable items).	____	____	____
	h. Supplies (look for capitalizable items).	____	____	____
	i. Travel, conference, spousal travel, and entertainment expenses (look for adequate documentation and abuse).	____	____	____
	j. Property tax expense (for unrecorded property).	____	____	____
	k. Other miscellaneous expenses.	____	____	____

Practice Tip

An analysis of trial balance expense accounts can prove to be a valuable tool for both the audit and any tax engagements you have with the client. At tax time, it's beneficial to have the details of expenses required to prepare the client's tax return. It will save you time (and money) to prepare these schedules during the audit.

	3. Calculate gross profit percentages by product line (or other method as deemed appropriate). Compare percentages to the preceding year's percentages or expected percentages and investigate significant deviations from the expected percentages.	____	____	____

Obj.		Done By	Date	W/P Ref.
	4. Calculate individual expense categories as a percentage of total expenses. Compare to similar percentages for the prior year or to expected percentages. Investigate any significant deviations from expected percentages.	____	____	____
	C. Detailed Tests			
	1. Obtain the cash disbursements journal and for a selected period(s):			
	a. Trace totals from the cash disbursements journal to the general ledger control account for accounts payable, cash, and such other accounts as payroll expense, rent expense, insurance expense, interest expense, etc.	____	____	____
	b. Select a sample of individual expenses from the cash disbursements journal for detailed testing. Trace selected expenses to supporting documentation, such as vendor invoices, canceled checks, or other subsidiary records. Determine that expenses are recorded in the proper amount and in the proper period.	____	____	____
	c. Test the arithmetic accuracy of the footings and crossfootings of the journals.	____	____	____
A B D	2. Scan source journals for the period for large or unusual transactions and determine that they are properly recorded.	____	____	____
A B C F	3. Determine that the following expense accounts have been traced to the analysis working papers for examination of the related asset and liability balances:			
	a. Bad debt expense (allowance for doubtful accounts—trade receivables).	____	____	____
	b. Insurance expense (prepaid insurance and accrued premiums for workmen's compensation).	____	____	____
	c. Property taxes (prepaid and/or accrued property taxes).	____	____	____
	d. Depreciation expense (property and equipment and accumulated depreciation).	____	____	____
	e. Amortization costs (intangible assets).	____	____	____
	f. Interest expense (notes payable, long-term debt, capitalized leases).	____	____	____
	g. Provision for income taxes (liability for income taxes currently payable, deferred income taxes).	____	____	____
	h. Loss on sale or disposition of property and equipment (property and equipment).	____	____	____
	i. Other expenses, as deemed appropriate.	____	____	____
	4. Determine that advertising costs are accounted for in accordance with SOP 93-7, *Reporting on Advertising Costs*.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	5. Consider whether the classification of expenses is in conformity with generally accepted accounting principles consistently applied.	____	____	____

D. Payroll

A B F	1. Compute the following as a percentage of total revenues and compare to prior year's percentages or expected percentages. Investigate any significant deviations from the expected percentages.			
	a. Payroll (direct and indirect labor, officers' salaries)	____	____	____
	b. Benefits	____	____	____
	c. Commissions	____	____	____
A B F	2. Compute average compensation and fringes divided by number of full-time equivalents (FTEs) and compare to prior years and peer group statistics.	____	____	____
A B F	3. Calculate and investigate total payroll and benefits costs divided by average assets, compare to prior year's ratio or expected ratio, and correlate results to other analytical procedures. Investigate significant or unexpected results.	____	____	____
A B F	4. Compute payroll tax expense as a percentage of total wages and salaries and compare to prior year's percentage or expected percentage. Investigate significant deviations from expected percentages.	____	____	____
A B F	5. Reconcile gross wages on payroll tax returns to general ledger.	____	____	____
A B F	6. Review payroll tax returns to determine that they are being properly filed; and tax liabilities are paid timely.	____	____	____
A B F	7. If analytical procedures are not deemed sufficient, select a sample of payroll transactions for detailed testing as follows:			
	a. Trace selected employee to personnel records, to verify existence of employee, pay rate, legal status, etc.	____	____	____
	b. Recalculate gross and net pay for propriety.	____	____	____
	c. Trace pay amount into proper recording into subledgers and general ledger.	____	____	____

E. Section Completion

	1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for operating and other expenses, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for operating and other expenses.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	2. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

____ ____ ____ ____
Done by

____ ____ ____ ____
Reviewed by

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Obj.		*Done By*	*Date*	*W/P Ref.*

XVI. Contingencies, Commitments, and Litigation

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Contingencies exist—Identify the existence of any contingencies arising from litigation, claims, and assessments; when the underlying cause occurred; the likelihood of an unfavorable outcome, and the amount or range of possible loss. (Assertions 1, 2, 3, and 4)

B. Proper recording and disclosure—The financial statements include proper accruals and/or disclosure of the contingencies. (Assertions 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Contingencies

Obj.	Procedure	Done By	Date	W/P Ref.
A B	1. If it appears the client may have engaged in any questionable or illegal acts or irregularities, obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. Procedures are to include inquiry of management at a level above those involved, if possible.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
A B	2. If management does not provide satisfactory information that there has been no illegal acts or irregularities, consult with the client's legal counsel or other specialists about the application of relevant laws and regulations. Arrangements for such consultation with client's legal counsel should be made by the client.	____	____	____
A B A B	3. Review minutes of directors' meetings and discuss all pertinent items with management. Make excerpts and agree to applicable working papers.	____	____	____
	4. Inquire of management as to the existence, amount, and accrual of contingencies, with respect to such matters as: (If none, so indicate.)			
	a. Litigation in process or threatened.	____	____	____
	b. Receivables or other assets sold or assigned with recourse.	____	____	____
	c. Discounted receivables.	____	____	____
	d. Debt guarantees of others.	____	____	____
	e. Accommodation endorsements.	____	____	____
	f. Potential tax assessments (property, sales, etc.).	____	____	____
	g. Additional federal or state income taxes.	____	____	____
	h. Governmental laws, regulations, or determinations with adverse effect (wage-hour, safety, etc.).	____	____	____
	i. Pension plans.	____	____	____
	j. Revenue subject to renegotiation.	____	____	____
	k. Self-insurance.	____	____	____
	l. Product warranties	____	____	____
A B	5. Review legal fees for the period for indication of possible contingent liabilities.	____	____	____
A B	6. Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the balance-sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel.	____	____	____
A B	7. Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.	____	____	____
A B	8. Obtain assurance from management, ordinarily in writing, that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with FASB Statement No. 5 (AC C59). With the client's permission, inform the lawyer that the client has given the firm this assurance.	____	____	____

Obj.		Done By	Date	W/P Ref.
A B	9. Have the client prepare a letter to its lawyer(s) to respond directly to us, as of the balance-sheet date, his or her summary and opinion as to the outcome of (*a*) all claims and lawsuits, threatened or pending, (*b*) tax assessments, proposed or made, (*c*) unbilled legal fees if any, (*d*) any other contingent liabilities of which the lawyer(s) have knowledge.	____	____	____

List of All Lawyer Letters Requested	*Date Requested*	*Received*

Obj.		Done By	Date	W/P Ref.
A B	10. Evaluate responses from lawyers and document conclusions:			
	a. If a response date is earlier than 2 weeks prior to date of auditors' report, obtain a written or oral update.	____	____	____
	b. If update not obtained, document why. (If lawyer does not report any matters to us and management represents to us there are no litigation or unasserted claims, it *may* not be necessary to obtain an update.)	____	____	____
	c. Cross-reference all recorded reported liabilities to current working papers.	____	____	____
	d. Document your conclusion(s) as to the effect(s) on the financial statements and our report of matters included in the attorney letter(s).	____	____	____
B	11. Consider the adequacy of financial statement disclosure for contingencies.	____	____	____
	B. Commitments			
A B	1. Inquire of appropriate officials as to the existence and amount of commitments, with respect to such matters as: (If none, so indicate.)			
	a. Unfilled purchase commitments in excess of normal requirements or at prices materially in excess of prevailing market prices.	____	____	____
	b. Contractual obligations for purchase or sale of property, plant, and equipment or other investments.	____	____	____
	c. Unused letters of credit.	____	____	____
	d. Long-term leases.	____	____	____
	e. Assets pledged as collateral for loans or deposits.	____	____	____
	f. Cumulative preferred stock dividends in arrears.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	g. Mergers or acquisitions pending.	____	____	____
	h. Capital stock repurchase agreements.	____	____	____
	i. Futures contracts.	____	____	____
	j. Other.	____	____	____

C. **Section Completion**

	1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for contingencies, commitments, and litigation, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions regarding those areas.	____	____	____
	2. The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________ ____ ____ ____
Done by

______________________________ ____ ____ ____
Reviewed by

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

XVII. Subsequent Events

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. Existence of subsequent event—Any events or transactions occurring after the balance-sheet date, but before issuance of the financial statements and auditor's report (subsequent events) which require adjustment or disclosure in the financial statements. (Assertions 1, 2, 3, and 4)

B. Proper recognition—The financial statements have been adjusted for changes in estimates resulting from evidence provided by subsequent events. (Assertions 1, 2, 3, and 4)

C. Proper disclosure—The financial statements include adequate disclosure of evidence provided by subsequent events which should not result in adjustment of the financial statements but should be disclosed. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

A B C 1. Perform at or near the completion of field work the following auditing procedures with respect to the period after the balance-

Obj.		Done By	Date	W/P Ref.
	sheet date for the purpose of identifying subsequent events that may require adjustment or disclosure in the financial statements:			
	a. Read the latest available interim financial statements; compare them with the financial statements being reported upon; and make any other comparisons considered appropriate in the circumstances. (Inquire of officers and other executives having responsibility for financial and accounting matters as to whether the interim statements have been prepared on the same basis as that used for the statements under audit.)	____	____	____
	b. Read the available minutes of the stockholders, directors, and appropriate committees to the date of the auditor's report. As to meetings for which minutes are not available, obtain written information regarding matters dealt with at such meetings. Indicate minutes read, persons questioned, and any significant information found.	____	____	____
	c. Scan the general ledger and journals for the period from the balance-sheet date to the date of the auditor's report and inquire into and investigate any large, unusual amounts or transactions. This test may be limited to the areas not covered in audit procedures applied in other programs, such as in the search for unrecorded liabilities.	____	____	____
A B C	2. As of the date of the auditor's report, inquire of and discuss with officers and other executives having responsibility for financial and accounting matters as to:			
	a. The client's operations and management.	____	____	____
	b. Changes in accounting/financial policies.	____	____	____
	c. New borrowings or other financing.	____	____	____
	d. Substantial contingent liabilities or commitments.	____	____	____
	e. Whether there has been any significant change in assets or liabilities.	____	____	____
	f. The current status of items in the financial statements being reported on that were accounted for on the basis of tentative, preliminary, or inconclusive data.	____	____	____
	g. Unusual adjustments made during the subsequent period.	____	____	____
	h. Commitments or plans for major purchases of capital additions or materials, and consideration of possible losses due to price trends.	____	____	____
	i. Events occurring that have caused a decline in the value of any assets or have made any significant portion of fixed assets inoperable or obsolete.	____	____	____
	j. Settlement of any liabilities for less than face value.	____	____	____

Obj.			Done By	Date	W/P Ref.
	k.	Liabilities in dispute or being contested.	____	____	____
	l.	Litigation, claims, and assessments.	____	____	____
	m.	Recent profit trends, losses of significant customers, unusual losses, substantial increases in costs, etc.	____	____	____
	n.	Examinations or audits instituted by regulatory agencies.	____	____	____
	o.	Employee benefit plans/pension plans.	____	____	____
	p.	Potential losses on marketable securities, carrying amounts of equity investments, loans, or other assets not already considered.	____	____	____
	q.	Regulatory commissions, governmental body requirements, or laws that could adversely affect the client.	____	____	____
	r.	Related-party transactions.	____	____	____
	s.	Expiration or cancellation of significant insurance coverage.	____	____	____
	t.	Whether any other unusual events or transactions occurred since the balance-sheet date.	____	____	____
A	3.	Assemble pertinent findings resulting from response of client's legal counsel and other auditing procedures concerning litigation, claims, and assessments.	____	____	____
A B C	4.	Obtain a letter of representation, dated as of the date of the auditor's report, from appropriate officials, generally the chief executive officer and chief financial officer in accordance with SAS No. 19 (AU section 333).	____	____	____
A B C	5.	Make such additional inquiries or perform such procedures deemed necessary and appropriate to dispose of questions that arise in carrying out the foregoing procedures, inquiries, and discussions.	____	____	____
C	6.	Consider adjustment of year-end financial statements or disclosure of any items resulting from the above procedures.	____	____	____
C	7.	Consider the possible effects on financial statements and disclosures of any matters causing substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.	____	____	____

B. Section Completion

	1.	The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________ ____ ____ ____
Done by

______________________________ ____ ____ ____
Reviewed by

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

XVIII. Related Parties

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

A. To identify related parties and related-party transactions. (Assertions 1 and 2)

B. To determine the substance of such transactions is reflected in the accounts. (Assertions 2, 3, and 4)

C. To obtain all information necessary for footnote and/or report disclosure. (Assertions 2 and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
A B C	1. Make inquiries of management about related parties, obtain related-party confirmation, if applicable, and inquire about any recorded or unrecorded transactions during the year.	____	____	____
A	2. Obtain names of stockholders and directors for evidence of related-party transactions.	____	____	____
A	3. Review last year's working papers for evidence of related-party transactions.	____	____	____

Obj.			Done By	Date	W/P Ref.
A	4.	Ask predecessor auditors about related parties.	____	____	____
A B C	5.	Investigate transactions with major customers, suppliers, and lenders for undisclosed relationships.	____	____	____
A B C	6.	Review minutes of stockholders' and directors' meetings for evidence of related-party transactions.	____	____	____
A B C	7.	Be alert for potential related-party transactions while examining confirmations of receivables and payables, large unusual transactions and attorneys' letters.	____	____	____
C	8.	Obtain a list of major customers, amounts of sales during the year and amounts of receivables at year end. Agree to detail client records. Consider disclosure.	____	____	____
B C	9.	Examine supporting documents of significant related-party transactions to determine:			
		a. Business purpose.	____	____	____
		b. Board of directors' approval.	____	____	____
		c. Reasonableness and consistency of amounts to be disclosed.	____	____	____
		d. Financial capabilities of related parties.	____	____	____

B. Section Completion

1.	The objectives of this audit program have been met.	____	____	____

This audit program section has been completed in accordance with firm policy.

______________________________ ____ ____ ____
Done by

______________________________ ____ ____ ____
Reviewed by

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

.200

Obj.		*Done By*	*Date*	*W/P Ref.*

XIX. Risks and Uncertainties

Financial Statement Assertion:

1. Presentation and disclosure.

Objective:

A. GAAP conformity—To determine that disclosure of certain significant estimates and certain concentrations is in conformity with GAAP consistently applied. (Assertion 1)

Note: The letter preceding the above audit objective serves as an identification code. This code is presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
A	1. Obtain or prepare a listing of any estimates used in determining the carrying values of assets and liabilities and gain and loss contingencies that are sensitive to change. Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate.	____	____	____
A	2. Consider whether it is at least reasonably possible that a material change in the estimate will occur in the near term.	____	____	____
A	3. If such a situation is identified, review support for the calculation of the effect of the change.	____	____	____
A	4. Obtain or prepare a listing of the following types of concentrations, if any, that existed at the balance-sheet date and that make the entity vulnerable to risk of near-term severe impact (severe impact is a higher threshold than materiality, but less than catastrophic). Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate:			
	a. Volume of business transacted with a particular customer, supplier, or lender	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	b. Revenues from particular products or services	____	____	____
	c. Available sources of supply of materials, labor or services, or of licenses or other rights used in operations	____	____	____
	d. Market or geographic area in which the entity conducts its operations	____	____	____
A	5. Determine whether it is at least reasonably possible that an event will occur in the near term that would cause the severe impact.	____	____	____
A	6. Determine whether disclosures required by SOP 94-6 are completely and accurately included in the financial statements.	____	____	____

B. Section Completion

1. The objectives of this audit program have been met. ____ ____ ____

This audit program section has been completed in accordance with firm policy.

______________________________ ____ ____ ____
Done by

______________________________ ____ ____ ____
Reviewed by

[*The next page is 5551.*]

AAM Section 5410

Suggested Supplemental Reference Materials for Use With Illustrative Audit Program for Corporations

.01 Suggested Supplemental Reference Materials

Accounting Standards—Current Text (Financial Accounting Standards Board)

Professional Standards (American Institute of CPAs)

AICPA Audit and Accounting Guides—when applicable

Financial Statement Preparation Manual (American Institute of CPAs)

Disclosure Checklist series (American Institute of CPAs) (individual paperback versions of sections of the *Financial Statement Preparation Manual*)

Auditing Procedure Studies (American Institute of CPAs)

Technical Practice Aids (American Institute of CPAs)

Accounting Trends & Techniques (American Institute of CPAs)

Derivatives—Current Accounting and Auditing Literature (American Institute of CPAs)

Standard Confirmation Forms (American Institute of CPAs)

Accountants' Handbook by Carmichael, Lilien & Mellman (Wiley)

Montgomery's Auditing by O'Reilly, Hirsch, Defliese and Jaenicke (Wiley)

Handbook of Modern Accounting by Davidson & Weil (McGraw-Hill)

Kohler's Dictionary for Accountants by Cooper & Ijiri (Prentice-Hall)

EITF Abstracts—A Summary of Proceedings of the FASB Emerging Issues Task Force (Financial Accounting Standards Board)

Financial Report Surveys (American Institute of CPAs)

Accounting Standards—Original Pronouncements (Financial Accounting Standards Board)

Federal Audit Guides (Commerce Clearing House)

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AAM Section 6000
Working Papers

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AAM Section 6100

Working Papers—General

.01 Working papers serve both as tools to aid the auditor in performing his work, and as written evidence of the work done to support the auditor's report. SAS No. 41, *Working Papers* (AU section 339), provides authoritative guidance on the functions and nature, general content, and ownership and custody of working papers.

General Discussion

.02 These sections present points of view on the organization and preparation of working papers.

.03 Proper planning is important in the design of specific working papers if they are to serve the objective of aiding the auditor in the conduct of his work. For example, a well-planned working paper may be designed to provide information that will be needed later in the preparation of tax returns and other required reports, such as those to regulatory bodies, and may therefore eliminate the need for examining the same documents twice to obtain necessary information. The format and content of the working papers may vary with the individual preferences of auditors and firms. These preferences may be informal common practices or expressed as part of a firm's formal written policies and procedures. A firm should consider the nature of its practice and the services commonly provided to its clients, as well as professional standards in developing its procedures and policies on working papers. Those procedures and policies should permit the flexibility necessary to meet the needs of individual engagements.

[The next page is 6201.]

AAM Section 6200
Basic Elements of Format

.01 Working paper formats generally include at least the following for identification purposes:

- A title or heading comprised of (a) the name of the client, (b) a caption that briefly describes the paper's contents, (c) the nature of the engagement, and (d) the applicable period or closing date covered by the engagement.
- The initials or names of the auditors who performed and reviewed the work presented in the paper and the date the paper was completed.

.02 In instances when one working paper requires more than one page, some auditors present the heading on only the lead page, fasten or staple all the applicable pages together as a unit and number each page, for example, 1 of 5, 2 of 5, and so forth. Many auditors index each working paper in some organized pre-established manner. This provides for ease in cross-referencing to other relevant papers, for more organized indexing and filing, and for a form of control over the working papers. (See AAM section 6400.)

.03 Some auditors purchase standard analysis paper that includes preprinted blocks for the initials or signature of the preparer and reviewer, and the dates on which the paper was prepared and reviewed. Others design their own signature and reference blocks and have them imprinted on all of their analysis paper and lined pads. These signature blocks may include captions such as the following:

—prepared by client and tested by

—prepared by

—date prepared

—date tested

—reviewed by

—date reviewed

—source

—work paper reference

—footed by

—extensions checked by

.04 Some auditors prefer to identify client preparation of schedules and analysis by notations or codes, such as "PBC," for prepared by client, rather than use a detailed signature and reference block.

[The next page is 6301.]

AAM Section 6300
Content of Working Papers

.01 The content of working papers varies with the circumstances and needs of the auditors on individual engagements. Some firms, however, include various general and specific instructions on working paper content in their policies concerning working papers.

General Considerations

.02 The following are some general considerations on working paper content that may be helpful.

- Working papers should be sufficiently intelligible, clear and neat so that another auditor who has had no previous association with the engagement can review the papers and determine the nature and extent of the work done and how the conclusions were reached that support the resulting auditor's report.
- The content of an individual working paper or group of related papers should include identification of the (1) source of the information presented (e. g., fixed assets ledger, cash disbursements journal), (2) the nature and extent of the work done and conclusions reached (by symbols and legend, narrative, or a combination of both), and (3) appropriate cross-references to other working papers.
- Before completion of the engagement, all questions or exceptions in the working papers should be resolved. If for some reason the auditor must leave the assignment without resolving all items, he should provide an open items listing on a separate temporary paper for the in-charge auditor's attention. An unresolved exception or incomplete explanation in the working papers may be construed by some as indication of an inadequate audit.
- Information and comments in the working papers generally represent statements of fact and professional conclusions. Accordingly, language should be clear and free from such vague judgmental adjectives as "good" or "bad." Conclusions should be supported by documented facts, especially if they concern the adequacy of the client's records.
- Working papers should be viewed as an integrated presentation of information. The auditor should cross-reference working papers to call attention to interaccount relationships and to reference a paper to other working papers summarizing or detailing related information.
- The preparer should view the working papers as if he were the in-charge auditor. All inferences and conclusions should be supported in the working papers and no misleading or irrelevant statements should be made.
- It is preferable to have negative figures in working papers indicated by parentheses instead of red figures to preserve their identity if the papers are photocopied or microfilmed.

Timesaving Considerations

.03 There are a number of ways to save time and avoid unnecessary detail in working paper preparation. The following examples may be helpful.

- Whenever possible, have the client's employees prepare schedules and analyses. (This, of course, presupposes that the client has the necessary personnel to prepare the materials.)
- Use of a detailed audit program may eliminate the need for lengthy comments in the working papers on the scope of audit procedures. (However, some believe that such comments are still necessary when a detailed program is used; this is a matter of individual firm judgment.)

- Analyze asset (or liability) accounts and their related expense or income accounts on the same working paper. Examples include property, plant, and equipment, accumulated depreciation and related depreciation expense; notes receivable, accrued interest receivable and interest income; notes payable, accrued or prepaid interest, and interest expense; and accrued taxes and related provisions for tax expense.
- Avoid unnecessary computations. For example, if only the totals are meaningful and can be tested by a single independent computation, check the total and avoid unnecessary checking of details.
- Consider using carryforward analyses for accounts that tend to remain constant each year or vary only in accordance with a constant predetermined formula. Examples may include long-term assets and related depreciation or amortization such as plant, equipment, and intangibles, long-term debt with predetermined payment schedules, and capital stock.
- Consider using adding machine tapes instead of writing separate lists. Enter names or explanations on the tapes, when appropriate.
- Do not manually copy a document when photographic reproduction is feasible.
- If in doubt, use a larger sheet of paper—an unused portion is less of a problem than running out of space.
- Use symbols (tick marks) whenever possible, especially when the same symbol applies to several working papers.

Symbols (Tick Marks)

.04 When using symbols, it should be helpful to consider the following basic concepts:

- Symbols are merely a shorthand means of explaining a work step performed on a particular item of data. Symbols serve as means of conserving time and space and, if properly used, may ease review of the working papers.
- For a working paper to be clear to a reviewer or other reader, each symbol must be clearly explained. The explanation may be located on the same page as the items subjected to the work step, or on a separate legend that is clearly cross-referenced to and from the page that presents the applicable items.
- Symbols should be kept simple, distinctive and clear so they can be quickly written by the preparer and easily identified by a reviewer.

.05 Applying these basic concepts is not that simple. Various auditors have conflicting notions about symbols. For example, on the matter of color, some believe all tick marks should be in color to make it easy to spot them in the working papers. Others believe it is a waste of time to keep "switching pencils" and observe that the color distinction is lost in photocopying. On another matter, some believe a set of standardized symbols can expedite preparation and review. Others believe that a set of standardized symbols is impractical because it lacks flexibility. Because it is generally agreed that symbols are an effective timesaver, it is desirable for firms to establish and communicate a policy on their use to maximize their potential effectiveness.

.06 Commonly used symbols, as noted, should be simple and distinctive, not elaborate hieroglyphics. The most common are variations on a simple checkmark—for example, a checkmark with a slash, a checkmark with a circle at the end, a double checkmark, and any one of these within a circle. This abbreviated listing alone provides eight distinctive tick marks. Symbols may also include circled letters or numbers.

[The next page is 6401.]

AAM Section 6400
Organization and Filing (Indexing)

.01 Some auditors organize their working papers during the course of an engagement into general categories such as the following:

- Planning and administration.
- Internal control understanding and assessment of control risk.
- Substantive test working papers arranged in order of the balance sheet and income statement classifications.
- Trial balances, consolidating working papers, journal entries (adjustments, reclassifications, eliminations for consolidation), and potential entries.
- Draft reports, financial statements, and notes.
- Programs, checklists, and questionnaires (some keep these as separate units, others interfile them among working papers by statement classifications).
- General matters such as current minutes, contracts, and articles of incorporation that may apply to future engagements as well as current work.

Under this approach, actual indexing and filing would be deferred until the conclusion of the engagement.

Predetermined Indexing

.02 Other practitioners and firms may use a predetermined indexing approach so that working papers can be indexed while the field work is still in progress. This offers the following advantages:

- Better control over working papers during the performance of field work.
- Constant arrangement of working papers in logical order to aid in review.
- Less time required in assembling and binding them into indexed files.
- Quicker access to specific working papers after they are filed.

.03 Predetermined indexing involves establishing a standard code for each section of the working papers, using letters and numbers, or numbers only. For example—

	Two Possible Alternatives	
Working trial balance—assets	B/S-A	T/B-1
Working trial balance—liabilities	B/S-L	T/B-2
Working trial balance—income & expense	P/L	T/B-3
Cash summary schedule	A	10
Receivables summary schedule	B	20
Inventory summary schedule	C	30

.04 Predetermined indexing requires recognition of the need for flexibility to meet unanticipated working paper needs or specialized industry requirements and it requires care to avoid undue complexity. Excessively complex references may obstruct rather than ease working paper preparation, cross-referencing and filing. Accordingly, it is helpful to develop an organizational plan adaptable to each section of the working papers. For example, some accountants classify working papers as lead schedules, primary detail, and secondary detail which might result in the following classification scheme for the above examples for cash:

	Using Letters and Numbers	*Using Only Numbers*
Lead schedule	(A)	(10)
Primary detail schedules	(A-1) (A-2) etc.	(10-1) (10-2) etc.
Secondary detail schedules	(A-1-1) (A-1-2) (A-1-3)	(10-1-1) (10-1-2)
	(A-2-1) (A-2-2) (A-2-3)	(10-2-1) (10-2-2)

.05 Predetermined (standardized) indexing systems may be printed on separate pages for reference during the performance of field work and insertion in the front of working paper binders or files when the work is completed. Some firms have their uniform indexing systems printed directly on their file or binder covers.

.06 A well-organized indexing system need not be too complex. On a fairly small engagement, the indexing system may be a lead schedule divider tab between each major group of accounts with the name of the account on it (e.g., cash or accounts receivable) with the related workpapers filed behind the lead schedule without being individually indexed. At the completion of the engagement, the pages can be consecutively numbered within each account group (e.g., 1 of 10, 2 of 10, etc.), since there typically are not numerous or complex layers of supporting schedules, extensive cross-referencing can be avoided.

.07 On large engagements, particularly those with detailed charts of accounts, firms may consider it necessary to develop more complex indexing systems. In one such system, standard index number series are assigned as follows:

Current workpaper file	1000—7000
Permanent file	7100—9999

.08 In this system, each index number consists of four digits, with the addition decimals if necessary. Numbers ending with double zero are reserved for lead schedules whose total agrees with a line item on the working trial balance (index 1400). Single zeros are used for specific types of accounts (such as 2010, petty cash funds).

.09 Certain index numbers can be permanently assigned to each major financial statement classification. For instance, index 2000 may be assigned to cash. If various bank accounts exist, the cash schedules are assigned index numbers 2002, 2003, etc. Documentation such as supporting confirmations and lists of outstanding checks would be assigned index numbers commencing with 2001.1, 2001.2, etc. As for the permanent workpaper file, index 9300, for example, may be assigned to internal control. Accordingly, flowcharts and related questionnaires would be assigned index numbers in that series.

Current and Permanent Files

.10 Working paper files are generally classified as current files and permanent (continuing) files. Current files contain information that is pertinent to a single engagement. Permanent files include information relevant to several recurring engagements. Some firms have their binder or file covers preprinted as current or permanent accompanied by pertinent portions of their uniform working paper indexes.

.11 A common challenge to many auditors is to keep the permanent file complete and current, and free from outdated or irrelevant materials that belong in an inactive file of superseded materials.

.12 Some auditors who have confronted one too many unwieldy permanent files believe all working papers should be classified as current with certain materials designated as matters of continuing interest to be carried forward each year until they become outdated. Under this approach, a firm may preprint its complete index on one type of file or binder cover and provide space to indicate whether specific contents are continuing or carryforward in nature.

.13 The permanent files should be reviewed and updated, as needed, annually. Examples of documents that may be found in permanent files are listed in AAM section 6400.15(*p*).

Practice Tip

The work-paper files should contain copies of final executed documents. Any drafts or unsigned versions of documents should be replaced with final versions.

Work-Paper Retention

.14 Determining the proper periods for retaining records is a major decision for practitioners. Records should be preserved for only as long as they serve a useful purpose or until all legal requirements are met. Record retention periods vary among firms; however, retention periods should generally correspond with the longest statute of limitations prevailing in each state for breach of contract, breach of fiduciary duty, and professional liability claims.

.15 Work-papers may be retained permanently or for periods corresponding with the longest state statute of limitations, as noted above. Generally, certain audited financial statement work-paper data, such as accounts receivable confirmations are destroyed after ten years. Examples of workpapers that should be retained permanently include auditor's reports, reports filed with the SEC, tax returns for current clients, and audit work-papers for current clients. Some firms divide the retention period into two parts, records are first filed in the office and later placed in storage (e.g., three years in the office and then permanently in storage). Other records, such as work-paper files for former clients, may be retained for three years in the office, seven years in storage and then destroyed after the retention period. No material should be destroyed without the specific approval of the engagement partner. An annual schedule should be established for reviewing and purging firm data. Since there is substantial variation in the retention periods used by firms, each firm should carefully consider its requirements and consult with legal counsel before adopting a retention period.

.16 For further guidance on record retention, see the AICPA *Management of an Accounting Practice Handbook.*

Index Topics

.17 The following is a list of topics to consider in developing a standard index for working papers. This list is detailed, but is by no means all-inclusive. For example, specialized industries such as life insurance and banking need other specialized topics. Several of the topics may be eliminated, condensed or expanded, depending on the auditor's needs and preferences. Topics that some auditors prefer to include in both the permanent and current files or only in the permanent files are followed by the letter (P).

Planning and administration

- Time & budget data
- General correspondence & memos
- Planning memos—current
- Planning notes & confirm copies for use in next engagement
- Engagement letters

- Schedules & analyses to be prepared by client
- Minutes
- Checklist of an administrative nature if required by firm policy

Audit or work program (Note 1)

Matters of continuing concern

- Client's industry—background (P)
- Description & brief history of client (P)
- Data & ratio analysis of client's operations (P)
- Client's facilities (P)
- Articles of incorporation (P)
- Bylaws (P)
- Current contracts & agreements (P)
    - — Debt agreements (P)
    - — Leases (P)
    - — Labor contracts (P)
    - — Agreements with officers & key people (P)
    - — Pension plans (P)
    - — Profit-sharing plans (P)
    - — Stock warrants (P)
    - — Stock options (P)
    - — Other agreements (P)
- Client's accounting policies & procedures (P)
- Carryforward analyses (Note 2)

Internal control

- Internal control questionnaire, narratives, flowcharts, etc. (Note 3)
- Initial assessment of control risk memos
- Tests of controls

Reports, financial statements and footnotes, trial balances, and assembly sheets

- Reports & financial statements (including letter, if any, on reportable conditions in internal control)
- Consolidating working papers
- Consolidation eliminating entries
- Trial balance

- Adjusting journal entries
- Reclassification journal entries
- Recap of possible adjusting entries
- Assembly sheets supporting footnote disclosures (if the information is not included elsewhere in the working papers)
- Disclosure checklists (if required by firm policy)
- Supporting schedules (if required for reports to regulatory bodies or other reports)
- Tax return information & work sheets (Note 4)

Assets

- Cash
- Marketable securities (and related income)
- Notes receivable (and related interest)
- Accounts receivable
  - — Summary and analyses
  - — Confirmation procedures (Notes 2 and 5)
- Allowance for doubtful accounts & notes (Note 2)
- Inventories
  - — Summary and analyses
  - — Price tests, cost & market
  - — Obsolescence review
  - — Observation, test counts & cutoff data
  - — LIFO determinations
- Prepaid expenses
- Other current assets
- Investments
- Property, plant & equipment, and accumulated depreciation, depletion & amortization (Note 2)
- Intangible assets, deferred charges & amortization (Note 2)
- Other assets
- Intercompany accounts

Liabilities

- Notes payable (and related interest)
- Accounts payable
- Accrued liabilities other than income taxes

- Accrued income taxes (current & deferred), related provisions & credits (Note 2)
  - Federal
  - State & local
- Other current liabilities
- Long-term debt (including current maturities and capitalized leases) (Note 2)
- Other long-term liabilities
- Deferred income (Note 2)

Commitments and contingencies

- Attorneys' letters
- Abstracts of commitments & contingencies noted during review of minutes, contracts & agreements, confirmation responses, etc.
- Subsequent events review
- Management representation letter

Equity (capital accounts) (Note 2)

- Capital stock
- Additional paid-in capital
- Treasury stock
- Retained earnings
- Partnership capital

Revenue and expenses

- Operating revenues
- Cost of sales
- Selling, general & administrative
- Other operating expenses
- Other income
- Other expense
- Extraordinary & unusual items
- Secondary schedules
  - Maintenance & repairs
  - Taxes other than income taxes
  - Rents
  - Royalties
  - Advertising costs
  - Legal fees
  - Interest expense recap

Notes to User:

1. Alternate practices of filing audit programs include:

   (a) Putting the program in a binder that is separate and distinct from the current and permanent files.

   (b) Putting the signed off program in the current file.

   (c) Keeping a master copy of the program in the permanent file with the signed off copies dispersed among the related working paper segments in the current file.

2. Certain classifications may lend themselves to carry-forward working papers. Examples include allowances for doubtful accounts, brief summaries of confirmation response statistics, accumulated depreciation and amortization, deferred income taxes and open tax positions, long-term debt, and capital accounts.
3. Internal control questionnaires may be filed as separate binders or as part of current of permanent files.
4. Some firms and practitioners keep tax return preparation working papers in files that are completely separate from other types of engagement working papers.
5. For situations involving voluminous confirmation responses or bulk inventory listings, the bulk materials may be filed in separate binders that are cross referenced to the pertinent working papers (for example: accounts receivable, accounts payable, and inventory).

[*The next page is 6501.*]

AAM Section 6500

Sample Working Papers

NOTE

Since, the content of working papers varies with the circumstances and needs of individual engagements, we have deleted this section. Please refer to AAM sections 6100—6400 for guidance on the content and organization of working papers.

[*The next page is 7001.*]

AAM Section 7000

CORRESPONDENCE, CONFIRMATIONS & REPRESENTATIONS

These samples are presented for illustrative purposes only. They are intended as mere conveniences for users of this Manual who may want points of departure when designing their own formats to meet their individual needs. These illustrations are neither all inclusive nor are they prescribed minimums. Auditors and accountants are to rely on professional standards and their individual professional judgment in determining what may be needed in the circumstances.

TABLE OF CONTENTS

[The next page is 7101.]

AAM Section 7100
Control of Confirmations and Correspondence

.01 Generally, clients prepare correspondence and confirmation requests on their own letterhead and submit to the auditor the signed originals and copies. The auditor may obtain one or more copies to serve as file copies for the current working papers, second requests and manuscript copies for the next engagement.

.02 There are two types of confirmation requests: the positive form and the negative form. Some positive forms request the respondent to indicate whether he or she agrees with the information stated on the request. Other positive forms, referred to as blank forms, do not state the amount (or other information) on the confirmation request, but request the recipient to fill in the balance or furnish other information.

.03 The negative form requests the recipient to respond only if he or she disagrees with the information stated on the request. Negative confirmation requests may be used to reduce audit risk to an acceptable level when (*a*) the combined assessed level of inherent and control risk is low, (*b*) a large number of small balances is involved, and (*c*) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.

.04 The confirmation requests should be reviewed to the extent the auditor considers necessary. For example, the auditor may perform the following for accounts receivable confirmation requests before they are mailed:

- Compare the names and addresses to the client's records.
- Compare balances per confirmation requests to the subsidiary ledger.

.05 The requests would then be stuffed in envelopes and submitted to the post office under the auditor's control.

.06 The auditor controls the mailings and receipt of responses so that the confirmation process is independent of the client.

.07 Mailing envelopes have the auditor's office or post office box number as the return address so that undeliverable letters are returned to the auditor and not to the client. For mailings, the auditor may provide the envelopes or affix a label on the client's envelope that covers the client's return address and replaces it with the auditor's address.

.08 Reply envelopes addressed to the auditor are enclosed with the request letter. Reply envelopes generally have prepaid postage to encourage responses. Some auditors also use codes on the reply envelopes so that responses may be sorted by engagement before the mail is opened. This feature may be particularly useful when there are several engagements that involve voluminous mailings.

.09 If the client objects to use of the auditor's name and address, some auditors suggest that a post office box in the client's name be used, with the returns to be opened under the auditor's control for the confirmation process, and that the post office be instructed that after the box is closed subsequent mail be forwarded to the auditor.

[The next page is 7201.]

AAM Section 7200

Requests for Confirmations and Related Materials

Wording of Confirmation Request Forms

.01 Forms and correspondence used for confirmation requests should state clearly that the client is requesting that a reply be sent to the CPA. Forms and correspondence used for information requests for engagements other than audits should not refer to "an audit." They should also use the term "accountant(s)" rather than "auditors." Suggested wording follows:

> Please send the following information to our certified public accountants (insert name and address of accountants) who are performing accounting services for the company.

.02 The samples of correspondence in this section include language that refers to auditors and an audit of the client's financial statements on the assumption that an audit is being performed. This language needs to be modified if services other than an audit are being performed.

.03 Request for Bank Cutoff Statements

(Prepared on client's letterhead)

(Date [Note (A)])

Financial Institution Official*
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of (name of customer) as of (balance-sheet date) and for the (period) then ended, we request that you send the following information directly to our auditors (insert name and address of auditors) as of the close of business (insert date):

1. The information requested on the enclosed standard form(s) to confirm account balance information with your financial institution.

2. For the account numbers listed below, statement(s) of our account(s) and the related paid checks for the period from (insert date) to (insert date) inclusive.

Account Number	Account Name
______________	______________
______________	______________
______________	______________
______________	______________

3. [Note (B)]

Sincerely,

(Name of Customer)

____

By: __________________________

NOTES TO USER:

(A) The request should be sent at least ten days prior to the audit date so the bank will be able to provide the information requested and to render the cutoff statements as requested. If the request does not reach the bank before the cutoff date, the cutoff statement will include transactions after that date.

(B) The letter may also include requests for:

- Confirmation of all securities or other items held for the clients account as of the closing date for collection or safekeeping, or as agent or trustee (a listing should be provided including titles and account numbers).
- Confirmation of the list of authorized signers for the above accounts. (This may have been previously requested at a preliminary date in connection with the assessment of control risk.)

---

* This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the transactions or arrangements. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

.04

STANDARD FORM TO CONFIRM ACCOUNT BALANCE INFORMATION WITH FINANCIAL INSTITUTIONS

CUSTOMER NAME

Financial Institution's Name and Address [ ]

[ ]

We have provided to our accountants the following information as of the close of business on ____________, 19___, regarding our deposit and loan balances. Please confirm the accuracy of the information, noting any exceptions to the information provided. If the balances have been left blank, please complete this form by furnishing the balance in the appropriate space below.* Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other deposit and loan accounts we may have with you comes to your attention, please include such information below. Please use the enclosed envelope to return the form directly to our accountants.

1. At the close of business on the date listed above, our records indicated the following deposit balance(s):

ACCOUNT NAME	ACCOUNT NO.	INTEREST RATE	BALANCE*

2. We were directly liable to the financial institution for loans at the close of business on the date listed above as follows:

ACCOUNT NO./ DESCRIPTION	BALANCE*	DATE DUE	INTEREST RATE	DATE THROUGH WHICH INTEREST IS PAID	DESCRIPTION OF COLLATERAL

(Customer's Authorized Signature) (Date)

The information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted below.

(Financial Institution Authorized Signature) (Date)

(Title)

EXCEPTIONS AND/OR COMMENTS

Please return this form directly to our accountants [ ]

[ ]

* Ordinarily, balances are intentionally left blank if they are not available at the time the form is prepared.

Approved 1990 by American Bankers Association, American Institute of Certified Public Accountants and Bank Administration Institute. Additional forms available from: AICPA – Order Department, P.O Box 1003, NY, NY 10108-1003

D451 5951

[The next page is 7205.]

.05 Request for Confirmation of Petty Cash Fund and Advances to Employees

(Prepared on client's letterhead)

(Date)

(Name)
(Address)

Our auditors, (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of the petty cash fund (or amount of advances) in your possession as of December 31, 19XX which was shown by our records as $______.

Please indicate in the space provided below whether the amount above agrees with your records. If not, please send the auditors any information you have that will help them reconcile the difference.

After signing and dating your reply, please return it directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

The foregoing information is in agreement with my records as of December 31,19XX with the following exceptions (if any):

....
....
....

Date: .... Signed: ....

.06 Securities and Cash in Custodian or Trust Accounts

(Prepared on client's letterhead)

(Date)

(Name of custodian or trustee)
(Address)

Our auditors, (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the enclosed list of securities owned at (insert date) and the amount of principal and income and amount of cash held by you at that date for each of the following accounts [Notes (B) & (C)]:

(If a list is not obtained from the client, the auditor should complete the following for each account:

	Name of account	Account No. [Note (A)]	Amount Held
1.	....	....	....
2.	....	....	....
3.	....	....	....)

Please also indicate to the auditors whether to your knowledge any of the securities are pledged or otherwise encumbered.

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

NOTES TO USER:

(A) Use the custodian or trustee's account number.

(B) This letter may be expanded, if necessary, to request cutoff statements of activity (principal and interest) in the accounts.

(C) Sometimes this request is combined with a request for cutoff bank statements and the standard form to confirm account balance information with financial institutions. However, it may be more practical to send separate letters because a bank's commercial banking and trust departments are usually separate operations.

.07 Securities Held by Brokers

(Prepared on client's letterhead)

(Date) [Note (A) below]

(Broker's Name)
(Address)

In connection with the audit of our financial statements, please send directly to our auditors (insert name and address of auditors), a statement of our account(s) [Note (B)] with you as of (insert date), indicating the following information:

1. Securities held by you for our account.
2. Securities out for transfer to our name.
3. Any amounts payable to or due from us.

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

NOTES TO USER:

(A) The request should be sent so it reaches the broker sufficiently in advance of the listing date for the broker to respond in a practical manner.

(B) It may be helpful to include the account number(s) used by the broker for the client's account(s).

.08 Sample Receipts for Return of Cash or Securities Counted by Auditor's Representative, and Cutoff Bank Statements Received Directly by the Auditors

Cash Count

The above detailed items were counted in my presence and returned to me intact by (insert individual's name), representative of (insert auditor's firm name).

(Date and Time) Custodian ....
(custodian's signature)

Securities Count

Received intact from (insert individual's name), representative of (insert auditor's firm name), the securities listed above contained in Box .... of the (insert name of bank or custodian) which were counted by him in my presence (or presented to him for count).

Date and Time .... Signed ....

Title ....

Cutoff Bank Statement(s)

Received intact from (insert individual's name), representative of (insert auditor's firm name), the cutoff bank statements and related paid checks for the period from .... to .... (periods indicated) for the accounts listed below:

Date and Time .... Signed ....

Title ....

NOTES TO USER:

- Receipt(s) should be written and signed in *ink.*
- For counts of petty cash funds, the receipt may be written directly on the bottom of the petty cash-count working paper. For security counts and returns of cutoff bank statements, the receipt may be prepared as a separate working paper.

.09 Accounts Receivable—Positive

(Prepared on client's letterhead)

(Customer's Name)
(Address)

In connection with the audit of our financial statements, please confirm directly to our auditors (insert name and address of auditors) the amount of your indebtedness to us which according to our records as of (insert date) amounted to $______.

If the amount shown is in agreement with your records, please check "A" below.

If the amount is not in agreement with your records, please check and complete "B" below.

After checking the appropriate response, please sign and date your reply and mail it directly to our auditors in the enclosed envelope. DO NOT SEND ANY PAYMENTS to our auditors.

Very truly yours,
(Client's authorized signature)

A ____________ The balance above agrees with my records.

B ____________ My records show a balance of $________.

The difference may be due to the following:

____

____

____

____
(Signed by)

____
(Date)

.10 Accounts Receivable—Negative

(May be a sticker or stamp used on client's statements to customers)

PLEASE CHECK THIS STATEMENT

If this statement is *not correct* please write promptly (using the enclosed envelope), giving details of any differences, directly to our auditors,

(Name of auditors)

____

(Address of auditors)

____

who are now conducting an audit of our financial statements.

If you do not write to our auditors, they will consider this statement to be correct.

Remittances should NOT be sent to the auditors.

NOTES TO USER:

- A negative confirmation may also be requested in letter form using similar wording.
- The auditor should consider sending confirmation requests at the time of the client's regular monthly billings. Coordination of confirmation procedures with the client's routine preparation and mailing of statements may offer efficiency to both the auditor and client.
- Negative confirmation requests may be used as a substantive procedure to reduce audit risk *only* when three conditions exist: (1) the combined assessed level of inherent and control risk is low, (2) a large number of small balances is involved, and (3) the auditor has no reason to believe that the recipients of the request are unlikely to give them consideration.

.11 Notes Receivable

(Prepared on client's letterhead)

(Date)

(Name)
(Address)

Our auditors (insert name and address of auditors) are performing an audit of our financial statements. Accordingly, please confirm directly to our auditors the amount of your indebtedness due us as of (insert date), which our records show as follows:

Type of indebtedness ______
Initial date of indebtedness ______
Original amount of indebtedness ______
Unpaid principal ______
Interest rate ______
Interest paid to ______
Periodic payments required ______
Description of collateral ______

If the above information is in agreement with your records, please so indicate by signing in the place provided below and return the copy of this letter directly to our auditors in the enclosed envelope.

If the above is not in agreement with your records, please so note in the space provided the particulars shown in your records and any information which may help reconcile the difference from our records. **Payments should not be sent to the auditors.**

Very truly yours,

(Client's authorized signature)

The above information is correct as of (insert date) with the following exceptions (if any): ______

______

______

.12 Inventories Held by Warehouses or Others When Listing Is Not Provided by Client

(Prepared on client's letterhead)

(Date)

(Name of Warehouse)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please send directly to our auditors the following information about merchandise held in your custody for our account at (insert date):

1. Quantities on hand; for each lot please indicate the following:
    (a) Lot number (list each lot separately)
    (b) Date received
    (c) Kind of merchandise
    (d) Unit of measure or package
        (1) Number of units
        (2) Kind of units (box, can, crate, quart, pound, dozen, etc.)
2. A statement about how you determined the above requested quantities; specify whether they were determined by physical count, weight or measure, or if they represent your book record.
3. A list of negotiable or nonnegotiable warehouse receipts issued, if any, and whether or not such receipts have, to your knowledge, been assigned or pledged.
4. Statement of any known liens against this merchandise.
5. Amount of unpaid charges, if any, as of (insert date).

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

.13 Inventories Held by Warehouses or Others When Listing Is Provided by Client

(Prepared on client's letterhead)

(Date)

(Name of Warehouse)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about the merchandise held by you for our account as of (insert date):

1. The correctness of the quantities shown on the enclosed listing of such merchandise prepared from our records (a second copy is enclosed for your files). If the enclosed listing differs from the quantities you held for us as of (insert date), please include details of the specific differences in your response to our auditors.

2. Your statement on how you determined the correctness of the quantities you are confirming; please specify whether determined by physical count, weight or measure, or whether the quantities are from your records.

3. A list of negotiable or nonnegotiable warehouse receipts issued, if any, and whether or not such receipts have, to your knowledge, been assigned or pledged.

4. Statement of any known liens against these goods.

5. Amount of any unpaid charges as of (insert date).

Please mail your reply directly to (insert name and address of auditors). A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

.14

STANDARD CONFIRMATION INQUIRY FOR LIFE INSURANCE POLICIES

Developed by
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
LIFE OFFICE MANAGEMENT ASSOCIATION
MILLION DOLLAR ROUND TABLE

ORIGINAL
To be mailed to accountant

______________19____

Dear Sirs:

Please furnish the information requested below in items 1 through 9 (and also in items 10 through 12 if any of those items are checked) for the policies identified on lines A, B and C This information is requested as of the date indicated. IF THE ANSWER TO ANY ITEM IS "NONE," PLEASE SO STATE. The enclosed envelope is provided for the return of one copy of this form to the accountant named below.

(Ins. Co.)______________________________

____

____

(Accountant)______________________________

____

____
(Name of owner as shown on policy contracts)

Information requested as of______________

Request authorized by

____

		Col. A	Col. B
A.	Policy number		
B.	Insured		
C.	Beneficiaries as shown on policies (if verification requested in item 11) Col. A— Col. B—		
1.	Face amount of basic policy	$	$
2.	Values shown as of (insert date if other than date requested)		
3.	Premiums, including prepaid premiums, are paid to (insert date)		
4.	Policy surrender value (excluding dividends, additions and indebtedness adjustments)	$	$
5.	Surrender value of all dividend credits, including accumulations and additions	$	$
6.	Termination dividend currently available on surrender	$	$
7.	Other surrender values available to policyowner — a. Prepaid premium value	$	$
	b. Premium deposit funds	$	$
	c. Other	$	$
8.	Outstanding policy loans, excluding accrued interest	$	$
9.	If any loans exist, complete either "a" or "b" a. Interest accrued on policy loans	$	$
	b. 1.) Loan interest is paid to (enter date)		
	2.) Interest rate is (enter rate)		

The accountant will indicate by a check (✓) which if any of items 10-12 are to be answered

☐	**10.**	Is there an assignee of record? (enter Yes or No)		
☐	**11.**	Is beneficiary of record as shown in item C above? (enter Yes or No*)	*	*
☐	**12.**	Is the name of policyowner (subject to any assignment) as shown at the top of the form? (enter Yes or No) _______ If No, enter name of policyowner of record ______________________________		

*If answer to 11 is No, please give name of beneficiary or date of last beneficiary change ______________

Date______________ By______________________________ Title______________________
For the insurance company addressed

Additional copies of this form are available from the American Institute of CPAs, 1211 Avenue of the Americas, New York, N Y 10036

STANDARD CONFIRMATION INQUIRY FOR LIFE INSURANCE POLICIES

Developed by
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
LIFE OFFICE MANAGEMENT ASSOCIATION
MILLION DOLLAR ROUND TABLE

DUPLICATE
To be retained by insurance company

______________19____

Dear Sirs:

Please furnish the information requested below in items 1 through 9 (and also in items 10 through 12 if any of those items are checked) for the policies identified on lines A, B and C This information is requested as of the date indicated IF THE ANSWER TO ANY ITEM IS "NONE," PLEASE SO STATE The enclosed envelope is provided for the return of one copy of this form to the accountant named below

(Ins. Co.)______________________

____

____

(Accountant)______________________

____

____
(Name of owner as shown on policy contracts)

Information requested as of______________

Request authorized by

____

		Col. A	Col. B
A.	Policy number		
B.	Insured		
C.	Beneficiaries as shown on policies (if verification requested in item 11) Col. A— Col. B—		
1.	Face amount of basic policy	$	$
2.	Values shown as of (insert date if other than date requested)		
3.	Premiums, including prepaid premiums, are paid to (insert date)		
4.	Policy surrender value (excluding dividends, additions and indebtedness adjustments)	$	$
5.	Surrender value of all dividend credits, including accumulations and additions	$	$
6.	Termination dividend currently available on surrender	$	$
7.	Other surrender values available to policyowner — a. Prepaid premium value	$	$
	b. Premium deposit funds	$	$
	c. Other	$	$
8.	Outstanding policy loans, excluding accrued interest	$	$
9.	If any loans exist, complete either "a" or "b" a. Interest accrued on policy loans	$	$
	b. 1.) Loan interest is paid to (enter date)		
	2.) Interest rate is (enter rate)		

The accountant will indicate by a check (✔) which if any of items 10-12 are to be answered

☐	**10.**	Is there an assignee of record? (enter Yes or No)		
☐	**11.**	Is beneficiary of record as shown in item C above? (enter Yes or No*)	*	*
☐	**12.**	Is the name of policyowner (subject to any assignment) as shown at the top of the form? (enter Yes or No) ________. If No, enter name of policyowner of record. ______________________		

*If answer to 11 is No, please give name of beneficiary or date of last beneficiary change ______________

Date______________By______________________Title______________
For the insurance company addressed

Additional copies of this form are available from the American Institute of CPAs, 1211 Avenue of the Americas, New York, N. Y. 10036

.15 Pension Plan Actuarial Information

(Prepared on client's letterhead)

(Date)

(Name of Actuary)
(Address)

In connection with the audit of our financial statements for the period ending (*fiscal year end*) by our independent auditors (name, address), please furnish them the information described below as it pertains to the XYZ Pension Plan, which is a defined benefit plan. For your convenience in response to those requests, you may supply pertinent sections, properly signed and dated, of your actuarial report, or pension expense report, if they are available and if they contain the requested information.

A. Please provide a brief description of the following:

1. The employee group covered.
2. The benefit provisions of the plan used in the calculation of the net periodic pension cost for the period and of the accumulated benefit obligation and the projected benefit obligation at the end of the period. Please identify any such benefit provisions that had not taken effect in the year. Please also provide the date of the most recent plan amendment included in your calculation. Please identify any participants or benefits excluded from the calculations, such as benefits guaranteed under an insurance or annuity contract.
3. The plan sponsor's funding policy for the plan.
4. Any significant liabilities other than for benefits, such as for legal or accounting fees.
5. The method and the amortization period, if any, used for the following:
    a. Calculation of a market-related value of plan assets, if different from the fair value.
    b. Amortization of any transition asset or obligation.
    c. Amortization of unrecognized prior service cost.
    d. Amortization of unrecognized net gain or loss.
6. Any substantive commitments for benefits that exceed the benefits defined by the written plan that are included in the calculations.
7. Determination of the value of any insurance or annuity contracts included in the assets.
8. Nature and effect of significant plan amendments and other significant matters affecting comparability of net periodic pension cost, funded status, and other information for the current period with that for the prior period.
9. The following information relating to the employee census data used in calculating the benefit obligations and pension cost:
    a. The source and nature of the data is __________________ and the date as of which the census data was collected is __________________.
    b. The following information concerning participants:

Participants	Number of Persons	Compensation (if applicable)
Currently receiving payments	______	______
Active with vested benefits	______	______
Terminated with deferred vested benefits	______	______
Active without vested benefits	______	______
Other (describe)	______	______

Note: If information is not available for all the above categories, please indicate the categories that have been grouped and describe any group or groups of participants excluded from the above information.

c. Information for the following individuals contained in the census:

Participants' Name or Number	Age or Birth Date	Sex	Salary	Date Hired or Years of Service

Note to Auditor: The auditor should select information from employer records to compare with the census data used by the actuary. In addition, the auditor may wish to have the actuary select certain census data from his files to compare with the employer's records.

B. Please provide the following information on the net periodic pension cost for the period ending on ________ :

1. Service cost $ ________
2. Interest cost
3. Actual return on assets
4. Other components
   a. Net asset gain or (loss) during the period deferred for later recognition
   b. Amortization of net loss or (gain) from earlier periods
   c. Amortization of unrecognized prior service cost
   d. Amortization of the remaining unrecognized net obligation or (asset) existing at the date of the initial application of FASB Statement No. 87—transition obligation or (asset)
   e. Net total of components

      (a + b + c + d) ________
5. Net periodic pension cost:
   (1 + 2 − 3 + 4e) $ ________
6. The above measurement of the net periodic pension cost is based on the following assumptions:
   Weighted-average discount rate ________%
   Weighted-average rate of compensation increase ________%
   Weighted-average expected long-term rate of return on plan assets ________%
   Please describe the basis on which the above rates were selected and whether the basis is consistent with the prior period.
   Please briefly describe the other assumptions used in the above measurement.
7. The calculations of the items shown in B1 to B5 are based on the following:

Asset information at ____________

Census data at ____________

Measurement date (must be not more than three months before the end of the last fiscal year) ____________

Please describe any adjustments made to project the census data forward to the measurement date or to project the results calculated at an earlier date to those shown in B1 to B5.

C. Please provide the following information on the benefit obligations for disclosure in the financial statements for the period ending ____________:

	Estimated
1. Pension Benefit Obligation	
a. Accumulated benefit obligation	
—vested	
—non vested	____________
—total	$ ____________
b. Additional benefits based on *estimated* future salary levels	____________
c. Projected benefit obligation (a + b)	____________
2. Fair Value of Plan Assets	
3. Unfunded Projected Benefit Obligation: (1c − 2)	
4. Unrecognized Prior Service Cost	
5. Unrecognized Net Loss or (Gain)	
6. Unrecognized Net Transition Liability or (Asset)	
7. Additional Liability	____________
8. Accrued or (prepaid) pension cost in the company financial statements (3 − 4 − 5 − 6 + 7)	$ ____________

9. The above amount of the projected benefit obligation is measured based on the following assumptions:
   Weighted-average discount rate ____________%
   Weighted-average rate of compensation increase ____________%
   Please provide a brief description of the other assumptions used in the measurement.
10. The calculation of the items shown in C1 to C8 is based on the following:
    Asset information at ____________
    Census data at ____________
    Measurement date (must be not more than three months before the current fiscal year end) ____________
    Please describe any adjustments made to project the census data forward to the measurement date or to project the results calculated at an earlier date to those shown in C1 to C8.
11. Please describe any significant events noted subsequent to the current year's measurement date and as of the date of your reply to this request and the effects of those events, such as a large plant closing, which could materially affect the amounts shown in C1 to C8.

D. Please provide an analysis for the period showing beginning amounts, additions, reductions, and ending amounts of the:

1. Projected benefit obligation,
2. Unrecognized prior service cost,
3. Unrecognized net loss (gain), and
4. Net transition obligation (asset).

E. Please provide our independent auditors with descriptions and the amounts of gains or losses from settlements, curtailments or termination benefits during the year, such as:

1. Purchases of annuity contracts,

2. Lump-sum cash payments to plan participants,

3. Other irrevocable actions that relieved the company or the plan of primary responsibility for a pension obligation, and eliminates significant risks related to the obligation and assets,

4. Any events that significantly reduced the expected years of future service of employees,

5. Any events that eliminated for a significant number of employees the accrual of defined benefits for some or all of their future service, or

6. Any special or contractual termination benefits offered to employees.

F. Was all of the information above determined in accordance with FASB Statements No. 87 and No. 88 (including the FASB's Guides to Implementation of Statements 87 and 88 and the American Academy of Actuaries', "An Actuary's Guide to Compliance with Statement of Financial Accounting Standards No. 87") to the best of your knowledge? If not, please describe any differences.

G. Describe the nature of your relationship, if any, with the plan or the plan sponsor that may impair or appear to impair the objectivity of your work.

Very truly yours,

____

.16 Pension Plan Assets Held by Trustee

(Prepared on client's letterhead)

(Date)

(Name of trustee or custodian)
(Address)

Our auditors (insert name and address of auditor) are conducting an audit of our financial statements. Accordingly, please provide our auditors directly with a listing of the assets including market values as of (insert date) for our employees' pension trust (insert title and trustee's account number).

Please also provide the auditors with the following information about our employees' pension trust for the period from (insert date) to (insert date) [see note below]:

1. Contributions by the Company during the above period.
2. Contributions by employees during the above period.
3. Payments to beneficiaries during the above period.
4. Any unpaid fees due for services rendered to (insert audit date).

Please send your reply directly to our auditors. A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

NOTE TO USER:

A listing of the assets might not be requested if one had already been received by the client. In that case, the auditor might want the trustee to confirm the total market value per the listing.

.17 Actuary of a PERS for Disclosure in Financial Reports Incorporating the PERS' Financial Statements and/or Actuary of a Single-Employer PERS or an Agent Multiple-Employer PERS for Disclosure in the Financial Reports of a Contributing Governmental Employer or Nonemployer Contributor That Does Not Include the PERS in Its Reporting Entity *

(Prepared on PERS or contributing governmental employer or nonemployer contributor letterhead)

(Name of Actuary of PERS)
(Address) Date

Dear ——————————:

In connection with the audit of our financial statements for the period ending (fiscal year end) by our independent auditors, (name and address of independent auditors), please furnish directly to them the information described below as it relates to the (name of PERS) and the participation therein of employees of the (name of governmental employer). Also, please provide a copy of the most recent actuarial valuation report.

For your convenience in response to these requests, you may supply pertinent sections, properly signed and dated, of your actuarial report, or pension expense report, if they are available and if they contain the requested information.

If any figures presented herein are estimates, please so indicate and briefly describe the estimation technique used.

A. Please provide a brief description of the following:

1. Types of employees covered and current membership with separate identification of the number of (a) retirees and beneficiaries currently receiving benefits, and terminated employees entitled to benefits but not yet receiving them and (b) full vested, partially vested, and nonvested active employees covered by the plan.

2. If agent or cost-sharing multiple-employer PERS, (name of governmental employer) current-year covered payroll.

B. Please provide, for each of the following participants, the indicated information relating to the employee census data used in performing the actuarial valuation(s) described in C1 and E2. Also, please identify the source, nature, and date as of which the census data was collected.

Participant's Name or Number	Age or Birth Date	Sex	Salary	Date Hired or Years of Service

(*Note to auditor*—Select sample participants from records and list them here.)

C. Please indicate, with respect to the actuarial present value of credited projected benefits (hereinafter referred to as the APV of CPB or "pension benefit obligation")

1. Date of the most recent actuarial valuation in which the APV of CPB was calculated and the date of any subsequent actuarial update.

2. Significant actuarial assumptions used to compute the APV of CPB, including rate of return on investment of present and future assets, projected salary increases due to (a) inflation and (b) merit or seniority, and postretirement benefit increases.

* Disclosures are required pursuant to GASB *Codification of Governmental Accounting and Financial Reporting Standards,* paragraphs Pe6.130—.132, P20.123—.127, and .131, as of June 15, 1987.

3. Amount of the entire APV of CPB, for the entire PERS, in total and segregated as follows:

    a. Retirees and beneficiaries currently receiving benefits and terminated employees entitled to benefits but not yet receiving them.

    b. Current employees:

        i. Accumulated employee contributions including allocated investment income, if any.

        ii. Employer-financed vested.

        iii. Employer-financed nonvested.

4. If agent multiple-employer PERS, amount of the APV of CPB applicable to (name of governmental employer) participants, in total and segregated as follows:

    a. Retirees and beneficiaries currently receiving benefits and terminated employees entitled to benefits but not yet receiving them. (If the pension benefit obligation applicable to retirees and beneficiaries currently receiving benefits, and related net assets available for benefits, are transferred to the PERS as a whole, please state that fact and provide here only the APV of CPB applicable to terminated employees entitled to benefits but not yet receiving them, and related net assets available for benefits.)

    b. Current employees:

        i. Accumulated employee contributions including allocated investment income, if any.

        ii. Employer-financed vested.

        iii. Employer-financed nonvested.

5. Net assets available for benefits as of the same date as the pension benefit obligation determined in accordance with the method used to value assets for balance sheet purposes; also identify the method used to value assets.

6. Explanation, including separate dollar effects on the APV of CPB described in C3 and C4, of any current-year changes in (a) actuarial assumptions or (b) benefit provisions.

D. Please indicate, with respect to plan assets:

1. Market value of the entire net assets available for benefits, for the entire PERS, on the same date as the APV of CPB.

2. Amortized cost value of the entire net assets available for benefits, for the entire PERS, on the same date as the APV of CPB, with disclosure of the method used to account for exchanges of "swaps" of securities.**

3. If agent or cost-sharing multiple-employer PERS that is included in the employer's reporting entity, market value of net assets available for benefits applicable to (name of governmental employer) participants on the same date as the APV of CPB. (Do not include net assets available for benefits applicable to retirees and beneficiaries currently receiving benefits, if the pension benefit obligation applicable to them is transferred to the PERS as a whole.)

** Information on amortized cost values and the method used to account for exchanges or "swaps" of securities need be obtained only if the plan is accounted for in accordance with the requirements of National Council on Governmental Accounting Statements Nos. 1, *Governmental Accounting and Financial Reporting Principles,* or 6, *Pension Accounting and Financial Reporting: Public Employee Retirement Systems, and State and Local Government Employers,* as permitted by GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers,* paragraph 4.

4. If agent or cost-sharing multiple-employer PERS that is included in the employer's reporting entity, amortized cost value of net assets available for benefits applicable to (name of governmental employer) participants on the same date as the APV of CPB, with disclosures of the method used to account for exchanges or "swaps" of securities.*** (Do not include net assets available for benefits applicable to retirees and beneficiaries currently receiving benefits, if the pension benefit obligation applicable to them is transferred to the PERS as a whole.)

E. Please indicate, with respect to contributions required and contributions made:

1. A brief description of funding policy, including the role of actuarially determined contribution requirements in carrying out that policy.

2. Date of the most recent actuarial valuation performed to compute actuarially determined contribution requirements.

3. Actuarial funding method used to compute actuarially determined contribution requirements and the period and method for amortization of any unfunded actuarial accrued liability.

4. That significant actuarial assumptions used to compute actuarially determined contribution requirements are the same as those used to compute the APV or CPB, or explain the differences.

5. Total actuarially determined contribution requirement for the entire PERS, and the amounts intended to (a) cover normal cost and (b) amortize any unfunded actuarial accrued liability, expressed in dollar amounts and as percentages of current-year covered payroll.

6. Total contributions actually made for the entire PERS by (a) contributing governmental employers or nonemployer contributors and (b) employees, expressed in dollar amounts and as percentages of current-year covered payroll.

7. If agent or cost-sharing multiple-employer PERS that is included in employer's reporting entity, actuarially determined contribution requirements applicable to (name of governmental employer) participants and the amounts intended to (a) cover normal cost and (b) amortize any unfunded actuarial accrued liability, expressed both in dollar amounts and as percentages of current-year covered payroll.

8. If agent or cost-sharing multiple-employer PERS that is included in employer's reporting entity, contributions actually made, applicable to (name of governmental employer) participants, by (name of contributing governmental employer or nonemployer contributor) and by (name of governmental employer) employees, expressed both in dollar amounts and as percentages of current-year covered payroll.

9. Explanations, including the separate dollar effects on the actuarially determined contribution requirements described in E5, E6, E7, and E8 of any current-year changes in (a) actuarial assumptions (b) benefit provisions, (c) actuarial funding method, or (d) other significant factors.

F. Please describe any significant events noted, subsequent to the dates described in C1 and E2 and as of the date of your response to this request, that could materially affect (the auditor should indicate the amount considered material) the information described in A to E. Also describe the effects of those events.

G. Please indicate that the information you provide has been determined in accordance with the provisions of GASB Statement No. 5, or explain any exceptions.

*** Information on amortized cost values and the method used to account for exchanges or "swaps" of securities need be obtained only if the plan is accounted for in accordance with the requirements of National Council on Governmental Accounting Statements Nos. 1, *Governmental Accounting and Financial Reporting Principles*, or 6, *Pension Accounting and Financial Reporting: Public Employee Retirement Systems, and State and Local Government Employers*, as permitted by GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers*, paragraph 4.

H. Please describe the nature of any relationship you have with the (name of PERS) or (name of contributing governmental employer or nonemployer contributor) that may impair, or appear to impair, the independence and objectivity of your work.

I. Please advise if notification has been received of a decision to partially or fully terminate the plan and explain the effect of the decision.

J. Please provide any additional information you consider necessary.

Very truly yours,

(Name of Contributing Governmental Employer or Nonemployer Contributor)

By (Name and Title of Requesting Official of Contributing Governmental Employer or Nonemployer Contributor)

.18 Actuary of a Cost-Sharing Multiple-Employer PERS, for Disclosure in Financial Reports of a Contributing Governmental Employer or Nonemployer Contributor That Does Not Include the Cost-Sharing Multiple-Employer PERS in Its Reporting Entity*

(Prepared on contributing governmental employer or nonemployer contributor letterhead)

(Name of actuary of PERS)
(Address) Date

In connection with the audit of our financial statements for the period ending (fiscal year end) by our independent auditors, (name and address of independent auditors), please furnish directly to them the information described below as it relates to the participation of employees of the (name of governmental employer) in the (name of PERS). Also, please provide a copy of the most recent actuarial valuation report.

For your convenience in response to these requests, you may supply pertinent sections, properly signed and dated, of your actuarial report, or pension expense report, if they are available and if they contain the requested information.

If any figures presented herein are estimates, please so indicate and briefly describe the estimation technique used.

Please provide the following:

A. (Name of governmental employer) current-year covered payroll.

B. For each of the following participants, the indicated information relating to the employee census data used in performing the actuarial valuation(s) in which the amounts described in C and G were computed.

Participant's Name or Number	Age or Birth Date	Sex	Salary	Date Hired or Years of Service

(*Note to auditor*—Select sample participants from records and list them here.)

C. Actuarially determined contribution requirement applicable to (name of governmental employer) participants, expressed both in a dollar amount and as a percentage of current-year covered payroll. Also, describe any current-year changes in actuarial assumptions, benefit provisions, actuarial funding method, or other significant factors, and the aggregate effect on the actuarially determined contribution requirement applicable to (name of governmental employer) participants, expressed as a percentage of current-year covered payroll.

D. The total PERS actuarial present value of credited projected benefits (APV of CPB).

E. Market value of the total PERS net assets available for benefits (as of the same date as the APV of CPB).

F. Amortized cost value of the total PERS net assets available for benefits (as of the same date as the APV of CPB).**

* Disclosures are required pursuant to GASB *Codification of Governmental Accounting and Financial Reporting Standards*, paragraph P20.127, as of June 15, 1987.

** Information on amortized cost values need be obtained only if the plan is accounted for in accordance with the requirements of National Council on Governmental Accounting Statements Nos. 1, *Governmental Accounting and Financial Reporting Principles*, or 6, *Pension Accounting and Financial Reporting: Public Employee Retirement Systems, and State and Local Government Employers*, as permitted by GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers*, paragraph 4.

G. The actuarially determined contribution requirement applicable to (name of governmental employer) participants, expressed as a percentage of the total current-year actuarially determined contribution requirement for the PERS as a whole.

H. Please indicate that the information you provide has been determined in accordance with the provisions of GASB Statement No. 5, or explain any exceptions.

I. Please describe the nature of any relationship you have with the (name of PERS) or (name of contributing governmental employer or nonemployer contributor) that may impair, or appear to impair, the independence and objectivity of your work.

J. Please provide information relating to subsequent events that could affect the information provided herein.

K. Please advise if notification has been received of a decision to partially or fully terminate the plan and explain the effect of the decision.

L. Please provide any additional information you consider necessary.

Very truly yours,

(Name of Contributing Governmental Employer or
Nonemployer Contributor)

By (Name and Title of Requesting Official of Contributing Governmental Employer or Nonemployer Contributor)

.19 Notes Payable

(Prepared on client's letterhead)

(Date)

(Name)
(Address)

Our auditors (insert name and address) are conducting an audit of our financial statements.

Accordingly, please confirm directly to them the following information relating to our note(s) payable to you, as of (insert date):

Date of Note: (insert date)

Original Amount: (insert amount)

Unpaid Principal

Balance: (insert amount)

Periodic payments required

Payment periods

Maturity Date: (insert date)

Interest Rate: (insert rate)

Date to which interest has been paid: (insert date)

Amount and description of collateral: (insert description)

Description of terms, e.g., demand provisions, prepayment penalties, etc.

Any other direct or contingent liabilities to you: (insert "None" or description)

If the above information is in agreement with your records at that date, please so indicate by signing in the place provided below and return the copy of this letter directly to our auditors in the enclosed envelope.

If the above is not in agreement with your records, please note in the space provided the particulars shown in your records and any information which may help reconcile the difference from our records.

Very truly yours,

(Client's authorized signature)

The above information is correct as of (insert date) with the following exceptions (if any):.......................

....

Date .... Signature ....

Title ....

.20 Mortgage Debt

(Prepared on client's letterhead)

(Date)

(Name of creditor or trustee)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about our mortgage indebtedness to you as of (insert date):

1. Original amount.
2. Date of note.
3. Unpaid principal balance.
4. Interest rate.
5. Terms for payment of principal.
6. Date to which interest has been paid.
7. Nature of mortgage and description or address of property mortgaged.
8. Amounts on deposit with you in escrow for:
    a. Insurance
    b. Real estate taxes
9. Amounts paid during the period (insert dates from and to) for:
    a. Insurance
    b. Taxes
10. Amounts on deposit with you for the "reserve for repairs."
11. The nature of defaults, if any.
12. Description of terms, e.g., prepayment penalties, demand provisions, etc.

A return envelope is enclosed for your reply.

Very truly yours,

(Client's authorized signature)

NOTE TO USER:

Many of the items requested will vary with the circumstances of the particular mortgage or other debt involved. The above sample assumes the indenture involves an escrow arrangement for insurance and real estate taxes and a deposit account for repairs.

.21 Accounts Payable

(Prepared on client's letterhead)

(Date)

(Name)
(Address)

In connection with the audit of our financial statements, please confirm directly to our auditors (insert name and address of auditors), the amount of our liability to you as of (insert date). Please attach a statement of our account due. If no balance is due, please attach a statement of our account showing payments made.

Please mail your reply directly to (name of auditors). A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

Our records indicate that a balance of $........... was due from (insert name of client) at (insert date).

Date..............................

Signed ....
Title ....

.22 Obligation to Lessor

(Prepared on client's letterhead)

(Date)

(Name of lessor)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements as of (insert balance sheet date) and for the (insert time period) then ended. In connection with this audit, please provide directly to our auditors the following information as of (insert balance sheet date) regarding the lease dated (insert date lease was executed) of (insert brief identification of property under lease) which we are leasing from you:

1. Inception and expiration dates for the lease period, from .... to ....
2. Amount of monthly rent ....
3. Renewal options (if any):
   a. Dates of renewal period, from .... to ....
   b. Amount of monthly rent for renewal ....
4. Purchase options (if any):
   a. Amount of purchase price ....
   b. Inception and expiration dates of option, from .... to ....
   c. Percent of monthly rent (if any) applicable towards purchase price ....
5. Dates and descriptions of amendments or supplementary understandings, if any, to the lease mentioned above.
6. The amount of outstanding delinquent payments, if any.
7. A statement that there are no defaults, or the nature of defaults, if any.

A return envelope is enclosed for your reply.

Very truly yours,

(Client's authorized signature)

NOTE TO USER:

The content of this type of letter will vary based on the auditor's professional judgment in the circumstances. To provide additional illustrative language, the above letter is not made parallel with the illustration at AAM section 7200.23.

.23 Property Out on Lease

(Prepared on client's letterhead)

(Date)

(Name of Lessee)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements as of (insert balance sheet date) and for the (insert time period) then ended. In connection with this audit, please confirm directly to our auditors the following information regarding the lease dated (insert execution date of lease) of (insert brief identification of property under lease) which you are leasing from us:

1. Inception and expiration dates of lease period from .... to ....
2. Amount of monthly rent ....
3. Total rental payments made ....
4. Date of last payment ....

A return envelope is enclosed for your reply.

Very truly yours,
(Client's authorized signature)

NOTES TO USER:

- If the leased property is of a mobile or portable nature such as a bulldozer or television camera, the confirmation may also include a request for specific serial numbers of significant equipment.
- In certain circumstances, the auditor may wish to consider confirming additional information such as renewal options, purchase options, and amendments or supplementary understandings.

.24 Registrar—Capital Stock

(Prepared on client's letterhead)

(Date)

(Name of Registrar)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of the close of business (insert balance sheet date) about each class of our preferred and common stock:

1. Authorized number of shares
2. Issued number of shares
3. Outstanding number of shares

Please also indicate the amount of any unpaid registrar fees due you as of (insert balance sheet date).

A return envelope is enclosed for your convenience.

Very truly yours,
(Authorized signature for client)

NOTES TO USER:

- It may be helpful to include the registrar's account number for the client's account to receive a timely response.
- Some auditors prefer that the confirmation request include identification of each class of stock.
- The above illustration assumes the client has a separate transfer agent (see AAM section 7200.25).

.25 Transfer Agent—Capital Stock

(Prepared on client's letterhead)

(Date)

(Name of Transfer Agent)
(Address)

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of (insert balance sheet date) about each class of our preferred and common stock:

1. Authorized number of shares
2. Number of shares issued and outstanding
3. Number of outstanding shares registered in the name of our Company.

Please also indicate the amount of any unpaid transfer agent fees due you as of (insert balance sheet date).

A return envelope is enclosed for your convenience.

Very truly yours,
(Authorized signature for client)

NOTES TO USER:

- It may be helpful to include the transfer agent's account number for the client's account to receive a timely response.
- Some auditors prefer that the confirmation request include identification of each class of stock.
- Depending on the auditor's judgment in the circumstances the confirmation request may also include inquiries about such matters as (i) the number of shares issued to each of specifically mentioned officers and directors, (ii) specified information about shareholders owning more than a stated percent of the total outstanding shares, and (iii) amounts deposited during the year for the payment of dividends.

.26 Request for Confirmation of Money Market Fund

(Prepared on client's letterhead)

(Date)

(Name)

(Address)

Our auditors, (insert name and address of auditors) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of our money market fund account(s) as of (insert date).

Please indicate in the space provided below the account number(s) and balance(s) of our account(s) per your records.

Please sign and date your reply and return it directly to the auditors. A stamped, self-addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's authorized signature)

Account No.	*Date*	*Balance*
....	....	....
....	....	....
....	....	....

Date: .... Signed: ....

.27 Confirmation of Contingent Liabilities

(Date)

Financial Institution Official *
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of (name of customer) as of (balance-sheet date) and for the (period) then ended, we have advised our independent auditors of the information listed below, which we believe is a complete and accurate description of our contingent liabilities, including oral and written guarantees, with your financial institution. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other contingent liabilities, including oral and written guarantees, between (name of customer) and your financial institution comes to your attention, please include such information below.

Name of Maker	Date of Note	Due Date	Current Balance

Interest Rate	Date Through Which Interest Is Paid	Description of Collateral	Description of Purpose of Note

Information related to oral and written guarantees is as follows:

____
____
____
____

Please confirm whether the information about contingent liabilities presented above is correct by signing below and returning this directly to our independent auditors (name and address of CPA firm).

Sincerely,

(Name of Customer)

____

By: ______________________________
(Authorized Signature)

* This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the transactions or arrangements. Some official institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

Dear CPA Firm:

The above information listing contingent liabilities, including oral and written guarantees, agrees with the records of this financial institution.* Although we have not conducted a comprehensive, detailed search of our records, no information about other contingent liabilities, including oral and written guarantees, came to our attention. [Note exceptions below or in an attached letter.]

____

____

____

____

____

____
(Name of Financial Institution)

By: ________________________ __________
(Officer and Title) (Date)

* If applicable, comments similar to the following may be added to the confirmation reply by the financial institution: This confirmation does not relate to arrangements, if any, with other branches or affiliates of this financial institution. Information should be sought separately from such branches or affiliates with which any such arrangements might exist.

.28 Confirmation of Compensating Balances

(Date)

Financial Institution Official*
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of (name of customer) as of (balance-sheet date) and for the (period) then ended, we have advised our independent auditors that as of the close of business on (balance-sheet date) there (were) (were not) compensating balance arrangements as described in our agreement dated (date). Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other compensating balance arrangements between (name of customer) and your financial institution comes to your attention, please include such information below. Withdrawal by (name of customer) of the compensating balance (was) (was not) legally restricted at (date). The terms of the compensating balance arrangements at (date) were:

EXAMPLES:

1. The Company has been expected to maintain an average compensating balance of 20 percent of its average loan outstanding, as determined from the financial institution's ledger records adjusted for estimated average uncollected funds.
2. The Company has been expected to maintain an average compensating balance of $100,000 during the year, as determined from the financial institution's ledger records without adjustment for uncollected funds.
3. The Company has been expected to maintain a compensating balance, as determined from the financial institution's ledger records without adjustment for uncollected funds, of 15 percent of its outstanding loans plus 10 percent of its unused line of credit.
4. The Company has been expected to maintain as a compensating balance noninterest bearing time deposits of 10 percent of its outstanding loans.

In determining compliance with compensating balance arrangements, the Company uses a factor for uncollected funds of ____ (business) (calendar) days.[1]

There (were the following) (were no) changes in the compensating balance arrangements during the (period) and subsequently through the date of this letter.

The Company (was) (was not) in compliance with the compensating balance arrangements during the (period) and subsequently through the date of this letter.

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* This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the compensating balance arrangements. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

[1] Not applicable if compensating balances are based on the financial institution's ledger records without adjustment for uncollected funds. If some other method is used for determining collected funds for compensating balance purposes, the method used should be described.

There (were the following) (were no) sanctions (applied or imminent) by the financial institution because of noncompliance with compensating balance arrangements.[2]

During the (period), and subsequently through the date of this letter, (no) (the following) compensating balances were maintained by the Company at the financial institution on behalf of an affiliate, director, officer, or any other third party and (no) (the following) third party maintained compensating balances at the bank on behalf of the Company. (Withdrawal of such compensating balances (was) (was not) legally restricted.)

Please confirm whether the information about compensating balances presented above is correct by signing below, and returning this letter directly to our independent auditors (name and address of CPA Firm).

Sincerely,

(Name of customer)

____

By: ______________________________

(Authorized Signature)

Dear CPA Firm:

The above information regarding the compensating balance arrangements with this financial institution agrees with the records of this financial institution.* Although we have not conducted a comprehensive, detailed search of our records, no information about other compensating balance arrangements, came to our attention. [Note exceptions below or in an attached letter.]

____

____

____

____

____

(Name of Financial Institution)

By: ____________________ __________

(Officer and Title) (Date)

---

[2] Applicable only if the financial institution has applied sanctions during the (period) or notified the Company that sanctions may be applied. Indicate details.

* If applicable, comments similar to the following may be added to the confirmation reply by the financial institution: This confirmation does not relate to arrangements, if any, with other branches or affiliates of this financial institution. Information should be sought separately from such branches or affiliates with which any such arrangements might exist.

.29 Confirmation of Lines of Credit

(Date)

Financial Institution Official *
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of (name of customer) as of (balance-sheet date) and for the (period) then ended, we have advised our independent auditors of the information listed below, which we believe is a complete and accurate description of our line of credit from your financial institution as of the close of business on (balance-sheet date). Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other lines of credit from your financial institution comes to your attention, please include such information below.

The Company has available at the financial institution a line of credit totaling (amount). The current terms of the line of credit are contained in the letter dated (date). The related debt outstanding at the close of business on (date) was $(amount).

The amount of unused line of credit, subject to the terms of the related letter, at (date) was $(amount).

Interest rate at the close of business on (date) was ____%.
Compensating balance arrangements are ____

____

____

____

This line of credit supports commercial paper (or other borrowing arrangements) as described below:

____

____

____

* This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the lines of credit. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

Please confirm whether the information about lines of credit presented above is correct by signing below and returning this letter directly to our independent auditors (name and address of CPA Firm).

Sincerely,

(Name of customer)

____

By: ______________________________
(Authorized Signature)

Dear CPA Firm:

The above information regarding the line of credit arrangements agrees with the records of this financial institution.* Although we have not conducted a comprehensive, detailed search of our records, no information about other lines of credit came to our attention. [Note exceptions below or in an attached letter.]

____

____

____

____

____
(Name of Financial Institution)

By: ______________________________ ______________
(Officer and Title) (Date)

* If applicable, comments similar to the following may be added to the confirmation reply by the financial institution: This confirmation does not relate to arrangements, if any, with other branches or affiliates of this financial institution. Information should be sought separately from such branches or affiliates with which any such arrangements might exist.

.30 Related-Party Confirmation

(Date)

(Name)

(Address)

In connection with an audit of our financial statements, please furnish answers to the attached questionnaire, sign your name, and return the questionnaire in the enclosed envelope directly to our auditors (firm name). The questionnaire is designed to provide the auditors with information about the interests of officers, directors, and other related parties in transactions with our Company.

Please answer all questions. If the answer to any question is "yes," please explain. Certain terms used in the questions are defined at the end of the questionnaire.

Very truly yours,

____

(Name)

____

(Title)

(Client Name)

Related-Party Questionnaire

1. Have you or any related-party of yours had any material interest, direct or indirect, in any sales, purchases, transfers, leasing arrangements or guarantees or other transactions since (beginning of period of audit) to which the Company (or specify any pension, retirement, savings, or similar plan provided by the client) was, or is to be, a party?

2. Do you or any related-party of yours have any material interest, direct or indirect, in any pending or incomplete sales, purchases, transfers, leasing arrangements, guarantees or other transactions to which the Company (or specify any pension, retirement, savings, or similar plan provided by the client) was, or is to be, a party?

3. Have you or any related-party of yours been indebted to the Company (or specify any pension, retirement, savings, or similar plan provided by the client) at any time since (beginning of period of audit)? Please exclude amounts due for purchases on usual trade terms and for ordinary travel and expense advances.

The answers to the foregoing questions are correctly stated to the best of my knowledge and belief.

(Date)	(Signature)

See definitions at end of questionnaire.

Definitions

Company: Parent company and any subsidiary.

Related Party: Any (1) corporation or organization (other than the Company) of which you are an officer, director, or partner or are, directly or indirectly, the beneficial owner of 10 percent or more of any class of equity securities; (2) any trust or other estate in which you have a substantial beneficial ownership or for which you serve as trustee or in a similar fiduciary capacity; and (3) any close relative of yours or your spouse's, or other person you may significantly influence (control) or be significantly influenced by.

Control: possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a party, whether through ownership, by contract, or otherwise.

Person: an individual, a corporation, a partnership, an association, a joint-stock company, a business trust, or an unincorporated organization.

Beneficial Owner: a person who enjoys, or has the right to secure, benefits substantially equivalent to those of the ownership of securities, even though the securities are not registered in the person's name. Examples of beneficial ownership include securities held for the person's benefit in the name of others, such as nominees, custodians, brokers, trustees, executors and other fiduciaries; a partnership of which the person is a partner; and a corporation for which the person owns substantially all of the stock. Shares (1) held (individually or in a fiduciary capacity) by the person's spouse, the person's or his or her spouse's minor children, or a relative of the person or his or her spouse who shares the same home with the person; or (2) as to which the person can vest or revest title in himself at once or at some future time are also considered as being beneficially owned.

.31 Safe Deposit Box Access Confirmation

[*Date*]

____
____
____

Our auditors, ____________________ [*name and address of auditors*], are conducting an audit of our financial statements. Accordingly, please confirm there has been no access to our safe deposit box number ____ between ____ and ____ o'clock.

Please indicate in the space below if the above is in agreement with your records. If it is not, please furnish the auditors any details concerning access to our safe deposit box during the period indicated.

After signing and dating your reply, please mail it directly to our auditors in the enclosed envelope.

Very truly yours,

____

[*Client's Authorized Signature*]

According to our records, there has been no access to the above described safe deposit box during the period specified, except as follows: ____

____

Signed:______________________________ Date: ________________________

[*Name and Title*]

.32 Insurance In Force Confirmation Request

[*Date*]

____
____
____

Our auditors, __________ [*name and address of auditors*], are conducting an audit of our financial statements. In that connection, please confirm the details of our insurance coverage in force at __________ [*balance-sheet date*] as described below:

Policy number	________	________
Insurance company	________	________
Type of coverage	________	________
Amount of coverage	________	________
Co-insurance, if any	________	________
Term of policy	________	________
Gross premium	________	________
Amount of unpaid premiums	________	________
Loss payees, if other than us	________	________
Claims pending at ________ [*date*]	________	________

Please compare this information with your records and inform our auditors, in the space below, if it is, or is not, in agreement with your records. After signing and dating your reply, please mail it directly to our auditors in the enclosed envelope.

Very truly yours,

____

[*Client's Authorized Signature*]

The above information agrees with our records at __________ [*balance-sheet date*] with the following exceptions:

____
____
____
____

Signed:__________________________ Date: ____________________

[*Name and Title*]

.33 Illustrative Letter To Actuary Requesting Employer's Benefit Cost Information

[Client's Letterhead]

[Date]

____
____
____

In connection with the audit of our financial statements for the period ending ____________ *[fiscal year end]* by our independent auditors ____ *[name, address]*, please furnish them a copy of the most recent actuarial valuation report for ______________________ *[name of plan]*. If a complete actuarial valuation was not prepared as of ____________ *[date]*, please provide any reports or letters that summarize end-of-period amounts. If the information requested below is included in the valuation report, you may refer to the location in your report rather than repeating such information.

A. Please provide a brief description of the following:

1. The participant group(s) (for example, employee, retiree and dependent group[s]) covered, and the types of benefits provided.

2. The provisions of the substantive plan at the beginning of the period used in the calculation of the net periodic postretirement benefit cost for the period.

3. Any changes between the provisions of the substantive plan at the beginning of the period used in the calculation of net periodic postretirement benefit costs and the substantive plan used in the calculation of the accumulated postretirement benefit obligation (APBO) at the disclosure date. Additionally, please specify the following:

   a. The disclosure date (which cannot be more than three months prior to the end of the period).

   b. How these changes were included in the net periodic postretirement benefit costs for the period.

4. The date and description of plan amendments adopted during the period and whether the amendment(s) were included in items 2. and 3. above.

5. Any participants, benefits or plan terms excluded from the calculations and the reasons for their exclusion.

6. The funding policy for the plan if other than pay-as-you-go.

7. Any significant liabilities other than for benefits.

8. The method and the amortization period, if any, used for amortizing:

   a. Any transition asset or obligation.

   b. Unrecognized prior service cost.

   c. Unrecognized net gain or loss.

9. If the plan is funded, provide:

   a. The amounts and types of securities used to value plan assets.

   b. Calculation of fair value of plan assets.

c. The date as of which fair value was calculated.

d. The method of determining the value of any contracts with insurance companies and participation provisions included in the plan assets.

10. The following information relating to the participants' demographic and compensation data used in calculating the APBO and net periodic postretirement benefit cost:

a. The source of the demographic data and the date as of which the data were collected.

b. The following information concerning the participants and their beneficiaries in the following (or a comparable) format. Please indicate any groups of participants excluded from the information.

Participants	Number of persons	Compensation (if applicable)
Retirees and beneficiaries eligible for benefits	________	________
Dependents of retirees eligible for benefits	________	________
Active employees fully eligible for benefits	________	________
Terminated employees fully eligible for benefits	________	________
Active employees not fully eligible for benefits	________	________
Other (identify)	________	________

c. Information for the following participants:

Participants' name or number	Age or birth date	Sex	Salary	Date hired or year of initial eligibility
________	________	________	________	________

11. A summary of the per-capita claims costs used in the valuation and the basis for their development, including:

a. In employer-specific claims data were used in connection with the development of per-capita claims cost by age, a description of the data, its source and the period from which it was taken.

b. If an external data source was used in connection with the development of per-capita claims costs by age, describe the nature of the external data source and how it was used.

c. The extent to which external data sources were used to adjust the historical claims data.

B. Please provide the following components of the net periodic postretirement benefit cost for the period (see A.2. above):

1	Service cost		$________
2	Interest cost		________
3.	Actual return on plan assets		________
4	Other components, net		
a	Net asset gain (loss) during the period deferred for later recognition	$________	
b	Amortization of net loss (gain) from earlier periods	________	
c	Amortization of unrecognized prior service cost	________	
d	Amortization of the transition obligation	________	
e	Net total of other components (a+b+c+d)	________	
5	Net periodic postretirement benefit cost (1+2−3+4e)		$________

C. Please provide the following information related to the APBO as of the disclosure date (see A.3. above):

		Beginning of period (transition date) *	End of period
1.	Accumulated postretirement benefit obligation (APBO)		
	a. Retirees and beneficiaries eligible for benefits	$ ______	$ ______
	b Dependents of retirees eligible for benefits	______	______
	c Active employees fully eligible for benefits	______	______
	d Terminated employees fully eligible for benefits	______	______
	e Active employees, not fully eligible for benefits	______	______
	f Other (identify)	______	______
	g. Total (sum of 1.a.—1.f.)	______	______
2.	Fair value of plan assets	______	______
3.	Funded status (1.g —2.)	______	______
4	Unrecognized prior service cost	______	______
5	Unrecognized net loss (gain)	______	______
6	Unrecognized transition obligation (asset)	______	______
7.	Accrued (prepaid) postretirement benefit cost (3 less items 4-6)	$ ______	$ ______

D. Please provide the following information regarding the assumptions used to compute the net periodic postretirement benefit cost and APBO. If a published standard table was used, provide its name.

ECONOMIC ASSUMPTIONS

		Net periodic cost	APBO
1	General inflation (e.g., CPI)	______%	______%
2	Weighted-average discount rate	______%	______%
3.	Weighted-average rate of compensation increase	______%	______%
4.	Weighted-average expected long-term rate of return on plan assets	______%	______%
5.	Estimated income tax rate included in rate of return	______%	______%
6.	Method used to determine market-related value of assets	______%	______%

EMPLOYEE DEMOGRAPHIC DATA

7.	Employee turnover rates by age	Describe or attach table	
8	Rates of retirement by age	Describe or attach table	
9.	Rates of disability by age	Describe or attach table	
10.	Rates of mortality by age	Describe or attach table	
11	Percentage of employees with dependents at retirement	______%	______%
12.	Spouse age difference	______%	______%

If participants in this plan are covered by a defined benefit pension plan for which expense is determined in accordance with FASB Statement No. 87, *Employers' Accounting for Pensions,* please state whether the

* This column should be included only in the initial year of application of FASB Statement No. 106.

above assumptions are consistent with those used in calculations in determining those pension amounts. If not, please explain the difference and the reasons for the difference.

SPECIFIC ASSUMPTIONS FOR RETIREE HEALTH CARE BENEFITS

	Net periodic cost	APBO
13 Weighted-average administrative (e g., claims settlement, legal, accounting, plan administration, etc) as a percentage of claims or other basis for assumption	_____%	_____%
14 Percentage expecting to elect coverage under the plan		
a Future retirees	_____%	_____%
b Their dependents	_____%	_____%
15 Health care cost trend rates (please provide rates for each year to the ultimate rate)	Describe or attach table	

a. Please state whether these rates are applicable to gross eligible charges or to net incurred claims cost. If applied to net incurred claims, please state what adjustments were made and what rates are to be shown for disclosure.

b. The effect of a one-percentage-point increase in assumed health care cost trend rate on:

i. The aggregate of service and interest cost components of net periodic postretirement benefit costs.

ii. APBO.

16. Please state whether the above assumptions are consistent with the prior period, and, if not, explain the reason for the changes.

17. Please describe any other significant assumptions used in the above measurement and the basis on which they were determined.

E. Please provide a description and the amounts of gains or losses from settlements, curtailments or termination benefits during the year, such as:

1. Purchase of insurance contracts where the risk of benefit payments is fully assumed by the insurance company.

2. Lump-sum cash payments to plan participants.

3. Other irrevocable actions that relieved the employer, plan sponsor or the plan of primary responsibility for a postretirement benefit obligation and eliminated significant risks related to the obligation and assets.

4. Any events that significantly reduced the expected years of future service of employees.

5. Any events that eliminated for a significant number of employees the accrual of defined benefits for some or all of their future service.

6. Any special or contractual termination benefits offered to employees.

F. Please describe any significant events (for example, plant closings) noted subsequent to the current year's measurement date, and the effects of those events, that could materially affect the amounts shown in B. or C.

G. If you have been notified of a decision by the plan sponsor to fully or partially terminate the plan, please describe the effect on the APBO and the net periodic postretirement benefit cost.

H. Was all of the information above determined in accordance with FASB Statement No. 106 to the best of your knowledge? If not, please describe any differences.

I. Describe the nature of your relationship, if any, with the plan or the plan sponsor that may impair or appear to impair the objectivity of your work.

J. Indicate your professional qualifications for performing actuarial valuations under FASB Statement No. 106.

Yours very truly,

____

[*Client Official*]

[The next page is 7301.]

AAM Section 7300

Inquiries to Legal Counsel [1]

.01 Illustrative Inquiry Letter to Legal Counsel [2]

(Prepared on client's letterhead—See Note A)

Date (See Note B)

(Name of lawyer)
(Address of lawyer)

Dear ....:

In connection with an audit of our financial statements at (balance sheet date) and for the (period) then ended, management of the Company has prepared, and furnished to our auditors (name and address of auditors), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (balance sheet date) and during the period from that date to the date of your response.

Pending or Threatened Litigation

(excluding unasserted claims)

> [Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

Unasserted Claims and Assessments

(considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome)

> [Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]

---

[1] If a client has not needed to retain legal counsel, the auditor may express an unqualified opinion on the financial statements even though he has not obtained a letter from legal counsel of the Company. In these circumstances, the auditor should obtain written representation from the Company that legal counsel has not been retained for matters concerning business operations that may involve current or prospective litigation (see AICPA **Technical Practice Aids,** section 8340.10).

[2] Extracted from the Appendix to Statement on Auditing Standards No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* [AU section 337A]. [See Note B.]

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

> [The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the company, such as guarantees of indebtedness of others.]

Very truly yours,

(Authorized signature for client)

NOTES TO USER:

(A) Auditors should carefully consider the provisions of SAS No. 12 [AU section 337] in drafting this letter.

(B) Sending of this letter should be timed so that the lawyer's response is dated as close to the auditor's opinion date as practicable. However, the auditor and client should consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

.02 Illustrative Inquiry Letter to Legal Counsel If Management Has Not Provided Details About Pending or Threatened Litigation

(Prepared on client's letterhead—See Note A)

Date (See Note B)

(Name of lawyer)
(Address of lawyer)

Dear ....:

In connection with an audit of our financial statements at (balance sheet date) and for the (period) then ended, please furnish to our auditors (name and address of auditors), the information requested below with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. Your response should include matters that existed at (balance sheet date) and during the period from that date to the date of your response.

Pending or Threatened Litigation

(excluding unasserted claims)

Please prepare a description of all litigation, claims, and assessments (excluding unasserted claims and assessments) involving amounts exceeding (amount) individually or lesser amounts that exceed (amount) in the aggregate. The description of each case should include—

1. The nature of the litigation.
2. The progress of the case to date.
3. How management is responding or intends to respond to the litigation (e.g., to contest the case vigorously or to seek an out-of-court settlement).
4. An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.

Unasserted Claims and Assessments

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5, as a matter of professional responsibility to us. *Please specifically confirm to our auditors that our understanding is correct.*

We have represented to our auditors that you have not advised us of any unasserted claims or assessments that are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.

Other Matters

1. Please specifically identify the nature of and reasons for any limitation on your response.
2. Please indicate the amount owed to you for services and expenses (billed and unbilled) at (balance sheet date).

Very truly yours,
(Authorized signature for client)

NOTES TO USER:

(A) Auditors should carefully consider the provisions of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* [AU section 337] in drafting this letter.

(B) Sending of this letter should be timed so that the lawyer's response is dated as close to the auditor's opinion date as practicable. However, the auditor and client should consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

.03 Improving Inquiry Techniques

If inquiries to legal counsel are not sufficiently detailed or specific, deficiencies in attorneys' responses may result. A conference between the auditor and the attorney may be necessary to clarify the attorney's written response and SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments,* paragraph 10 [AU section 337.10] provides for such a conference. However, to improve the auditor's ability to receive all of the information necessary to complete his audit, he may wish to consider including the following matters in an inquiry to legal counsel:

a. A request that the attorney specify the effective date of his response if it is other than the date of his reply.

b. A request that the attorney mail his response so that it will be received by a certain date.

c. A request that the nature of any litigation specifically identify (i) the proceedings, (ii) the claim(s) asserted, (iii) the amount of monetary damages sought, or if no amounts are indicated in preliminary case filings, a statement to that effect, and (iv) the objectives sought by the plaintiff, if any, other than monetary or other damages, such as performance or discontinued performance of certain actions.

d. A request that the attorney avoid such vague phrases as "meritorious defenses," "without substantial merit," and "reasonable chance" in expressing an opinion on the outcome of litigation.

e. If an opinion cannot be expressed on the outcome of litigation, a request that the attorney so state together with his reasons for that position.

f. A request that the attorney specify to what extent potential damages are covered by insurance. (It may be possible to obtain the opinion of the insurer's counsel regarding the applicability of insurance coverage.)

g. A request that the attorney provide a summary of material litigation, claims, and assessments settled during the period.

h. A statement that confirmation of the understanding regarding disclosure of unasserted claims and assessments is an integral part of the audit inquiry and that failure to so confirm will require a follow-up contact.

i. A statement that the attorney's response will not be quoted or referred to in the financial statements without first consulting with him.

[The next page is 7401.]

AAM Section 7400
Representation Letters

.01 Illustrative Representation Letter—Audit of Financial Statements

Introductory Comment (Extracted from the Appendix to SAS No. 19, *Client Representations* [AU section 333A])

The following letter is presented for illustrative purposes only. The written representations to be obtained should be based on the circumstances of the audit and the nature and basis of presentation of the financial statements being audited. The introductory paragraph should specify the financial statements and periods covered by the auditor's report, for example, "balance sheets of XYZ Company as of December 31, 19X1 and 19X0, and the related statements of income and retained earnings and cash flows for the years then ended." Similarly, representations concerning inventories and sales and purchase commitments would not be obtained if such items are not material to the company's financial position and results of operations or if they are not recorded in the financial statements under a comprehensive basis of accounting other than generally accepted accounting principles, for example, financial statements prepared on the cash basis of accounting.

The illustrative letter assumes that there are no matters requiring specific disclosure to the auditor. If such matters exist, they should be indicated by listing them following the representation, by reference to accounting records or financial statements, or by other similar means. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, item 14 could be modified as follows: "Except as discussed in Note X to the financial statements, no events have occurred. . . ." Similarly, in appropriate circumstances, item 4 could be modified as follows: "We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except that certain marketable securities have been excluded from current assets based on our intention not to dispose of them, which is supported by the minutes of the December 7, 19X1, meeting of the board of directors."

Certain terms are used in the illustrative letter that are defined elsewhere in authoritative literature, for example, irregularities (SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* [AU section 316]) and related parties (SFAS 57, *Related Party Disclosures,* paragraph 24f [AC R36.406]). To avoid misunderstanding concerning the meaning of such terms, the auditor may wish to furnish those definitions to the client and request that the client include the definitions in the written representations.

The illustrative letter assumes that management and the auditor have reached an understanding on the limits of materiality for purposes of the written representations. However, it should be noted that a materiality limit would not apply for certain representations, as explained in SAS No. 19, paragraph 5 [AU section 333.05].

Illustrative Representation Letter (Extracted from the Appendix to SAS No. 19 [AU section 333A])

(Prepared on client's letterhead)

(Date of Auditor's Report)

(To Independent Auditor)

In connection with your audit of the (identification of financial statements) of (name of client) as of (date) and for the (period of audit) for the purpose of expressing an opinion as to whether the (consolidated) financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of (name of client) in conformity with generally accepted accounting principles (other comprehensive basis of accounting), we confirm, to the best of our knowledge and belief, the following representations made to you during your audit.

1. We are responsible for the fair presentation in the (consolidated) financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles (other comprehensive basis of accounting).

2. We have made available to you all—

   a. Financial records and related data.

   b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

3. There have been no—

   a. Irregularities involving management or employees who have significant roles in the internal control structure.

   b. Irregularities involving other employees that could have a material effect on the financial statements.

   c. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.

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

5. The following have been properly recorded or disclosed in the financial statements:

   a. Related party transactions and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.

   b. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.

   c. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line-of-credit or similar arrangements.

   d. Agreements to repurchase assets previously sold.

6. There are no—

   a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

   b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5 [AC section C59].

7. There are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59].

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

9. Provision, when material, has been made to reduce excess or obsolete inventories to their estimated net realizable value.

10. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.

11. Provision has been made for any material loss to be sustained in the fulfillment of, or from inability to fulfill, any sales commitments.

12. Provision has been made for any material loss to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices.

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

14. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

....
(Name of Chief Executive
Officer and Title)

....
(Name of Chief Financial
Officer and Title)

NOTES TO USER:

This illustration is only one example of a representation letter. Alternate wording is permissible and it may be advisable to tailor the letter to the needs of an engagement.

.02 Illustrative Representation Letter—Review of Financial Statements

(Prepared on client's letterhead)

(Date of Accountant's Report)

(To the Accountant)

In connection with your review of the (identification of financial statements) of (name of client) as of (date) and for the (period of review) for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your review.

1. The financial statements referred to above present the financial position, results of operations, and cash flows of (name of client) in conformity with generally accepted accounting principles. In that connection, we specifically confirm that—

   a. The company's accounting principles, and the practices and methods followed in applying them, are as disclosed in the financial statements.

   b. There have been no changes during the (period reviewed) in the company's accounting principles and practices.

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

   d. There are no material transactions that have not been properly reflected in the financial statements.

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

   f. There are no 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, and there are no other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.

   g. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.

   h. There are no related party transactions or related amounts receivable or payable that have not been properly disclosed in the financial statements.

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

   j. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

2. We have advised you of all actions taken at meetings of stockholders, board of directors, and committees of the board of directors (or other similar bodies, as applicable) that may affect the financial statements.

3. We have responded fully to all inquiries made to us by you during your review.

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

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

[Source: SSARS 1, Appendix D (AR section 100.55).]

.03 Illustrative Representation Letter—Personal Financial Statements

[*Date of accountant's report*]

[*To the accountant*]

In connection with your [*compilation, review, or audit*] of the statement of financial condition and the related statement of changes in net worth of James and Jane Person as of [*date*] and for the [*period*] then ended for the purpose of [*description*], we confirm, to the best of our knowledge and belief, the following representations made to you during your [*compilation, review, or audit*].

1. We are responsible for the fair presentation in the statements of financial condition and changes in net worth in conformity with generally accepted accounting principles. All assets are presented at their estimated current values and all liabilities are presented at their estimated current amounts, which have been determined in accordance with guidelines promulgated by the American Institute of Certified Public Accountants. (Because of our limited expertise with generally accepted accounting principles, including financial statement disclosure, we have engaged you to advise us in fulfilling that responsibility.)

2. We have made all financial records and related data available to you. We have not knowingly withheld from you any financial records or related data that in our judgment would be relevant to your [*compilation, review, or audit*].

3. The following have been properly recorded or disclosed in the financial statements:

   a. Related party transactions and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees. I understand that related parties include members of my family as well as business entities in which I, or members of my family, have an investment that allows the exercise of control or significant influence.

   b. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line-of-credit or similar arrangements.

   c. Agreements to repurchase assets previously sold.

4. There are no violations or possible violations of laws or regulations that have come to our attention whose effects are regarded as significant enough to be considered for disclosure in the financial statements or as a basis for recording a loss contingency, and there are no other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.

5. There are no material transactions or balances that have not been properly recorded or disclosed in the financial statements.

6. We have satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor have any assets been pledged.

7. We have not retained an attorney for matters that may involve current or prospective litigation, and we are not aware of any pending or threatened litigation, claims, or assessments that should be disclosed in the financial statements.

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

9. No events have occurred subsequent to the date of the statement of financial condition that would require adjustment to, or disclosure in, the financial statements.

10. We have responded fully to all inquiries made to us by you during the engagement.

____
(James Person)

____
(Jane Person)

[Source: AICPA *Personal Financial Statements Guide.*]

.04 Illustrative Representation Letter to Other Accountants

(Firm's Letterhead)

[Date]

____
____
____

In connection with the report you have been requested to reissue on the financial statements of ________ *[client's name]* for the year ended ______ *[date]*, which statements are to be included comparatively with similar statements for the year ended ______ *[date]*, we make the following representations.

We have audited (or reviewed or compiled) the balance sheet of ________________ *[client's name]* as of ______ *[balance-sheet date]* and the related statements of earnings, retained earnings, and cash flows for the year then ended. Our procedures in connection with the engagement did not disclose any events or transactions subsequent to ______ *[predecessor's balance-sheet date]* which, in our opinion, would have a material effect upon the financial statements, or which would require mention in the notes to the financial statements of ______ *[client's name]* for the year then ended.

Should anything come to our attention prior to the date our report is issued which, in our judgment, would have a material effect upon the financial statements covered by your report, we shall notify you promptly.

Very truly yours,

____

[Engagement Partner's Signature]

Note: If any matters come to the firm's attention that may require revision of the previous financial statements, they should be included in a separate paragraph after approval by the engagement partner.

.05 Letter to Other Accountants Upon Whose Work We Plan to Rely

(Firm's Letterhead)

[*Date*]

____
____
____

We are auditing the financial statements of ____________________ [*client's name*], ________ [*parent company*]. The financial statements of ____________________ [*other accountants' client's name*] that you are auditing are to be included in the financial statements of ____________________ [*client's name*]. We will rely on your report on the financial statements in expressing an opinion on the (consolidated) financial statements of ____________________ [*client's name*] (and subsidiaries). In that connection, we will refer to your report.

Please confirm to us that your firm is independent with respect to ____________________ [*client's name*] and ____________________ [*other accountants' client's name*] within the meaning of Rule 101 of the Code of Professional Conduct of the American Institute of Certified Public Accountants.

Please provide us promptly, in writing, with the following information in connection with your current examination of the financial statements of ____________________ [*other accountants' client's name*] with respect to:

1. Related-party transactions or other matters that have come to your attention. We are aware of the following related parties: ____________________ [*names of known related parties*].
2. Any limitation on the scope of your examination that is related to the financial statements of ________ [*client's name*], or that limits your ability to respond to this inquiry.

Please update your letter to indicate any additional matters of the type designated above that have come to your attention through the date of your report on the financial statements of ____________________ [*other accountants' client's name*].

Very truly yours,

____

[*Engagement Partner's Signature*]

[The next page is 7501.]

AAM Section 7500
Communication With Audit Committees

.01 Illustrative Communication With Audit Committees

Addressee:*

Statement on Auditing Standards (SAS) No. 61, *Communication With Audit Committees* (AU section 380) issued by the AICPA Auditing Standards Board requires the auditor to communicate certain matters to those responsible for the oversight of the financial reporting process. The following comments regarding the scope and results of our audit of [*name of client*] for the year ended December 31, 19X2 will assist you in overseeing the financial reporting and disclosure process for which management is responsible.

Scope of Audit

Our responsibility is to express an opinion on the financial statements based on our audit. The audit is to be conducted in accordance with generally accepted auditing standards. 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 also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation.

Results of Audit

[This part of the letter would address the following:

1. Management's choice of significant accounting policies and their application. This includes methods proposed for new transactions or events, significant unusual transactions, or controversial areas such as equity investments, off-balance sheet financing or revenue recognition;
2. Procedures used by management to determine accounting estimates and the data the auditor has considered to determine the reasonableness of the estimates;
3. Effects of audit adjustments that have or have not been recorded in the financial statements. Such adjustments, whether or not recorded, may have significant effects on current and future financial statements or on the company's control structure (i.e., a proposed adjustment may have resulted from errors detected during the audit that result from weaknesses in the internal control structure);
4. Other information presented by management that is included with the entity's audited financial statements. The auditor should discuss the nature of his responsibility for such information with the audit committee,* including procedures performed, if any, and the results;
5. Nature of and circumstances surrounding any disagreements with management about the application of GAAP, the determination of accounting estimates, or scope of the audit that could be significant to the entity's annual reporting;
6. Auditor's views about any accounting or auditing matters discussed by management with other auditors (opinion shopping);
7. Major discussions by management with the auditor about the initial or continued retention of the auditor; and

* Audit Committee, or other formally designated oversight group which is equivalent to the audit committee such as a finance committee or budget committee.

8. Any serious difficulties encountered in conducting the audit.]

This report is intended solely for the information and use of the audit committee,* management and others in the organization (or specified regulatory agency or other specified third party).

[*Signature*]

[*Date*]

[Source: SAS No. 61 (AU section 380)]

NOTES TO USER:

SAS No. 61 (AU section 380), is required to be followed for (1) entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee) and (2) all Securities and Exchange Commission (SEC) engagements.

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* Audit Committee, or other formally designated oversight group which is equivalent to the audit committee such as a finance committee or budget committee.

.02 Report on Reportable Conditions

[*Date of Auditor's Report on the Financial Statements*]

In planning and performing our audit of the financial statements of the ________________ [*client's name*] for the year ended ________________ [*financial statement date*], we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted the following matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Bank Reconciliations

Bank reconciliations have been prepared for the operating cash account, but they have not been in agreement with the general ledger, often by as much as ________________. At ________________, the general ledger balance varied from the bank reconciliation by $________.

In prior years, the bank reconciliations did not reconcile exactly to the general ledger; however, the variances were not as significant as in 199X. To maintain effective internal controls over cash, it is critical that bank accounts be reconciled to the general ledger monthly with differences identified and resolved immediately. At the present time, an adjusting journal entry should be made to bring the general ledger balance into agreement with the reconciled balance.

Accounts Payable

A listing of accounts payable as of ________________ could not be produced to support the general ledger amount. We were able to reconcile accounts payable to the general ledger amount by reviewing computer-generated accounts payable listings dated ________________, along with examining unpaid invoices at the time of our field work.

As indicated in previous letters to the Board, accounts payable has been an ongoing problem due to the fact that the accounts payable listing is not reconciled to the general ledger monthly. Proper recording of accounts payable is a key to maintaining adequate financial statements. Whether computer-generated or manually prepared, a detailed accounts payable listing should be reconciled monthly to the general ledger balance. All reconciliations should be reviewed and approved by someone other than the preparer, with the reviewer being responsible for ensuring that all differences are resolved.

Property and Equipment

Documentation provided to support the changes in property and equipment was not in agreement with the changes in the general ledger balances, for some categories, by as much as ________. Also, the computer-generated list of property and equipment was not in agreement with the total property and equipment recorded in the general ledger; therefore, this listing was not a useful resource.

The property and equipment computer listing should be reviewed, revised, and reconciled to the general ledger. Changes in property and equipment should be recorded timely and the detailed property and equipment listing should be reconciled to the general ledger balances monthly.

The procedures for recording fixed asset additions and deletions should be reviewed to determine their adequacy. Adjusting journal entries with regard to trade-ins, sales and other retirements of fixed assets should be reviewed by the Treasurer or someone other than the person preparing the entry. Examples of problems encountered include improper capitalization of assets when a like kind exchange or trade-in is involved and improper recording of gain or loss on sale of assets.

An annual or biannual physical inventory of equipment is an effective management tool to help maintain detail property and equipment records and strengthen controls of safeguarding equipment. The Board should consider making a physical inventory a standard procedure.

This report is intended solely for the information and use of the Board of Directors, management, and others within the entity.

Very truly yours,

____

[*Engagement Partner*]

.03 Report on Reportable Conditions That Also Identifies a Material Weakness

[*Date of Auditor's Report on the Financial Statements*]

In planning and performing our audit of the financial statements of the ________________ [*client's name*] for the year ended ________________ [*financial statement date*], we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted the following matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Accrued Vacation

Although accrued vacation has not been recorded on the financial statements, the amount of accrued vacation must be considered in determining the fair presentation of the financial statements. The year end analysis of accrued vacation had a balance significantly lower than the prior year's balance. The details of the analysis were traced to the "attendance control cards." We found (1) the number of days earned on the listing did not agree to that recorded in the cards, (2) individuals were reported in the cards with earned vacation but were not on the listing, and (3) some of the cards appeared to not have been maintained.

Detailed records of vacation days earned and used by employees should be timely and accurately maintained. At least annually, these days should be converted to dollar amounts. Management should review the conversion and consider reporting this liability on the financial statements for complete recognition of liabilities.

Discussions with the Office Manager revealed that not all employees are required to notify her when they use vacation days. All employees should be required to inform the Office Manager of all vacation days taken. Employees should also be asked to periodically review their vacation records with the Office Manager and to indicate their agreement by signing the records.

Bad Debts

During 199X, the Board approved the write-off of accounts receivable of about ________. The write-off was charged to revenue rather than to bad debt expense.

Procedures for recording bad debt write-offs should be reviewed for adequacy. All adjusting entries should be reviewed by the Treasurer or a member of management other than the person preparing the journal entry.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe that the following reportable condition is a material weakness.

Blank Checks

Blank checks are maintained in an unlocked cabinet along with the check signing machine.

Blank checks and the check signing machine should be locked in separate locations so as to prevent the embezzlement of funds.

This report is intended solely for the information and use of the Board of Directors, management, and others within the entity.

Very truly yours,

____

[Engagement Partner]

[The next page is 7601.]

AAM Section 7600
Reliance Letter

.01 Illustrative Reliance Letter

Addressee:

The following is in response to your letter to our firm dated ____.

We performed an audit of ABC Company's balance sheet dated December 31, 19X0, and the related statements of income, retained earnings, and cash flow for the year then ended. The financial statements were audited as of the financial statement date and the audit procedures performed were completed on March 28, 19X1 (audit report date). No additional audit procedures were performed subsequent to March 28, 19X1.

The audit was conducted in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. However, a properly designed and executed audit may not detect a material irregularity. For example, generally accepted auditing standards do not require that an auditor authenticate documents, nor is an auditor trained to do so. Also audit procedures that are effective for detecting a misstatement that is unintentional may not be effective for a misstatement that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client.

We understand that you intend to rely on the report and associated statements in connection with *(describe as precisely as possible the transaction in connection with which the third party intends to rely on the report and statements).* It should be noted that the audit procedures performed in order to render an opinion on the financial statements of ABC Company may not be adequate or appropriate for this purpose. Because of the limitations inherent in the audit process we may not have detected all material misstatements. Accordingly, our audit was not intended for your benefit and should not be taken to supplant the inquiries and procedures that you should take to satisfy yourself as to ABC Company's credit-worthiness. We recommend that you perform your own due diligence investigation which should include but not be limited to the following steps (itemize). We emphasize that this list of procedures may not be all inclusive and that we cannot provide any assurance that the procedures we have mentioned will be sufficient for your purposes.

[*Signature*]

[*Date*]

[The next page is 7701.]

AAM Section 7700
Proposal Letter

.01 Illustrative Proposal Letter

[*Date*]

____
____
____

We appreciate this opportunity to present a proposal for [*nature of services*] and a brief description of our firm and services.

Our firm was formed in 19__. We have __ partners and __ staff and support personnel working with clients in accounting and auditing, taxation, and various consulting services. Although we serve all size clients, our clientele consists primarily of small and medium-size businesses such as yours.

Our professional objectives are to provide the highest quality services on a timely basis. As a member of the AICPA Division for Firm's Private Companies Practice Section, our accounting and auditing practice has been subjected to a review by another firm of CPAs. We received an unqualified opinion as a result of that review. We extend our client relationships to include ongoing contact and services to achieve our services objectives.

We have extensive experience in the ____ industry. This experience and related understanding of your industry's operations permit us to design, perform, and complete engagements for your company effectively and at a reasonable cost.

Our services include the following:

- Accounting, Auditing, and Attestation Services

  Our accounting, auditing, and attestation services include annual or special audits, compilations and reviews of financial statements, and the examination and review of financial and other information under the attestation standards. We accompany our report on audited financial statements with a reportable conditions letter and a management letter that include suggestions to correct internal control weaknesses and recommendations for operational efficiencies. Our purpose in making these suggestions is to help you accomplish your operational objectives. These suggestions often result in cost savings.

- Tax Services

  We offer diversified tax services, including assistance in all phases of federal, state, and local income taxes; estate, inheritance, and gift taxes; and payroll and other taxes. These services include tax return preparation, tax research, and representation of clients at administrative proceedings before the various taxing authorities. The objectives of our tax services are to minimize taxes and potential problems.

- Consulting Services

  Our consulting services are designed to assist clients in improving efficiency and profitability. Our approach offers assistance in such areas as developing plans for problem identification or implementing more effective operating controls, evaluating information systems and installing or upgrading data processing systems.

____________________, an audit partner, will be primarily responsible for your engagement.

As you requested, our proposal is for ________________ [*state nature of services*].

We estimate that our fees for the proposed services will be approximately $________, plus out-of-pocket expenses, billable as the work progresses. Our fees are based on time spent on the engagement. Should we encounter any unforeseen circumstances requiring additional time, you will be notified promptly of the situation.

Our fee estimate is based on the assumption that your personnel will prepare certain schedules and analyses for us. We also anticipate their assistance in locating invoices and other documents for our examination.

Our firm is organized and staffed to help you satisfy our business needs. Please call ________ with questions about this proposal.

Very truly yours,

____

[*Firm Signature*]

____

[The next page is 8001.]

AAM Section 8000
Audit Risk Alerts

The material included in this section is intended to provide auditors with an overview of recent economic, professional, and regulatory developments that may affect audits they perform. The material in this section has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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AAM Section 8010
Audit Risk Alert—1995/96

Introduction

.01 This Alert is intended to help auditors plan their 1995 year-end audits. Successful audits are a result of a number of factors, including the acceptance of clients with integrity; adequate partner involvement in planning, supervising, and performing audits; an appropriate level of professional skepticism; and the allocation of sufficient audit resources to high risk areas. Addressing these factors in each audit engagement requires substantial professional judgment based, in part, on a knowledge of professional standards and current developments in business and government.

.02 Throughout the audit process, from the initial consideration of whether to accept a client to the issuance of an audit report, auditors should consider overall engagement risk. Engagement risk consists of the following three components:

1. *Client's business risk*—The risk associated with the entity's survival and profitability
2. *Audit risk*—The risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated
3. *Auditor's business risk*—The risk of potential litigation costs from an alleged audit failure and the risk of other costs (whether an audit failure is alleged or not) such as fee realization and reputational effects from association with the client

.03 Although this Alert does not provide a complete list of risk factors to be considered, and the items discussed do not affect risk in every audit, it can be used as a planning tool for considering matters that may be especially significant for a specific audit. During the conduct of all engagements, auditors must remember that their responsibilities to boards of directors, shareholders, creditors, and the public are paramount. This requires traits that are hallmarks of auditors—independence, objectivity, and integrity.

Implication of the Current Economic Environment

.04 The Dow Jones industrial average has risen to record highs nearly every day in 1995 as fears of inflation ebb and the U.S. economy continues its slow growth. As it now appears, by 1996—an election year—the United States will be in a slow-growth economy led by corporate spending in this country and abroad. Consumer spending likely will pick up after another bout of trimming back debt, but not for a few quarters. The gross national product is expected to grow at a 2 to 3 percent rate in 1996.

.05 Still smarting from the 1990-1991 recession, American businesses have been watching the economy very closely since growth downshifted abruptly from the 5.1 percent pace of late 1994 to a 2.8 percent rate in early 1995. Four years after the recovery began, wages remain virtually stagnant, taking a toll on buying power. Installment borrowing by hard-pressed consumers has expanded by some $80 billion, to $356 billion, since late 1992. Loan payments now take as large a bite out of disposable income as they did during the debt-burdened 1980s. As a result, consumers are turning cautious, and consumer spending has risen at an anemic 1.4 percent annual rate in 1995.

.06 The drag from higher short-term interest rates could make the economy seem pretty shaky for a while. But analysts on and off Wall Street believe the current pause will prove refreshing—by keeping inflation under wraps and thus allowing long-term interest rates to come down further. That combination, in turn, should ensure continued economic expansion. The consensus forecast calls for economic growth to average around 2.5 percent and inflation around 3.5 percent through 1996.

.07 Economic expansion has made life more profitable for most entities. Going forward, domestic demand may slacken, but entities that can exploit export markets should keep logging big gains.

.08 Current economic conditions may raise a number of issues to which auditors should be alert when planning a 1995 year end audit. Some of the more relevant issues are discussed in the sections that follow.

Increase in Merger Activities

.09 As outlined in the preceding section, among the characteristics of the current economic environment are a soaring stock market in the United States, steady interest rates, and low inflation. These facts seem to have triggered an "urge to merge," which may also reflect interest by foreign companies in investing in the United States particularly because of the lower U.S. dollar. Economic conditions may also heighten an urge to go public through initial public offerings (IPOs).

.10 In view of the number of recent mergers and acquisitions, often at a premium to book value, auditors should pay particular attention to purchase price allocations and be satisfied that (1) the amounts assigned are supported by appraisals or other appropriate documentation and (2) that assigned amortization periods for intangibles, especially goodwill, are reasonable (forty years is not always reasonable). For publicly held companies, the Securities and Exchange Commission (SEC) is closely scrutinizing amortization periods for goodwill and other intangible assets. The SEC staff is likely to raise questions where information in Management's Discussion and Analysis (MD&A) calls into question either the carrying amount or the assigned amortization periods for recorded intangibles.

.11 Auditors should reassess each year the realization of the carrying amount of intangibles and consider whether the amortization period continues to be appropriate in light of current-year events, such as operating losses, competition, planned restructurings, or plans to dispose of operations. Auditors also should consider carefully any provisions of a combination agreement that call for post-acquisition adjustments of purchase price. Contingent payments should be appropriately classified as either purchase price or compensation depending on the facts and circumstances.

Exiting an Activity

.12 Entities continue to announce large layoffs and plant closings that result in significant charges to earnings. A restructuring occurs when an entity changes its business strategy or its corporate structure in hopes of achieving improved operating results in the future. Restructurings typically give rise to employee-related costs, costs associated with elimination of product lines, and costs related to consolidation of operations. Restructurings also prompt asset write-downs and losses on expected disposals of assets.

.13 The Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) published EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in Restructuring)*. Specifically, the EITF consensus limits accrual of restructuring costs related to employee termination benefits and other costs to exit an activity; it prohibits anticipation of costs that will benefit activities that will be continued. In addition to limiting the types of costs accrued, the EITF consensus established additional conditions that must be met for a restructuring charge to be accrued. Entities must now commit to a formal exit plan that meets specified criteria before exit costs may be accrued. For public entities, the SEC is continuing to focus on the appropriateness of restructuring charges. That focus has resulted in expanded disclosure and, in some cases, restatement of previously issued financial statements. It is anticipated that the EITF consensus will reduce the number and amounts of restructuring charges.

.14 EITF Issue No. 94-3 uses the term *exit costs* to describe costs that are not associated with or do not benefit activities that will be continued. An exit cost is one that meets either of the following conditions:

1. The cost was not incurred by the entity prior to the date management committed to an exit plan (the commitment date) and will be incurred as a direct result of the plan to exit an activity.

2. The cost was incurred under a contractual obligation prior to the commitment date and will either continue after the activity is stopped, with no economic benefit, or will result in a cancellation penalty when canceled.

Examples of exit costs include a cancellation penalty for a lease relating to a facility that will no longer be used. (See the appendix of the EITF consensus for examples of costs that do not qualify as exit costs.)

.15 Exit costs should be recognized as liabilities at the commitment date. A liability should be recognized only for exit costs that can be reasonably estimated at that time. Other exit costs should be recognized when they can be reasonably estimated. Exit costs should be reported as a component of continuing operations gross of any income-tax effect. Operating revenues and expenses related to activities that will be exited should be included in other operating activities and not combined and reported as a separate component of income.

.16 When an entity revises preconsensus restructuring plans, SEC registrants should consider carefully if the revision is a change in estimate of the plan costs or a modification that results in a new plan that therefore is subject to the guidance of EITF Issue No. 94-3. The SEC staff has noted that it will be looking for the disclosures specified in the EITF consensus and has emphasized that the EITF required a description of the types and amounts of exit costs paid and charged against recorded liabilities for financial statements of all periods prior to completion of the exit plan.

Reliance on Third Party Funding

.17 In today's economy, auditors may observe an increase in the number of circumstances involving client reliance on third party funding to support deficit operations and mitigate going concern issues. In addition, auditors may observe increased numbers of clients carrying significant balances due from related entities or significant stockholders. Management's plan may rely on the continued support of deficit operations by a wealthy owner or other related party. The auditor's decision not to modify the auditor's report for a going concern uncertainty depends on receiving adequate evidence regarding the third party's future participation and support.

New Auditing and Attestation Pronouncements

Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements Issued

.18 In November 1995, the AICPA's Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 77, *Amendments to SAS No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, *and No. 62,* Special Reports. These amendments, among other things—

- Clarify that a written audit program is required in every audit.
- Preclude the use of conditional language in the auditor's explanatory paragraph to indicate that there is substantial doubt about the entity's ability to continue as a going concern. This amendment is necessary as some auditors continue to issue reports in which the auditor's conclusion about the entity's ability to continue as a going concern is unclear because of the use of conditional terminology such as "If the company is unable to obtain refinancing, there may be substantial doubt about the company's ability to continue as a going concern."

.19 In addition, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 5, *Amendment to SSAE No. 1,* Attestation Standards. This amendment provides guidance on the nature and extent of working papers for attestation engagements.

Amendments to Statement on Auditing Standards No. 72

.20 In September 1995, the ASB issued SAS No. 76, *Amendments to SAS No. 72,* Letters for Underwriters and Certain Other Requesting Parties (AU section 634). This Statement (AU section 634) is effective for letters issued pursuant to paragraph 9 of SAS No. 72 (AU section 634.09) after April 30, 1996.

.21 Accountants may be requested to provide a comfort letter, for instance, in connection with a municipal bond offering; however, the party requesting the comfort letter often is not willing to provide the accountant with the representations required in paragraphs 6 and 7 of SAS No. 72 (AU section 634.06 and .07). This new SAS provides reporting guidance and an example of a letter, actually a form of agreed-upon procedures report, that the accountant can provide in response to such a request.

Two New Standards for Agreed-Upon Procedures Engagements

.22 The ASB also issued two new Standards in September 1995 dealing with agreed-upon procedures—SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622), and SSAE No. 4, *Agreed-Upon Procedures Engagements* (AT section 600). SAS No. 75 (AU section 622) supersedes SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement.* Both standards were issued because the ASB had observed that there was wide diversity in practice in performing agreed-upon procedures engagements, and also because existing guidance did not address significant issues related to these engagements.

.23 Both SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) provide detailed guidance on topics such as agreement on and sufficiency of procedures, engagement letters and representation letters, and the practitioner's responsibility for knowledge of matters outside the agreed-upon procedures. In addition, both Standards provide detailed reporting guidance, including illustrative reports, and guidance on combined reporting—that is, reporting when engaged to perform agreed-upon procedures as part of or in addition to another form of service (for example, a review or compilation of a financial statement).

.24 The primary difference between the two Standards is that SAS No. 75 (AU section 622) is applicable when a practitioner applies agreed-upon procedures to specified elements, accounts, or items of a financial statement, and SSAE No. 4 (AT section 600) is generally applicable when a practitioner applies agreed-upon procedures to nonfinancial statement subject matter—for example, inspecting dates noted on shipping documents to determine whether the dates are prior to a specified cutoff date. Another difference between the two Standards is that SSAE No. 4 (AT section 600) requires a *written* assertion from management as a condition of engagement performance and SAS No. 75 (AU section 622) does not have this requirement because assertions are effectively embodied in the elements, accounts, or items of a financial statement, where the basis of accounting is clearly evident.

.25 Both SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) prohibit the practitioner from expressing negative assurance in agreed-upon procedures reports by stating that the practitioner should present the results of applying agreed-upon procedures in the form of findings. (The predecessor agreed-upon procedures standards permitted practitioners to provide negative assurance in agreed-upon procedures reports.) The ASB prohibits the expression of negative assurance in agreed-upon procedures reports because such language could cause users to conclude that the practitioner was communicating assurance beyond the findings in his or her report. Also, the ASB believes that negative assurance should be reserved for review-level engagements.

.26 Both SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) address the use of internal auditors in agreed-upon procedures engagements. These Standards state that internal auditors or other personnel may prepare schedules, accumulate data, or provide other information for the practitioner's use in performing agreed-upon procedures. However, the Standards clearly state that the agreed-upon procedures enumerated or referred to in the practitioner's report are to be performed entirely by the practitioner. Both Standards also provide examples of appropriate and inappropriate use of internal auditors.

.27 Both SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) are effective for reports dated after April 30, 1996, with earlier application encouraged. To reduce exposure to liability, practitioners should consider early adoption of the new Standards, especially by eliminating negative assurance, and specifying the user agreement as to the suitability of procedures.

Revised Standard Providing General Guidance on Compliance Audits of Recipients of Governmental Financial Assistance

.28 In February 1995 the ASB issued SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AU section 801), to provide general guidance to practitioners engaged to perform compliance audits of recipients of governmental financial assistance. SAS No. 74 (AU section 801), which supersedes SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance,* reduces the level of detail provided at the auditing standard level. Practitioners should be aware that the detailed audit and reporting guidance previously in SAS No. 68 is now provided in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* (Product No. 012055HV, $28 members/$31 nonmembers) and in AICPA Statement of Position (SOP) 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards* (Product No. 014852HV, $14 members/$15.50 nonmembers).

.29 SAS No. 74 (AU section 801) continues to recognize three levels of audits—generally accepted auditing standards (GAAS), *Government Auditing Standards* (also known as the "Yellow Book"), and certain other federal requirements—of recipients of governmental financial assistance. SAS No. 74 (AU section 801) is applicable when the auditor is engaged to audit a governmental entity under GAAS, under *Government Auditing Standards,* and in certain other circumstances involving governmental financial assistance, such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations. SAS No. 74 (AU section 801) is effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994.

Auditing Interpretations Issued in 1995

.30 In 1995, the Audit Issues Task Force (AITF) of the ASB issued several auditing Interpretations, some of which are discussed in the sections that follow. Interpretations are issued by the AITF to provide timely guidance on the application of ASB pronouncements, and are reviewed by the ASB. An Interpretation is not as authoritative as a pronouncement of the ASB, but practitioners should be aware that they may have to justify departures from an Interpretation if the quality of their work is questioned.

.31 *Client Representations.* In October 1995, the AITF issued an auditing Interpretation of SAS No. 19, *Client Representations,* titled "Management Representations When Current Management Was Not Present During the Period Under Audit" (AU section 9333.05—.06). This Interpretation (AU section 9333.05—.06) provides guidance for obtaining a written management representation letter when current management was not present during the period under audit. This Interpretation (AU section 9333.05—.06) states that in an audit engagement, the auditor should obtain written representations from current management on all periods covered in the auditor's report. Practitioners encountering this situation may wish to obtain tailored representations from individuals within the organization, such as the accounting manager, or suggest that current management obtain representation letters from those who report to them.

.32 Practitioners should be aware that the guidance in this Interpretation (AU section 9333.05—.06) has caused many firms to reconsider their current practices and procedures in this area.

.33 *Reissuing the Auditor's Report to Remove a Going Concern Report Modification.* In August 1995, the AITF issued an auditing Interpretation of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* titled "Eliminating a Going Concern Explanatory Paragraph From a Reissued

Report" (AU section 9341.01—.02). On occasion, a client may request that the auditor reissue a report or consent to its inclusion in a regulatory filing and remove a going concern explanatory fourth paragraph because the client believes that the original condition or event giving rise to the going concern issue has been subsequently resolved. For example, if the auditor had previously modified his or her report for going concern because of continuing operating losses, loss of a major customer, or inability to restructure its debt, but subsequently the client has taken what it believes are appropriate steps to rectify these problems, the auditor may reissue the report without the going concern report modification. However, before doing so, the auditor should (1) audit the condition, event, or transaction that the client has indicated resolves the going concern issue and (2) perform subsequent events procedures, including obtaining updated legal confirmations and an updated general representation letter.

.34 If the auditor is satisfied that the matter giving rise to the original going concern report modification has been satisfactorily resolved, and the results of subsequent events procedures do not reveal any new problems, the going concern report modification may be removed in the reissued report. The report ordinarily should be dual-dated for the subsequent event that mitigates the original matter or matters giving rise to going concern.

.35 This may also apply when, as predecessor auditor, the auditor is requested by a former client to reissue a report or consent to its use in an offering document. However, it would be acceptable to have the successor auditor perform the work on the behalf of the predecessor auditor. If the successor auditor has completed an audit of a subsequent period, and represents to the predecessor auditor that he or she does not intend to modify the report for a going concern problem, the predecessor auditor may, but is not required to, accept the successor auditor's representation in lieu of performing the subsequent event procedures regarding the going concern issue.

.36 *Filings Under Federal Securities Statutes.* An auditing Interpretation of SAS No. 37, *Filings Under Federal Securities Statutes* (AU section 711), was issued. This Interpretation amends Interpretation No. 2 of AU section 711 titled "Consenting to Be Named as an Expert in an Offering Document in Connection With Securities Offerings Other Than Those Registered Under the Securities Act of 1933" (AU section 9711.12—.15), to clarify that if the term *expert* is defined under applicable state law, the accountant may agree to be named as an expert in an offering document in an intrastate securities offering. The accountant may also agree to be named as an expert, as that term is used by the Office of Thrift Supervision (OTS), in securities offering documents that are subject to the jurisdiction of the OTS.

.37 *Reports on the Processing of Transactions by Service Organizations.* The AITF issued two new auditing Interpretations of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324). Interpretation No. 1, "Describing Tests of Operating Effectiveness and the Results of Such Tests" (AU section 9324.01—.03), clarifies what information and how much detail should be included in a service auditor's description of the tests. Interpretation No 2, "Service Organizations That Use the Services of Other Service Organizations (Subservice Organizations)" (AU section 9324.04—.18), provides guidance on how a user auditor's and a service auditor's procedures are affected when a service organization uses a subservice organization. It describes how a user auditor may obtain information about relevant control structure policies and procedures at a subservice organization, identifies what information about a subservice organization should be included in the service organization's description of policies and procedures, and indicates how a service auditor's report is affected when a service organization uses a subservice organization.

.38 *Reporting on a Special-Purpose Financial Statement That Results in an Incomplete Presentation But Is Otherwise in Conformity With Generally Accepted Accounting Principles (GAAP).* Interpretation No. 13 of SAS No. 62, *Special Reports,* titled "Reporting on a Special-Purpose Financial Statement That Results in an Incomplete Presentation But is Otherwise in Conformity With Generally Accepted Accounting Principles" (AU section 9623.80—.87), was also issued in 1995. It provides guidance when, for example, an entity wishing to sell a division or product line prepares an offering memorandum that includes a special-purpose financial statement that presents certain assets and liabilities, revenues, and expenses relating to the division or product line being sold. The Interpretation (AU section 9623.80—.87) discusses (1) whether an offering memorandum (not including a filing with a regulatory agency) constitutes a contractual agreement for purposes of issuing an auditor's report under SAS No. 62 (AU section 623), (2) whether an agreement between a client, and one or more third parties other than the auditor, to prepare financial statements using a special-purpose presentation constitutes a contractual agreement for purposes of issuing an auditor's report under SAS No. 62 (AU section 623), and (3) what guidance the auditor should follow when he or she is requested to add additional third parties that were not parties to the original contract or agreement to the restricted distribution of his or her report.

Audit Issues

Auditor Skepticism

.39 Auditors should be more skeptical about the answers they receive from management. Explanations received from an entity's management are merely a first step in an audit process, not the only or the last step. Auditors must listen to the explanation, then examine or test it by looking at sufficient competent evidential matter. The familiar phrase *healthy skepticism* should be viewed as a "show-me" attitude and not a predisposition to accepting unsubstantiated explanations. Auditors should document findings and conclusions in the working papers as if they will be challenged.

Use of Analytical Procedures

.40 Current guidance for the application of analytical procedures as part of the audit is found in SAS No. 56, *Analytical Procedures* (AU section 329). Three broad types of analytical procedures commonly used by auditors are the following:

1. *Trend analysis* is the comparison of an account balance or item to the prior year balance or to a trend of balances from two or more prior periods.

2. *Ratio analysis* is the comparison of a ratio calculated for the current year to a related or similar ratio for a prior year, an industry average, or a budget. Ratios commonly have financial statement data in the numerator and the denominator.

3. *Model-based procedures* involve the use of client operating data and the relevant external data (industry information and general economic information) to develop an expectation for the account balance or item. There are two types of model-based procedures—reasonableness tests and regression analysis. Model-based procedures differ from ratio and trend analysis in two key ways: (*a*) although expectation formation is implicit in trend and ratio analysis, expectation formation is explicit in model-based procedures, and (*b*) model-based procedures use operating and external data in addition to financial data to develop the expectation.

.41 SAS No. 56, paragraph 5 (AU section 329.05), states that "Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor." Whatever type of analytical procedures are used by the auditor, there are three general steps in performing these procedures:

1. Develop an expectation for the account balance or item, using trend analysis, ratio analysis, or model-based procedures.

2. Compare the expected amount to the recorded balance.

3. Based on the difference between the recorded and estimated balance, and using consideration of the objectives and of the precision of the procedure, determine the desired nature and extent of further audit testing.

.42 Analytical procedures are an important audit tool, the effectiveness of which can be greatly increased by proper attention to expectation formation and assessment of the precision of the procedure. Auditors should be cautioned not to view analytical procedures as an easy and inexpensive audit approach. Rather, the use of analytical procedures should be viewed as an audit approach that can and sometimes should require considerable planning and effort, but that provides evidence commensurate with that planning and effort. Explanations of differences discovered during the application of analytical procedures should be clearly documented in the working papers.

Using the Work of an Attorney

.43 Auditors should be aware that audit guidance is provided in SAS No. 73, *Using the Work of a Specialist* (AU section 336), when relying on the representations or work of an attorney for other than litigation, claims, and assessments as addressed in SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU section 337). For example, if an attorney is engaged by the client or the auditors to interpret the provisions of a contractual agreement, that attorney should be treated as a specialist for the purpose of using the attorney's work as evidential matter in performing substantive tests to evaluate material financial statement assertions.

.44 In this and similar situations, the auditor should follow the guidance in SAS No. 73 (AU section 336), including the need to evaluate the professional qualifications of the attorney. Additionally, just as SAS No. 12 (AU section 337) urges the auditor to get the attorney's response in writing, it is also a good practice to obtain legal opinions in writing on SAS No. 73 (AU section 336) matters that are complex and material to the financial statements.

Audit Sampling

.45 Under SAS No. 39, *Audit Sampling* (AU section 350), there are four key requirements related to audit sampling:

1. A sample should be selected in such a way that it may be expected to be representative of the population from which it is selected.

2. Misstatements disclosed in a sample should be projected to the population, thus yielding an estimate of the total projected misstatement in the population.

3. The auditor should consider sampling risk, which is the risk that a sample will result in an incorrect audit decision.

4. The auditor should consider tolerable misstatement, which is the auditor's specification of the largest error that may exist in the sampled population without causing the financial statements to be materially misstated.

.46 A recent survey was conducted by the Audit Sampling and Analytical Techniques Committee of the New York State Society of CPAs. Survey forms were mailed to eight hundred New York firms (with two or more professionals). The findings of the survey are based on 163 usable responses from the firms that reported having an audit practice.

.47 The survey indicated that, SAS No. 39's (AU section 350) requirements notwithstanding, large percentages of responding firms did not project misstatements, consider tolerable misstatement, or consider the risk of incorrect acceptance. The survey results suggest many firms could benefit from further education in the proper use of audit sampling and, to some extent, the audit-risk model.

.48 SAS No. 39 (AU section 350) requires selection of a "representative sample." This does not mean that the sample selection process must be random so that each item has an equal chance of selection. It does mean that the selection process should not create a sample that has characteristics so different from the population that any sample projection is unreliable. Selection of every *n*th item is certainly one approach that normally results in representative samples. Selection of items based on scanning for "interesting" items, including large extensions or quantities as well as other characteristics, can also create acceptable samples provided the judgmental process does not exclude significant portions of the population. For example, weighting the judgmental selection toward large extensions in the raw materials of a manufacturer could result in extensive testing of the pricing of steel and exclusion of cheaper types of components from the samples tested. Although the steel in the example may deserve more attention, the sample selection should not exclude other types of inventory.

.49 Although SAS No. 39 (AU section 350) mandates projection of misstatement rates, it first requires consideration of why the misstatement occurred. Projection is required to emphasize the fact that misstatements cannot be assumed to be isolated. The reliability of the projection is dependent on whether the misstatement occurred uniformly throughout the population. The audit judgment can be made only after the reasons for the misstatements' occurrences have been determined. Auditors should, therefore, investigate misstatements as well as project them.

.50 For further information about SAS No. 39 (AU section 350) and its requirements, auditors can refer to the following AICPA publications:

1. General Audit and Accounting Guide *Audit Sampling* (Product No. 013144HV, $28 members/$31 nonmembers)[1]
2. Continuing Professional Education Course *Audit Sampling*—MicroMash (Product No. 700493HV/DOS 3.5" or Product No. 700495HV/Windows 3.5" $120)

Audit Team's Responsibility for Subsequent Events for Period From Completion of Fieldwork to the Release of the Auditor's Report

.51 Sometimes a client may request the auditor to delay issuance of the audit report, pending resolution of a matter that could affect either the financial statements or the report (for example, settlement of a lawsuit or refinancing of debt). On occasion, these delays can extend several months from the date fieldwork was completed. Although the delay may have been requested to resolve a matter that would be favorable to the client, the risk exists that new events could occur during the intervening period that would affect the financial statements or the audit report.

.52 Accordingly, auditors should decide whether the delay in issuance of the audit report results in a significant increase in the risk that a material subsequent event or transaction affecting the financial statements or report could have occurred. When the risk is high, the subsequent review work should be brought forward to a more current date. In any event, auditors should consider specifically asking management about any significant events that may have occurred between the date of the audit report and the date of release, as well as reviewing any current interim financial information.

Audit Communication and Reporting Issues

Proposed Amendment to Eliminate the Required Uncertainties Explanatory Paragraph

.53 In June 1995, the ASB issued an exposure draft of a proposed amendment to SAS No. 58, *Reports on Audited Financial Statements* (AU section 508), that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

.54 Under existing standards, when certain uncertainties exist, such as the amount of the ultimate liability for environmental remediation efforts, the auditor is required to add an explanatory paragraph to the auditor's report describing the matter giving rise to the uncertainty and indicating that the outcome of the uncertainty cannot be determined at the time. Existing accounting standards generally require that information about the uncertainty be disclosed in the financial statements; therefore, the required uncertainties explanatory paragraph tends to be

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[1] A revised edition of this product is scheduled to be available in February 1996—Product No. 021061HV.

redundant because it communicates information already disclosed in the financial statements. If that information were not disclosed in the financial statements, a departure from GAAP would exist and the auditor would be required to issue a qualified or adverse opinion on the financial statements.

.55 In making the decision to amend SAS No. 58 (AU section 508), the ASB considered the December 1994 issuance, by the AICPA's Accounting Standards Executive Committee (AcSEC), of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (Product No. 014880HV, $8.50 members/$9.50 nonmembers). Among its other disclosure requirements, the SOP requires that financial statements disclose specified information about significant estimates when certain criteria are met. The criteria in SOP 94-6 for disclosure of information about certain significant estimates are similar to the criteria in SAS No. 58 (AU section 508) for consideration of the inclusion of an uncertainties explanatory paragraph in the auditor's report. Accordingly, when the criteria for disclosure in the financial statements are met, the auditor generally is required to consider adding an uncertainties explanatory paragraph to the auditor's report. The correlation between these two sets of criteria probably would result in an increase in the number of reports issued with uncertainties explanatory paragraphs.

.56 The proposed revision of SAS No. 58 (AU section 508) would not affect SAS No. 59 (AU section 341), nor would it preclude the auditor from adding a paragraph to the auditor's report to emphasize a matter disclosed in the financial statements, as provided for in paragraph 37 of SAS No. 58 (AU section 508.37).

.57 The title of the exposure draft of the proposed amendment is *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements; comments on the proposed amendment were due by October 20, 1995. The ASB will be considering the views expressed in the comment letters at its November 1995 meeting. If the ASB votes to eliminate the required uncertainties paragraph, an announcement will be published in the *CPA Letter.* If this occurs, practitioners will be permitted to delete the uncertainties paragraph for year end audits.

Communication—Predecessor/Successor Auditor Situations

.58 In deciding whether to accept an engagement, an auditor's client acceptance procedures should include inquiries of the predecessor auditor about facts that might bear on the integrity of management. The successor auditor should try to elicit specific examples or other factual information (for example, ask if there were delays in providing documents, unreasonable deadlines, last minute favorable adjustments, unsupported transactions, or extremely aggressive accounting positions) rather than attempt to draw a conclusion from the predecessor (for example, "You don't have any concerns about management's integrity, do you?") The predecessor's responses should be kept confidential and not shared with others, including the prospective client. Importantly, the auditor should obtain authorization from the prospective client to make the above inquiries. Also, it is a good idea to get the client authorization in writing.

.59 Predecessor auditors ordinarily should respond fully to the successor's inquiries, but only after having received appropriate authorization (preferably in writing) from the former client. Successor auditors are now frequently asked to acknowledge in writing to predecessor auditors their agreement to a number of representations before they are given access to the predecessor working papers. Successor auditors should read these letters carefully, particularly with regard to representations they might be asked to make about not using the information they gather from predecessor working papers as audit evidence in rendering their opinion on the current financial statements.

.60 Interpretation No. 3 of SAS No. 7, *Communications Between Predecessor and Successor Auditors,* titled "Audits of Financial Statements That Had Been Previously Audited by a Predecessor Auditor" (AU section 9315.08—.18), was recently issued by the ASB. This Interpretation (AU section 9315.08—.18)—

1. Describes communication that a successor auditor should attempt with the predecessor.

2. Clarifies that information obtained from the review of the predecessor's working papers and report and inquiries of the predecessor, in and of themselves, are not sufficient competent evidential matter to form a basis for the successor auditor to express an opinion on the reaudited financial statements.

3. States that the successor may consider information obtained from inquiries of the predecessor and any review of the predecessor's working papers and report in planning a reaudit.

4. Discusses how a successor should address the issue of not being able to observe inventory or make physical counts at the reaudit date(s).

Reporting Terminated Auditor-Client Relationships to the SEC

.61 Within five business days of becoming aware of the cessation of a client-auditor relationship (either by resignation, termination, or replacement by another firm), firms that are members of the AICPA's SEC Practice Section (SECPS) are required under the SECPS's membership requirements to notify the client formally in writing that the relationship has ended. This notification letter is separate and distinct from the letter that the auditor is asked to provide the entity (for inclusion in the Form 8-K) stating whether the auditor agrees with the disclosures in the Form 8-K. The auditor should transmit simultaneously a copy of this client notification letter to the Chief Accountant of the SEC at 450 Fifth Street, NW, Stop 11-3, Washington, DC 20549 or by fax to (202) 942-9656.

A Corporate-Governance Approach to Improved Financial Reporting

.62 In September 1995, the Public Oversight Board (POB) issued the report *Directors, Management, and Auditors—Allies in Protecting Shareholder Interests.* The report calls for the participants in the financial reporting process to take a logical and necessary next step to improve corporate governance and the quality of financial information provided to investors. The audit committee and board of directors must insist upon, and financial management and the auditor must deliver, their candid views about the appropriate accounting principles and estimates (that is, not just their acceptability) and the clarity of the related disclosures of financial information that the entity reports publicly. In this report, the POB concludes that three steps are needed to further improve the credibility of financial reporting:

1. The board of directors must recognize the primacy of its accountability to shareholders.

2. The auditor must look to the board of directors as the client.

3. The board and its audit committee must expect, and the auditor must deliver, candid communication about the quality of the entity's financial reporting.

The POB initially distributed approximately 26,000 copies of this report. Because of the report's widespread distribution, auditors of all types of entities, including not-for-profit and governmental entities, should be aware of the report's content. Auditors may be requested to comment on the appropriateness of a client's accounting principles.

.63 Copies of the POB report can be obtained by contacting the Public Oversight Board's offices at One Station Place, Stamford, CT 06902 or by telephone at (203) 353-5300.

Audit Problems to Watch For

Management Fraud

.64 Management fraud continues to generate adverse publicity and financial exposure to auditors. It is important that, in every audit, auditors consider the possibility that some managements, when given the right incentives and opportunity, will engage in practices intended to deceive and mislead others.

.65 Management fraud continues to be a significant problem because of the incentives (for example, compensation linked to operating results) and opportunities that restructurings, changes in technology, and the complexity of business transactions offer. Accordingly, it is important that auditors address the risk of management misrepresentation in designing the audit approach, exercise the appropriate degree of professional skepticism during the performance phase and in evaluating the results, and consult with others when indications of possible fraudulent activities are identified.

.66 For additional guidance in this area, practitioners should refer to an article written by Howard Groveman, CPA, CFE that appeared in the October 1995 *Journal of Accountancy* titled "How Auditors Can Detect Financial Statement Misstatement." The major points discussed in this article are as follows—

- The most frequent audit failures appear to result from inappropriate audit team reactions to warning signals. In cases reported to the AICPA's quality control inquiry committee, problems also include inexperienced staff assigned to audits and a lack of professional skepticism.
- To maintain the appropriate degree of skepticism, auditors should not assume client management is dishonest but also should not unquestioningly expect honesty. The audit team should evaluate evidence objectively to determine whether financial statements are free of material misstatement.
- Inventory misstatements have caused numerous financial statement problems. To prevent or detect inventory abuses, the inventory observation team should include experienced personnel; a partner or manager should be present or easily reached.
- An entity's use of aggressive accounting practices may indicate management is more concerned with the portrayal of favorable financial results than with the reality. All practices should be acceptable under GAAP and the financial statements should make overall business sense.
- Other potential problem areas auditors may encounter include inappropriate revenue recognition, inadequate loss reserves, understated costs and expenses, and unusual or related party transactions or balances.

Revenue Recognition

.67 Revenue recognition practices continue to warrant auditors' close attention. Specifically, auditors should—

1. Be satisfied that the revenue recognition practice used for regular, recurring transactions is appropriate for the business practices currently followed by the client. Changes in the client's business environment or its practices may necessitate a change in revenue recognition policies.
2. Design audit procedures to identify unconventional recording practices and unusual sales arrangements—significant contingencies, extended terms, right of return, bill-and-hold arrangements, consignment arrangements, and the like—that may affect the timing of revenue recognition or the adequacy of reserves for sales returns and allowances.
3. Evaluate with professional skepticism any recognition of revenue resulting from significant transactions that are unusual for the client, especially those that occur near quarter end or year end.

.68 *Revenue Recognition—Side Agreements.* Auditors also should be alert to the potential for "side agreements," whereby various additional terms or conditions are agreed to by the entity and the customer that may preclude revenue recognition or otherwise affect the accounting treatment of a transaction. Although the use of such side agreements appears to be most prevalent in the high technology industry, particularly in the computer hardware and software segment, it may exist in other industries as well.

.69 A side agreement may take the form of either a separate written agreement or merely an oral understanding between the client and its customers either to provide terms other than those specified in written agreements or to not enforce the terms of written agreements. Many times these side agreements create significant obligations or contingencies (such as agreements to install or customize delivered products or accepting financing arrangements with third parties) that may preclude immediate revenue recognition.

.70 Because very few individuals within the entity may be aware of the use of side agreements, it is often difficult to determine their existence. In fact, accounting and financial personnel may not be aware of the side agreements. Accordingly, management representations and standard audit procedures in the revenue and accounts receivable areas may not be an adequate audit response.

.71 When there is a significant risk of undisclosed side agreements, in addition to confirmation of account balances and material revenue transactions, confirmation should also be made of relevant contract terms to obtain assurance from customers that side agreements do not exist. Such confirmations should be addressed to the contract signer and not to the accounts payable department. Since it is difficult to perform alternative procedures to sample items for which a confirmation is not received, which may be effective in identifying undisclosed side agreements, auditors should make every effort to obtain a response to these special confirmations.

Related Party Transactions

.72 Transactions with related parties cannot be presumed to be at arm's length. It is important to understand both the business purpose and the substance of all significant related party transactions. Proper accounting for related party transactions reflects the substance of the transaction, not merely its form. Material related party transactions are to be disclosed in accordance with FASB Statement No. 57, *Related Party Disclosures* (AC R36).

.73 SAS No. 45, *Omnibus Statement on Auditing Standards—1983,* "Related Parties" (AU section 334), provides guidance and suggested procedures that may disclose the existence of related party relationships and transactions. Auditors should communicate identified related party relationships and transactions to all members of the engagement team so that proper consideration is given to the existence of related party relationships and transactions throughout the audit.

Electronic Data Interchange

.74 Electronic Data Interchange (EDI) is the electronic exchange of business data between entities in a standard format, replacing documents such as purchase orders, invoices, and checks. EDI's most publicized use is in the retailing and auto manufacturing industries for purchases from suppliers, but it is also used in the banking industry for electronic fund transfers and in the insurance industry to process medical benefit claims. Entities of all sizes use EDI because large retailers and auto manufacturers, for example, may require the use of EDI by their suppliers as a condition of doing business.

.75 The auditor should inquire at the planning stage of an engagement whether the entity is using EDI and, if so, for what business applications (for example, purchases, shipping documents, payments). If a material number of transactions is processed through EDI, the auditor should consider the following procedures:

1. Inquire about the existence of trading partner agreements; such contracts clarify the rights and responsibilities of each of the trading partners. A model trading partner agreement is available from the American Bar Association.

2. Gain an understanding of the entity's controls over access to the EDI system, controls over authorization of transactions to that system, and procedures for review and aging of unmatched items.

3. Consult with a specialist in EDI.

The AICPA's Information Technology Division issued a publication titled *EDI Control, Management, and Audit Issues* (Product No. 043004HV, $30 members/$33 nonmembers) in July 1995. That document describes EDI in detail and includes a chapter discussing audit issues in an EDI environment. The AICPA's Auditing Standards Division plans to issue by year end an Auditing Procedure Study (APS) titled *Audit Implications of EDI.*

Client/Server Computing

.76 In client/server computing, an entity's computers are networked and the processing of data may take place at both the end-user workstation and at another platform, such as the minicomputer or mainframe. If an audit client has implemented client/server computing in such a way that it will affect the financial statements, the auditor may find it useful to consult an expert on client/server technology. Because of the distributed nature of the client/server environment, controls over access to data and programs and controls over the integrity of data may take on added importance. Procedures to ensure that databases are synchronized would also be important. By consulting an expert, the auditor is more likely to identify any control issues and design an effective, cost-efficient audit.

.77 The Auditing Standards Division plans to issue an APS titled *Auditing in a Client/Server Environment* in 1996. The APS will identify audit issues that may be encountered in a client/server environment.

Conducting Business on the Internet

.78 The Internet is a worldwide network of computer networks. No one organization owns, manages, or controls the Internet. Rather, it is a combination of over 20,000 privately owned and operated networks. These networks, each of which has a unique address, are interconnected (using telephone lines, satellite connections, and dedicated high-capacity backbones) to provide a worldwide web of communication links.

.79 Auditors whose clients use the Internet should be aware of two areas of potential risk. The first relates to the confidentiality of information that the entity transmits and receives over the Internet. Although this risk often would not relate to audit risk, it could represent a significant business risk to the entity. Electronic mail and data transferred over the Internet may be subject to electronic eavesdropping. Sensitive data may need to be protected using encryption hardware or software facilities that are widely available on the market.

.80 The second area of risk relates to the potential exposure of the entity's computer systems and data to intrusion by other users of the Internet. This is primarily a client business risk, but may also affect audit risk if financial systems and data are lost. Access controls or other security measures are advisable to protect user systems.

.81 An article recently appeared in *The New York Times* on October 11, 1995 titled, "Discovery of Internet Flaws Is Setback for On-Line Trade." This article outlined newly publicized weaknesses in the basic structure of the Internet that indicate that the worldwide computer network may need a time-consuming redesign before it can be safely used as a commercial medium. Specifically, the article states that, "The flaws could allow an eavesdropper or criminal to divert many types of documents or software programs traveling over the Internet, examine or copy or alter them, and then pass them on to the intended recipient—who would have no easy way of knowing that the files had been waylaid. Not only would electronic mail be read in transit or credit card numbers be copied en route, but special security techniques meant to protect such transactions could be dismantled without the user's knowledge."

AICPA Peer Review Program

Quality Review Program Merges With Peer Review Program

.82 Effective April 3, 1995, the AICPA's Quality Review Program and the Private Companies Practice Section (PCPS) Peer Review Program were merged. The combined program is called the AICPA's Peer Review Program. The Quality Review Executive Committee, having senior status with authority to establish and conduct the review program in cooperation with state CPA societies, was renamed the AICPA's Peer Review Board.

.83 Most firms will experience no noticeable difference in their next peer review as a result of the merger except that the reviews for PCPS member firms will be administered by a state society. Outlined below are some of the significant changes resulting from the merger of the programs.

- Peer reviews of PCPS member firms with ten or fewer professional staff ordinarily will be limited to four of the nine quality control elements (independence, consultation, supervision, and professional development). Previously, all PCPS member firms were also reviewed for compliance with the inspection element.
- A sole practitioner PCPS member firm with up to four professional staff may send its working papers, reports, files, and so forth to the reviewer rather than have the review conducted at the firm's office. Previously, only sole practitioners with no professional staff were permitted that option.
- A PCPS member firm that performs agreed-upon procedures is now permitted to elect an off-site review, providing the firm conducts no audits. Previously, such a firm was required to have an on-site review.
- Subsequent peer reviews must now be completed within three years and six months after the end of the period covered by the previous review. Previously, firms enrolled in the quality review program were required to begin the field work for their subsequent reviews within three years after the date of the exit conference for the previous review.

The combination does not affect SECPS members that audit SEC registrants. Those firms still must be members of the SECPS and participate in its peer review program, under the oversight of the POB.

Proposed Framework for a System on Quality Control

.84 The AICPA's Joint Task Force on Quality Control, in cooperation with the ASB, was formed in late 1993 with representatives of the SECPS Peer Review Committee, PCPS Peer Review Committee, and Peer Review Board (formerly the Quality Review Executive Committee), as well as the ASB, to consider possible revisions to Statements on Quality Control Standards and related Interpretations and guidance materials.

.85 As a result of the work of the Joint Task Force on Quality Control, exposure drafts of two new Statements on Quality Control Standards were issued in August 1995. The first proposed Standard, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice,* will supersede Statement on Quality Control Standard No. 1, *System of Quality Control for a CPA Firm* (QC section 10). The new Statement proposes to replace the nine elements of quality control with five broader elements. The second proposed Standard, *Monitoring a CPA Firm's Accounting and Auditing Practice,* will provide guidance on the monitoring element of quality control. It is anticipated that the new Standards will be issued in 1996.

Recurring Peer Review Comments

.86 This section sets forth certain reminders to auditors based on frequently recurring comments noted in peer review letters of comment. Many of the items discussed in the following sections were discussed in last year's Alert; however, the problems continue to occur.

.87 *Working Paper Requirements.* Peer reviews continue to identify deficiencies in working papers. In a number of circumstances, reviews have noted an absence of working papers or inappropriate or incomplete working paper content. SAS No. 41, *Working Papers* (AU section 339), provides auditors with guidance on the functions, nature, content, ownership, and custody of working papers. Auditors should ensure that the working papers are sufficient to show that the accounting records agree or reconcile with the financial statements or other information being reported on and that the standards of fieldwork have been observed.

.88 SAS No. 41 (AU section 339) states that working papers should ordinarily include documentation showing that—

1. The work has been adequately planned and supervised.
2. A sufficient understanding of the internal control structure has been obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. The audit evidence obtained, the auditing procedures applied, and the testing performed have provided sufficient competent evidential matter to afford a reasonable basis for an opinion.

Auditors should recognize that certain SASs contain specific documentation requirements that are summarized in footnote 2 of SAS No. 41 (AU section 339.01). In addition, auditors performing engagements under *Government Auditing Standards* are reminded to refer to those standards for certain additional requirements for working papers.

.89 Following are a few reminders about the preparation and review of working papers:

- Auditors should evaluate with professional skepticism the evidence obtained in relation to the accumulated knowledge of the client and the industry(ies) in which it operates. Professional skepticism is especially important when management is pressured for results and is also called for when the preaudit financial statements show unusually favorable results.
- Auditors should not leave open points in the working papers, whether in the form of open questions, marginal notes, or "to do" lists. An adversary will look for and find all of the things the auditor said he or she should do but did not do.
- Auditors should destroy superseded drafts of schedules, memoranda, financial statements and reports in both hard copy and electronic format. It may require a more conscious effort to dispose of electronic files, but that effort should be made.
- Auditors should destroy desk files at the completion of the engagement. Desk files are, like audit working papers, subject to subpoena.

.90 *Incomplete Financial Statement Disclosures.* SAS No. 32, *Adequacy of Disclosure in Financial Statements* (AU section 431), sets forth the auditor's responsibility to ensure that audited financial statements include disclosures required by GAAP. This is most effectively accomplished through the use of disclosure checklists and review of the financial statements by someone not otherwise associated with the engagement. A number of the more common disclosure deficiencies noted in peer reviews relate to disclosure requirements set forth in—

1. FASB Statement No. 47, *Disclosure of Long-Term Obligations* (AC C32). For example, this Statement (AC C32) requires disclosure of the combined aggregate amount of maturities for each of the five years following the date of the latest balance sheet presented.
2. FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25). Auditors should be aware that many entities other than financial institutions have concentrations of credit risk. For example, an entity that has material bank accounts above the insured limit at one bank should disclose a concentration of credit risk at that bank.

Other common disclosure deficiencies occur in connection with related party transactions, pension and profit-sharing plans, leases, current and deferred income taxes, classification of debt, and industry specific disclosures.

.91 *Communication With Audit Committees.* SAS No. 61, *Communication With Audit Committees* (AU section 380), requires auditors to communicate certain matters to those who have responsibility for the oversight of the financial reporting process (for example, an audit committee). The auditor is required to make these communications only in audits of (1) entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee, and (2) all SEC engagements (as defined). Therefore, in audits of most nonpublic smaller entities that only have a board of directors, the auditor may, but is not required to, make these communications. This communication may be oral or written. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the working papers. If those matters that are required to be communicated do not apply to a particular engagement (for example, there were no disagreements with management), documentation is not necessary because no communication was required.

.92 *Other Common Deficiencies Noted on Peer Reviews.* The Peer Review Committee noted several other common audit engagement deficiencies, many of which are presented below.

- *Audit programs*—It was noted that audit programs were frequently missing or not tailored to the client industry. Practitioners should refer to SAS No. 22, *Planning and Supervision* (AU section 311), for guidance on audit programs.

- *Consideration of internal control structure*—It was noted that the auditor's understanding of the entity's internal control structure was frequently not obtained and documented. Practitioners should refer to SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), for guidance on the independent auditor's consideration of an entity's internal control structure in an audit of financial statements in accordance with GAAS.

- *Inquiry of a client's lawyer*—It was noted that lawyers' letters were frequently missing, inadequate or not dated reasonably close to the date of the auditor's report. For guidance on legal inquiries, practitioners should refer to SAS No. 12 (AU section 337).

- *The confirmation process*—It was noted that confirmations of receivables were inadequate or were not mitigated by appropriate alternative procedures. SAS No. 67, *The Confirmation Process* (AU section 330), provides guidance about the confirmation process in audits performed in accordance with GAAS. SAS No. 67 (AU section 330) describes the form of confirmation requests (the positive form and the negative form) and the type of audit evidence provided by responses to confirmation requests. In addition, SAS No. 67 (AU section 330) provides guidance when the auditor has not received replies to positive confirmation requests.

- *Client representations*—It was noted that client representation letters were frequently improperly dated or were not appropriately tailored. SAS No. 19 (AU section 333) establishes a requirement that the auditor obtain written representations from management as a part of an audit performed in accordance with GAAS and provides guidance concerning the representations to be obtained.

- *Communication of internal control structure related matters*—It was noted that certain matters related to the conduct of the audit were not communicated to those who have responsibility for oversight of the financial reporting process. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU section 325), requires auditors to report, preferably in writing, matters considered to be reportable conditions. If the information is communicated orally, auditors are required to document the communication in the working papers.

Lessons From Litigation

General Reminders

.93 Auditors should keep the following fundamental issues in mind during the conduct of any audit engagement to elude potential auditor litigation:

1. The critical importance of basic professional skepticism

2. The requirement that auditors obtain evidence to support management's representations—even when management are alumni of the CPA firm

3. The importance of effective and timely preacceptance procedures (Most lawsuits against auditors occur within the first five years of the relationship and the initial year can be particularly problematic.)

4. That auditors must emphasize and understand (*a*) the business purpose of transactions and (*b*) relationships and material transactions with shareholders

5. That there are litigation-sensitive environments (for example, rapid-growth entities, recently completed or contemplated IPOs, entities in financial distress, and entities with material related party transactions)

Bad Clients

.94 In her article "Do You See Trouble When It Walks in the Door?" (*The Practicing CPA*, June 1995), Mary C. Eklund, Esq. explains the idea of "bad clients." Ms. Eklund states that CPAs unwittingly accept or retain bad clients when they fail to consider whether a client presents a litigation risk, and when they recognize some risk but refuse to believe a lawsuit could happen to them.

.95 Bad clients nearly always give early hints of trouble. Auditors should be alert to the warnings and should refuse to accept or to continue the engagement. Following are some examples outlined by Ms. Eklund in her article:

- Early warning signs of a business in trouble:
  - *a.* Employee turnover, especially in the accounting area
  - *b.* Director resignations
  - *c.* Slow payment to suppliers and service providers
  - *d.* Large or unusual year end transactions
  - *e.* Unusual sources of or high rates for loans
  - *f.* Material transactions not recorded in the usual manner
  - *g.* Suspicious confirmation responses
- Clients who demand an unusually low fee or unrealistically fast service
- Clients who refuse to sign engagement or representation letters
- Clients who give evasive answers or make it difficult for auditors to get the information or documents they need
- Clients with significant weaknesses in accounting and administrative controls
- Client ownership and management in transition
- Clients who are unreasonable or who consistently ignore the auditor's advice
- The disreputable client and the bully

.96 If the auditor sees several signs, he or she should reconsider the risk of continuing with the engagement. Auditors should screen all clients each year. The goal should be to avoid accepting or continuing with bad clients. Ms. Eklund recommends the following steps to assist auditors in identifying potentially bad clients.

1. *Evaluate the client's real needs and demands*—Consider not only the services requested but also the services needed. Auditors should ask themselves if they can do what the client needs for the amount they are being paid.

2. *Evaluate your ability to handle the client's needs and demands*—Assess the firm's capabilities in light of the objectives, scope, and any special circumstances of the engagement, and then determine whether the firm can truly meet all expectations.

3. *If this is a new client, make every attempt to interview the predecessor accountant*—Try to find out the real reason for a change of accountants, and ask the predecessor accountant specific questions, such as the following:

   - Has the client ever lied to you?
   - Has the client ever unreasonably delayed payment or refused to pay you?
   - Did the client ever refuse to sign an engagement or representation letter?
   - Has the client ever threatened to sue you?
   - Have you ever had disagreement with the client on accounting principles or tax reporting?

4. *Perform an industry check*—Ask the prospective client for a list of customers and suppliers and obtain permission to talk with a few of them. Find out from them if the prospective client pays bills on time, has respect, and maintains good relationships with peers. Also, find out whether the prospective client's industry is subject to frequent or sudden business failures.

New GAAP Requirements

Pronouncements Becoming Effective in 1995

.97 A number of new pronouncements became effective in 1995. The following is a list of some of these pronouncements:

- FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (AC P16 and P40), is effective for employers that sponsor defined benefit postretirement plans with no more than five hundred participants for fiscal years beginning after December 15, 1994.

- FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), is effective for entities with less that $150 million in total assets for fiscal years ending after December 15, 1995.

- FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC D22 and I08), and the related pronouncement, FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (an amendment of FASB Statement No. 114) (AC D22 and I08), are effective for fiscal years beginning after December 15, 1994.

- FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made* (AC C67), and FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations* (AC C25 and No5), are effective for fiscal years beginning after December 15, 1994, except for not-for-profit organizations with less than $5 million in total assets and $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 15, 1995. (For implementation guidance on FASB Statements No. 116 (AC C67) and 117 (AC C25 and No5), refer to the *Journal of Accountancy*, September 1995, "Implementing FASB 116 and 117," by Martha L. Benson, Alan S. Glazer, Henry R. Jaenicke, and Kenneth D. Williams.)

- FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), is effective for financial statements issued for fiscal years ending after December 15, 1994, except for entities with less than $150 million in total assets. For those entities, this Statement (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1995. For additional guidance on derivatives and FASB Statement No. 119 (AC F25), refer to—

1. The *Journal of Accountancy*, June 1995, "Derivatives: What's an Auditor to Do?," by Barry N. Winograd and Robert H. Herz.

2. The *Journal of Accountancy*, March 1995, "The Question of Derivatives," by Roger H.D. Molvar and James F. Green.

- The accounting requirements of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, are effective for transactions entered into in fiscal years that begin after December 15, 1995, though they may be adopted on issuance.

- SOP 93-7, *Reporting on Advertising Costs* (Product No. 014804HV, $8.50 members/$9.50 nonmembers), is effective for fiscal years beginning after June 15, 1994.

- SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (Product No. 014882HV, $8.50 members/$9.50 nonmembers), has effective dates that are concurrent with the effective date of FASB Statements No. 116 (AC C67) and 117 (AC C25 and No5).

- SOP 94-6 is effective for fiscal years ending after December 15, 1995.

Some of these new pronouncements, such as FASB Statements No. 106 (AC P16 and P40), 114 (AC D22 and I08), 118 (AC D22 and I08), and SOP 93-7, deal with measurement issues. However, all will require new disclosures. Collecting the information necessary to make these disclosures, some of which are subjective in nature, may require significant effort on the part of both clients and auditors.

Financial Instruments

.98 Derivatives have become important financial management tools for many entities. The past decade has witnessed an unprecedented growth in the use and acceptance of derivatives, resulting in a market involving aggregate notional amounts of trillions of dollars. Much of this growth can be ascribed to the fact that derivatives, when properly used and monitored, may help entities manage risks that they face in conducting their day-to-day business.

.99 Recent losses incurred by various types of entities as a result of derivative transactions have raised questions about the nature, suitability, and use of these financial instruments. Derivative transactions are of concern to many parties, including the boards of directors and managements of entities that use such instruments, regulators in the related industries, investors, creditors, other financial statement users, and auditors of the financial statements of those entities.

.100 The FASB has had a Financial Instruments Project on its agenda since 1986 at the request of many constituents, including the auditing profession, the SEC, bank regulators, and some preparers. Those constituents expressed concerns about the lack of accounting guidance and the resulting inconsistencies in practice in accounting for financial instruments and transactions, especially for innovative and complex financial instruments created during the past decade.

.101 To date, the project has resulted in the issuance of several Statements, including FASB Statements No. 105 (AC F25), 107 (AC F25), and 119 (AC F25).

.102 FASB Statement No. 119 (AC F25) requires disclosures about the amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value, with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. FASB Statement No. 119 (AC F25) also amends FASB Statements No. 105 (AC F25) and 107 (AC F25) to require such distinction in certain disclosures required by those Statements (AC F25).

.103 For entities that hold or issue derivative financial instruments for trading purposes, FASB Statement No. 119 (AC F25) requires disclosure of average fair value and of net trading gains or losses. For entities that hold or issue derivative financial instruments for purposes other than trading, it requires disclosure about those purposes and about how the instruments are reported in financial statements. For entities that hold or issue derivative financial instruments and account for them as hedges of anticipated transactions, FASB Statement No. 119 (AC F25) requires disclosure about the anticipated transactions, the classes of derivative financial instruments used to hedge those transactions, the amount of hedging gains and losses deferred, and the transactions or other events that result in recognition of the deferred gains or losses in earnings. FASB Statement No. 119 (AC F25) also encourages, but does not require, quantitative information about market risks of derivative financial instruments, and also of other assets and liabilities, that is consistent with the way the entity manages or adjusts risks and that is useful for comparing the results of applying the entity's strategies to its objectives of holding or issuing the derivative financial instruments.

.104 *Audit Implications of Derivatives Use.* As outlined above, all types of entities in all industries, from manufacturing to retail to not-for-profit organizations to pension funds, use derivative financial instruments. The use of derivative financial instruments is not limited to large corporations.

.105 Derivatives cover a broad range of financial instruments that "derive" their value from other financial instruments, underlying assets, or indices. They include listed futures and options, forwards, currency and interest rate swaps, and various combinations of these instruments. Auditors should understand the characteristics of derivatives that may have an impact on how the audit of an entity that uses derivatives will be conducted. Characteristics that auditors will need to consider include the following:

- Off-balance-sheet nature
- Complexity
- Leverage
- Illiquidity
- Unclear accounting and tax rules
- Legal risk
- Operational and control risk

.106 Whether auditing a buyer (for example, a commercial company or not-for-profit entity) or a seller (for example, a bank) of derivative financial instruments, auditors need to focus on the use of derivatives either for trading or speculative purposes, controls over these financial instruments, compliance with the accounting and disclosure rules, and importantly, for either a buyer or seller, fair value determinations, particularly for those derivatives for which a ready market does not exist.

.107 In their consideration of derivatives, auditors should focus on basic audit objectives that are no different from those they would apply to other areas: existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosures.

.108 When planning an audit, auditors need a clear understanding of how an entity uses derivatives. Auditors also must make a preliminary assessment of management controls over derivatives activities. This will provide a basis for determining the nature and degree of testing of such controls, with the goal of determining the extent to which the controls can be relied upon.

.109 As with any other audit area, auditors should perform tests of controls to determine the degree of reliance that can be placed on the internal control system as a basis for reducing substantive testing. Given the complexity of individual derivative transactions and the large dollar amounts often associated with them, it is not surprising that auditors often choose to rely heavily on substantive tests to satisfy their audit objectives.

.110 Auditors also must focus on financial statement presentation issues to ensure financial statement users have a clear idea of how an entity uses derivatives and to satisfy all of the reporting requirements for public entities.

.111 *Guidance on Derivatives.* In December 1994, the FASB issued a Special Report *Illustrations of Financial Instrument Disclosures* which provides illustrative examples applying the disclosure requirements of FASB Statements No. 105 (AC F25), 107 (AC F25), and 119 (AC F25). (To order, call the FASB at (203) 847-0700, ext. 10.)

.112 AcSEC's Financial Instruments Task Force, with the assistance of representatives of the ASB, recently issued the report *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888HV, $7.25 members/$8 nonmembers.) The document provides background information on derivatives and overviews of related accounting and auditing considerations.

.113 In addition, the AICPA has developed some common-sense questions for boards of directors to ask to help them gain a better understanding of their organizations' activities in derivative financial instruments and assess whether such activities are well managed and controlled. (See "Questions About Derivatives," the *CPA Letter,* July/August 1994.)

Impaired Long-Lived Assets and Long-Lived Assets Held for Disposal

.114 FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC D22 and I08), requires that long-lived assets and certain identifiable intangibles (including goodwill) to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the entity should estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset.

.115 FASB Statement No. 121 (AC D22 and I08) is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is not permitted. Impairment losses resulting from the application of this Statement (AC D22 and I08) should be reported in the period in which the recognition criteria are first applied and met. The initial application of this Statement (AC D22 and I08) to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.116 It should be noted that the FASB decided to prohibit the cumulative effect adjustment and retroactive application of the Statement's (AC D22 and I08) requirements for assets to be held and used because measurement of an impaired asset is based on estimates that are likely to change and management's assessment of events and circumstances is subjective and not readily subject to retroactive review. Impairment losses resulting from the application of FASB Statement No. 121 (AC D22 and I08) should be reported in the period in which the recognition criteria are first applied and met.

Accounting for Stock-Based Compensation

.117 The FASB's "Stock-Based Compensation" project included the reconsideration of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (AC C47), and related authoritative pronouncements. In June 1993, the FASB issued an exposure draft, *Accounting for Stock-Based Compensation.* The proposed accounting differed considerably from existing practice and was quite controversial. Particularly at issue was the tentative conclusion to require recognition of compensation expense for certain fixed-price stock options at the time they are issued. The proposed Standard required that compensation cost be measured as the fair value of the option or other stock-based award at the date it is granted, using an option-pricing model.

.118 Strong opposition to the proposed Standard came from a wide group of constituencies. In December 1994, the FASB decided to drop the requirement for expense recognition and will only encourage companies to do so. For those that do not, the cost of the options granted will be required to be disclosed in the notes to the financial statements.

.119 In October 1995, the FASB issued FASB Statement No. 123, *Accounting for Stock-Based Compensation*. This Statement establishes financial accounting and reporting standards for stock-based employee compensation plans.

.120 The accounting provisions of this Statement are effective for transactions entered into in fiscal years that begin after December 15, 1995, though they may be adopted on issuance. The disclosure requirements of FASB Statement No. 123 are effective for financial statements for fiscal years beginning after December 15, 1995, or for an earlier fiscal year for which this Statement is initially adopted for recognizing compensation cost. Pro forma disclosures required for entities that elect to continue to measure compensation cost using APB Opinion No. 25 (AC C47), must include the effects of all awards granted in fiscal years that begin after December 15, 1994. Pro forma disclosures for awards granted in the first fiscal year beginning after December 15, 1994, need not be included in financial statements for that fiscal year but should be presented subsequently whenever financial statements for that fiscal year are presented for comparative purposes with financial statements for a later fiscal year.

New Guidance on Early Warning of Significant Risks and Uncertainties

.121 In December 1994, AcSEC issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. This SOP establishes disclosure requirements for risks and uncertainties, and applies to all audits, reviews, and full disclosure compilations.

.122 The thrust of the SOP's requirements is to provide financial statement users with information about situations that could have a significant impact on an entity's financial condition in the near term (within one year from the date of the financial statements).

.123 SOP 94-6 applies to financial statements that are prepared in conformity with GAAP and applicable to nongovernmental entities. It applies to all entities that issue such statements. It does not apply to condensed or summarized interim financial statements. It requires reporting entities to include in their financial statements disclosures about the nature of their operations and the use of estimates in the preparation of financial statements.

.124 In addition, if specified disclosure criteria are met, it requires entities to include in their financial statements disclosures about certain significant estimates and current vulnerability due to certain concentrations.

.125 SOP 94-6 states that the financial statements should include a description of the business, including the location and relative importance of its principal markets.

.126 The second requirement is that the financial statements contain a simple explanation that preparation of financial statements in conformity with GAAP necessitates the use of management estimates.

.127 The third requirement states that where estimates are used to determine carrying values for assets or liabilities or in the disclosure of gain or loss contingencies, additional disclosure is necessary if both the following criteria are met:

1. It is reasonably possible that the estimate of the effect on the financial statements will change in the near term.
2. The effect of the change would be material to the financial statements.

Examples of circumstances requiring such a disclosure include—

- Inventory and equipment subject to rapid technological obsolescence.
- Capitalized computer software costs.
- Valuation allowances for commercial and real estate loans.
- Litigation-related obligations.
- Amounts reported for long-term obligations for pension and postemployment benefits.
- Estimated net proceeds on disposition of a business or assets.

If the criteria are met, the disclosure should—

1. Describe the nature of the uncertainty.
2. Indicate that it is at least reasonably possible that the estimate will change within one year from the balance-sheet date (the term *reasonably possible* is not required to be used in the disclosure to convey this concept).
3. If the estimate involves a FASB Statement No. 5, *Accounting for Contingencies* (AC C59), loss contingency (for example, an impairment of an asset or incurrence of a liability), include an estimate of the amount of the possible loss or range of loss.

.128 The final requirement of the SOP focuses on an entity's vulnerability to certain concentrations. SOP 94-6 indicates that if business concentrations expose an entity to the risk of a near-term severe impact, the occurrence of which is reasonably possible, disclosure is appropriate. Business concentrations may relate to a customer, a supplier, a lender, a grantor, or a contributor. Concentrations that are inherent in the industry or geography are not required disclosures.

.129 The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which the SOP is first applied. Early application is encouraged but not required.

.130 Auditors should be aware that significant new disclosures are likely to result from the implementation of SOP 94-6. The effort to gather information needed to determine what disclosures are necessary, as well as their content, is expected to be significant, particularly in the year of initial adoption.

New Guidance on Accounting for Limited Liability Companies and Limited Liability Partnerships

.131 Limited liability companies and limited liability partnerships (hereinafter referred to as limited liabilities companies or LLCs) are becoming the entity of choice for many enterprises. LLCs combine the limited liability aspect of corporations with the flow-through tax attributes of partnerships. To provide guidance on applying existing accounting literature to this relatively new form of entity, AcSEC recently issued Practice Bulletin No. 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships* (Product No. 033160HV, $6.50 members/$7.25 nonmembers).

.132 Because an LLC is formed under state law, its characteristics may vary depending on the state in which it is organized. However, LLCs generally have the following characteristics:

1. An LLC is an unincorporated association of two or more "persons."
2. Its members have limited personal liability for the debts and obligations of the entity.

3. It is classified as a partnership for federal income-tax purposes and thus lacks at least two of the corporate characteristics of limited liability—free transferability of interests, centralized management, and continuity of life.

Practice Bulletin No. 14 does not impose any new accounting requirements. Instead, it provides guidance to help LLCs apply existing accounting principles. Specifically, Practice Bulletin No. 14 provides reporting guidance for LLCs organized in the United States that prepare financial statements in accordance with GAAP. Practice Bulletin No. 14 also provides guidance on certain accounting issues for LLCs organized in the United States. For accounting issues not addressed in Practice Bulletin No. 14, an LLC should comply with the existing requirements of GAAP.

.133 Practice Bulletin No. 14 is effective for financial statements issued after May 31, 1995.[2]

Recognition of Gain or Loss on Early Extinguishment of Debt

.134 The SEC staff recently issued Staff Accounting Bulletin (SAB) No. 94, *Recognition of a Gain or Loss on Early Extinguishment of Debt,* that provides guidance on gain or loss recognition when an entity makes an announcement of intent to call an obligation in a period that precedes the actual extinguishment of that debt. The SAB is an interpretation of existing accounting guidance on early extinguishment of debt, primarily APB Opinion No. 26, *Early Extinguishment of Debt* (AC D14), and FASB Statement No. 76, *Extinguishment of Debt* (AC D14). In SAB No. 94, the SEC staff indicates that it is not appropriate to recognize a gain or loss on early extinguishment of debt (the difference between reacquisition cost and the net carrying amount of the extinguished debt) in a period before the period in which the debt is considered extinguished. The SEC staff also indicates that in periods preceding extinguishment, interest expense and other carrying costs of the debt should be recognized in accordance with the terms of the instrument.

Accounting Issues

Environmental Remediation Liabilities

.135 During the last several years, a number of significant clarifications have been provided in the guidance for accounting and disclosure of environmental costs. On the environmental outlays issue, the FASB's EITF has released three consensuses on the treatment of costs incurred for environmental purposes. EITF Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination,* generally requires expensing the cost of contamination treatment. However, capitalization is permitted if the costs (1) extend the asset's life, increase its capacity, or improve its efficiency relative to the property's condition when originally constructed or acquired; (2) mitigate or prevent future contamination; or (3) are incurred in preparing the property for sale. Further, costs are capitalized to the extent of recoverability. EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal,* requires (subject to recoverability tests) the capitalization of costs incurred to treat asbestos as long as they are experienced within a reasonable time frame after the acquisition of the property with a known asbestos problem. EITF Issue No. 93-5, *Accounting for Environmental Liabilities,* calls for an environmental liability to be evaluated independently from any potential claim for recovery and the loss arising from the recognition of an environmental liability to be reduced only when a claim for recovery is probable of realization. Further, discounting environmental liabilities for a specific clean-up site is allowed, but not required, if the aggregate amount of the obligation and the amount and timing of the cash payments for that site are fixed or reliably determinable.

.136 Guidance for contingency accounting is provided by FASB Statement No. 5 (AC C59), which states that a loss contingency should be recognized as a loss if (1) it is probable that a liability has been incurred or an asset impaired and (2) the amount of the liability or the impairment can be reasonably estimated. For measurement of a contingent loss, FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (AC C59), states that

[2] SAS No. 69 (AU section 411) identifies AICPA Practice Bulletins as authoritative (that is, "must-know") accounting principles.

when the reasonable estimate of a loss is a range and no amount within the range is a better estimate than another, the minimum amount should be accrued.

.137 The SEC requires more specific disclosures in reports on Form 10-K. Regulation S-K, Items 101, 102, and 303, and SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies,* provide the SEC's guidance for environmental disclosures.

.138 On June 30, 1995, AcSEC issued an exposure draft of a proposed SOP on accounting for environmental remediation liabilities titled *Environmental Remediation Liabilities (Including Auditing Guidance).* The proposed SOP would provide authoritative guidance on specific accounting issues present in the recognition, measurement, display, and disclosure of environmental remediation (clean-up) liabilities. A nonauthoritative section of the exposure draft discusses major federal legislation on pollution control and clean-up laws, and the need to consider various state and other non-U.S. government requirements.

.139 The draft provides that environmental remediation liabilities of reporting entities should be accrued when the criteria of FASB Statement No. 5 (AC C59) are met. It also includes benchmarks to help entities determine when such liabilities are to be recognized.

.140 The draft proposes that an accrual of environmental liabilities should include incremental direct costs of remediation and the costs of compensation and benefits for employees to the extent that an employee is expected to devote time directly to remediation tasks. It also recommends that the liability measurement include an entity's share of the liability for a specific site, and its share of the amount that other potentially responsible parties or the government will not pay.

.141 In addition, the draft includes guidance on the display of environmental remediation liabilities in financial statements and on disclosures about environmental-cost-related accounting principles, loss contingencies for environmental remediation, and other loss contingency disclosure considerations.

.142 The proposed SOP also contains an appendix that provides guidance on the application of GAAS to the audit of an entity's financial statements as it relates to environmental remediation liabilities. The guidance contains examples of inquiries an auditor might make of entity personnel to identify potential environmental remediation liabilities. It also describes how to apply SAS No. 57, *Auditing Accounting Estimates* (AU section 342), when auditing management's estimate of the liability, including guidance on using the work of a specialist.

Financial Statement Disclosures Overload

.143 Much is being written and discussed on the subject of financial statement disclosures. Many users and preparers of financial statements suggest that improvements need to be made. The AICPA Special Committee on Financial Reporting, chaired by Edmund Jenkins (the Jenkins Committee), triggered some of this current discussion. Specifically, in its report issued in 1994, one of the Jenkins Committee's recommendations stated that "standard setters and regulators should expand their efforts to eliminate disclosures that are less useful."

.144 In an effort to reduce disclosures, the SEC has considered streamlining or otherwise improving disclosures. The SEC issued proposed rules for comment which call for abbreviated financial statements to be included in proxy statements, and other reports issued to shareholders. The abbreviated statements would exclude a substantial number of footnote disclosures, but change no requirements for other filings with the SEC. The comment deadline on the SEC's proposal was October 10, 1995.[3]

.145 The FASB is addressing some of the concerns of the Jenkins Committee report in its current projects while calling for academic and other research on disclosure issues. In addition, the FASB plans to host a seminar late in 1995 to bring a number of interested parties together to discuss the topic of financial statement disclosures. Furthermore, the FASB is encouraging all interested parties to comment on this topic.

[3] The SEC withdrew this proposal on October 31, 1995.

.146 In January 1995 the PCPS Executive Committee agreed to examine this issue and established a Special Task Force on Standards Overload (the Special Task Force). The Special Task Force has developed recommendations and prepared its report *Report of the PCPS Special Task Force on Standards Overload* which will now be considered by the PCPS Executive Committee, the AICPA, the FASB, and the profession as a whole.

Auditing Standards Division Publications

.147 The following publications are published by the Auditing Standards Division and are available from the AICPA Order Department by calling (800) TO-AICPA. Product numbers and prices are shown in parentheses.

- *Codification of Statements on Auditing Standards*—includes SAS Nos. 1–73 as well as SSAEs (059025HV, $52 members/$57.25 nonmembers)

- *Selected Auditing Procedures Studies*[4]—Auditing Procedures Studies are nonauthoritative documents issued to inform auditors of developments and advances in auditing procedures and to provide practical assistance. The cost is $28.50 to members and $31.50 to nonmembers. Product numbers are shown in parentheses.

  — *Auditing With Computers* (021057HV)

  — *Auditing in Common Computer Environments* (021059HV)

  — *Consideration of the Internal Control Structure in a Computer Environment: A Case Study* (021055HV)

  — *Auditing the Allowance for Credit Losses of Banks* (021050HV)

  — *Audits of Inventories* (021045HV)

  — *The Independent Auditor's Consideration of the Work of Internal Auditors* (021051HV)

Other Pronouncements

.148 Following is a list of various authoritative pronouncements issued from January 1, 1995 to November 1, 1995, and their effective dates.

Statements of Financial Accounting Standards and Interpretations Issued by the FASB[5]

.149 To order copies of the following publications, call the FASB at (203) 847-0700, ext. 10.

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[4] The Auditing Standards Division plans to issue the following APSs in late 1995 or early 1996:

- *Implementing SAS No. 70,* Reports on the Processing of Transactions by Service Organizations
- *Audit Implications of Electronic Data Interchange*
- *Auditing in a Client/Server Environment*

[5] See Audit Risk Alert *State and Local Governmental Industry Developments—1995* [AAM section 8070] for recently issued Statements of the Governmental Accounting Standards Board.

Description		Effective Date
FASB Statement No. 120 (AC In6)	*Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*	Financial statements for fiscal years beginning after December 15, 1995
FASB Statement No. 121 (AC D22 and I08)	*Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of*	Financial statements for fiscal year beginning after December 15, 1995
FASB Statement No. 122 (AC Mo4)	*Accounting for Mortgage Servicing Rights*	Should be applied prospectively in fiscal years beginning after December 15, 1995, to transactions in which a mortgage banking enterprise sells or securitizes mortgage loans, with servicing rights retained, and to impairment evaluations of all amounts capitalized as mortgage servicing rights, including those purchased before the adoption of the Statement.
FASB Statement No. 123	*Accounting for Stock-Based Compensation*	The accounting requirements of this Statement are effective for transactions entered into in fiscal years that begin after December 15, 1995, though they may be adopted on issuance. (See Statement for effective dates for disclosure requirements.)
FASB Interpretation No. 41 (AC B10)[6]	*Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*	Financial statements issued for periods ending after December 15, 1994

.150 In addition, the FASB staff is developing a guide to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), that will provide implementation guidance in a question and answer format. This Special Report is expected to be issued by the end of 1995.

EITF Consensus Positions

.151 To order copies of the following publications, call the FASB at (203) 847-0700, ext. 10.

[6] FASB Interpretation No. 41 (AC B10) was issued in December 1994.

Description		Date Consensuses Reached
EITF Issue No. 94-1	*Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects*	November 17, 1994 May 18–19, 1995
EITF Issue No. 94-3	*Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*	May 19, 1994 November 17, 1994 January 19, 1995
EITF Issue No. 94-5	*Determination of What Constitutes All Risks and Rewards and No Significant Unresolved Contingencies in a Sale of Mortgage Loan Servicing Rights under Issue No. 89-5*	September 21–22, 1994 November 17, 1994 January 19, 1995
EITF Issue No. 94-6	*Accounting for the Buyout of Compensatory Stock Options*	September 21–22, 1994 November 17, 1994 January 19, 1995
EITF Issue No. 94-7	*Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*	September 20–21, 1995
EITF Issue No. 94-9	*Determining a Normal Servicing Fee Rate for the Sale of an SBA Loan*	January 19, 1995
EITF Issue No. 94-10	*Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109*	July 20–21, 1995
EITF Issue No. 95-2	*Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party*	July 20–21, 1995
EITF Issue No. 95-3	*Recognition of Liabilities in Connection with a Purchase Business Combination*	May 18–19, 1995
EITF Issue No. 95-4	*Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease*	July 20–21, 1995
EITF Issue No. 95-5	*Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights*	July 20–21, 1995
EITF Issue No. 95-6	*Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation*	July 20–21, 1995 September 20–21, 1995
EITF Issue No. 95-7	*Implementation Issues Related to the Treatment of Minority Interests in Certain Real Estate Investment Trusts*	September 20–21, 1995
EITF Issue No. 95-8	*Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*	September 20–21, 1995
EITF Issue No. 95-9	*Accounting for Tax Effects of Dividends in France in Accordance with FASB Statement No. 109*	September 20–21, 1995

Description		Date Consensuses Reached
EITF Issue No. 95-10	*Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109*	July 20–21, 1995
EITF Issue No. 95-12	*Pooling-of-Interests with a Common Investment in a Joint Venture*	September 20–21, 1995 [7]
EITF Issue No. 95-13	*Classification of Debt Issue Costs in the Statement of Cash Flows*	September 20–21, 1995
EITF Issue No. 95-14	*Recognition of Liabilities in Anticipation of a Business Combination*	September 20–21, 1995 [8]

Statements of Position and Practice Bulletins Issued by the AICPA

.152 To order copies of the following publications, call the AICPA Order Department at (800) TO-AICPA. The cost is $8.50 to members and $9.50 to nonmembers. Product numbers are shown in parentheses.

Description		Effective Date
SOP 94-5	*Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises* (014883HV)	Financial statements issued for periods ending after December 15, 1994
SOP 94-6	*Disclosure of Certain Significant Risks and Uncertainties* (014880HV)	Financial statements issued for fiscal years ending after December 15, 1995
SOP 95-1	*Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises* (014889HV)	Financial statements for fiscal years beginning after December 15, 1995
SOP 95-2	*Financial Reporting by Nonpublic Investment Partnerships* (014808HV)	Financial statements issued for fiscal years beginning after December 15, 1995
Practice Bulletin No. 14	*Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships* (033160HV)	Financial statements issued after May 31, 1995

Electronic Pronouncements

.153 The following professional standards are available in electronic format for computer use.

AICPA Pronouncements

.154 To order, call the AICPA Order Department at (800) TO-AICPA. Product numbers and prices are shown in parentheses. Disks are available in 3½″ (1.44MB) or 5¼″ (1.2MB) format. Subscribers receive updates approximately four times a year.

- *Professional Standards*—Subscription (Product No. G01030HV, $160 members) or Annual Edition (Product No. 016990HV, $98.75 members/$108.50 nonmembers)

[7] The EITF intends to discuss this issue further at its November 15—16, 1995 meeting.

[8] See footnote 7.

- *Technical Practice Aids*—Subscription (Product No. G01031HV, $125 members) or Annual Edition (Product No. 016971HV, $97.50 members/$107.50 nonmembers)
- *Audit and Accounting Guides*—Subscription (Product No. G01009HV, $345 members/$400 nonmembers)

These products are compatible with computer systems that have the following specifications:

- IBM PC or 100 percent compatible systems
- DOS 2.0 (or higher)
- 512K RAM minimum
- Single diskette and hard drive

FASB Financial Accounting Research System for Windows™ on CD-ROM

.155 The Windows version of the Financial Accounting Research System (FARS) is now available from the FASB. For ordering information, call the FASB at (203) 847-0700, extension 558. FARS for Windows is designed to be loaded on your hard drive and is available on CD-ROM or on Diskettes (currently ten). Updates to FARS will be sent approximately four times a year as appropriate with the issuance of new documents. FARS includes the following pronouncements:

- *Original Pronouncements*—FASB and AICPA pronouncements (including totally superseded pronouncements): FASB Statements, Interpretations, Technical Bulletins, Concepts Statements, ARBs 43–51; APB Opinions and Statements; AICPA Accounting Interpretations and Terminology Bulletins
- *Current Text*—Integration of financial accounting and reporting standards arranged by topic. Contains General Standards, Industry Standards, and *Current Text* sections that have been totally superseded but are still applicable due to a delayed effective date.
- *EITF Abstracts*—Full text of each abstract for every issue discussed by the FASB's Emerging Issues Task Force since its inception in 1984. Also includes EITF topical index.
- *Implementation Guides*—Questions and answers from FASB Special Reports and other published implementation guidance
- *Comprehensive Topical Index*—References linked to appropriate sections in the above.

System Requirements:

- Intel-compatible 80386 processor or greater
- Four MB of RAM (8MB or more recommended)
- Microsoft Windows™ 3.1 running in enhanced mode
- Fixed disk (hard drive) containing 25 megabytes of free disk space
- A monitor
- Use or other Microsoft-compatible input device

FARS is also available in a DOS version on Diskette only. Call (203) 847-0700 extension 575 for details on the DOS version of FARS or for technical questions on the Windows version.

Pricing:

For a single-user system—The cost for the service is $448 for members and academics. For all others the cost is $560.

For network application—CD-ROM (or one set of ten diskettes) with documentation will be provided for each network. The pricing is based on concurrent usage, and you must have a reasonable mechanism or process in place to assure that the number of concurrent users of FARS does not exceed the number of concurrent FARS users declared for your network. Cost of first user is $448 for members[9] and academics, $560 for all others. For each additional user, the cost is $396 for members and academics, $495 for all others.

Industry Developments

.156 The AICPA issues Audit Risk Alerts that focus on recent developments in various industries to provide auditors with overviews of current economic, industry, regulatory, and professional developments. The following industries are covered:

- Agribusiness [AAM section 8080]
- Airlines [AAM section 8090]
- Banks and Savings Institutions [AAM section 8050]
- Casinos [AAM section 8110]
- Common Interest Realty Associations [AAM section 8100]
- Construction Contractors [AAM section 8120]
- Credit Unions [AAM section 8020]
- Employee Benefit Plans [AAM section 8060]
- Federal Government Contractors [AAM section 8130]
- Finance Companies [AAM section 8140]
- Health Care [AAM section 8030]
- High-Technology Enterprises [AAM section 8200]
- Insurance Companies [AAM section 8040]
- Investment Companies [AAM section 8150]
- Not-for-Profit Organizations [AAM section 8180]
- Oil and Gas Producers [AAM section 8160]
- Public Utilities [AAM section 8220]
- Real Estate Companies [AAM section 8210]
- Securities [AAM section 8170]
- State and Local Governments [AAM section 8070]

Copies of these industry developments are available from the AICPA Order Department at (800) TO-AICPA. The cost is $6.50 each to members and $7.25 each to nonmembers. They are also included in the loose-leaf service for Audit and Accounting Guides.

Information Technology Division Publications

[9] Member of the Financial Accounting Foundation and Accounting Research Association of the AICPA.

.157 The AICPA's Information Technology Division has published the following documents that may be useful to auditors. To order, call the AICPA Order Department at (800) TO-AICPA. Product numbers and prices are shown in parentheses.

- Practice Aid, *CPA Firm Technology Planning Guide* (Product No. 038510HV, $10.25 members/$11.25 nonmembers). This Practice Aid is designed to help firms implement new technology and includes a technology planning checklist and sample plan.
- Practice Aid, *Computer Disaster Recovery Planning Guide* (Product No. 043003HV, $20 members/$22 nonmembers). This Practice Aid is designed to help entities implement a computer disaster recovery plan. The aid discusses, among other things, general office and personnel procedures, tape backup procedures, tape rotation, and virus protection software.
- Practice Aid, *Image Processing and Optical Character Recognition* (Product No. 043000HV, $14.50 members/$16 nonmembers). This Practice Aid is designed to help firms implement image processing and optical character recognition (OCR) and includes a diagram of an image processing system and a description of the technical architecture used by one organization. Image processing and OCR are two technologies that accounting professionals are encountering in their daily operations. They enable organizations to become more efficient and to provide better customer service.
- Practice Aid, *Information Security* (Product No. 043007HV, $17 members/$18.75 nonmembers). This Practice Aid explores the various elements of information security in relation to audit implications, MAS opportunities, client service delivery, and general awareness.
- Practice Aid, *Microcomputer Security* (Product No. 043005HV, $20 members/$22 nonmembers). This Practice Aid is designed to give organizations an overview of microcomputer security, and considers a number of common problems of microcomputer security.
- Practice Aid, *Quick Response* (Product No. 043008HV, $17 members/$18.75 nonmembers). This Practice Aid describes the various technologies that support Quick Response, along with the benefits to retailers and suppliers for implementing this strategy. Quick Response is a strategy that attempts to best meet the needs of the ultimate consumer by developing new business relationships and using technology to get products quickly through the merchandise pipeline.
- Practice Aid, *EDI Control, Management and Audit Issues* (Product No. 043004HV, $30 members/$33 nonmembers). This Practice Aid is a practical guide for CPAs involved with EDI. It is a reference document that contains all the essential and pertinent informative material on the various management, legal, and audit aspects of EDI.
- Technology Bulletin, *Client/Server Computing and Cooperative Processing* (Product No. 043006HV, $17 members/$18.75 nonmembers). This Technology Bulletin examines the capabilities and features of client/server computing—one of the hottest terms in the information technology industry today. Client/server computing has allowed many organizations to reduce their computing costs by off-loading processing from the mainframe to more affordable, smaller machines.
- Technology Bulletin, *Executive Information Systems* (Product No. 043002HV, $20 members/$22 nonmembers). This Technology Bulletin is designed to inform accounting professionals about the capabilities and features of today's executive information systems.
- Technology Bulletin, *Memory Management* (Product No. 043001HV, $20 members/$22 nonmembers). This Technology Bulletin is designed to help accounting professionals understand the issue of personal computer memory management and how to take full advantage of their computer's resources.

AICPA Services

Accountants Forum

.158 The AICPA has established a national "Accountants Forum" that is available on the CompuServe Information Network. The Accountants Forum enables participants to access information and communicate with each other, the AICPA, and state societies via CompuServe. The Accountants Forum was launched on June 30, 1995, and contains the following components:

1. *Library*—Contains nonauthoritative professional information developed by the AICPA and thirty-five participating state CPA societies, such as exposure drafts of proposed standards, practice aids, and newsletters. Users are able to search and download Library files. Information about AICPA activities, including task force and committee meetings, are posted in the Library.
2. *Message Center*—Functions as a bulletin board through which participants may post public messages, questions, and responses.
3. *Conference Center*—Enables individuals or groups to conduct informal online conversations, as well as formal moderated conferences.
4. *Catalog*—Enables members to access AICPA and state society catalogs, order advertised products, and register for conferences and continuing professional education courses. (Available in late 1995.)
5. *Research Database*—Enables users to search authoritative professional literature. (Available in late 1995.)

Accountants Forum users also have unlimited access to CompuServe's many services, including e-mail, travel reservations, news services, and other reference sources. AICPA members, participant state societies, and the general public who already use CompuServe can access the Accountants Forum either by entering the "GO AICPA" command or, if they are using CompuServe's "WinCIM" software, clicking on the "Professional" button on the main menu and selecting Accountants Forum. To sign up for a CompuServe account (and receive free communications software and a $25 usage credit), call (800) 524-3388 and ask for the "AICPA Package" or "rep no. 748." Users are charged $9.95 per month for CompuServe (including five free hours), plus $2.95 an hour after the fifth hour.

Technical Hotline

.159 The AICPA's Technical Information Service answers inquiries about specific audit or accounting problems. Call toll-free (800) TO-AICPA.

Professional Ethics Division

.160 The AICPA's Professional Ethics Division answers inquiries about the application of the AICPA Code of Professional Conduct. Call toll-free (800) TO-AICPA.

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.161 This Audit Risk Alert supersedes *Audit Risk Alert—1994.*

[The next page is 8055.]

AAM Section 8015

Compilation and Review Alert—1995/96

NOTICE TO READERS

This Compilation and Review Alert is intended to provide CPAs with an overview of recent practice developments and professional standards that may affect the compilations and reviews they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Introduction

.01 *Compilation and Review Alert—1995/96* is a nonauthoritative practice aid designed to help accountants plan and perform their 1995 compilation and review engagements. It clarifies certain existing professional standards, suggests ways of implementing AICPA Statements on Standards for Accounting and Review Services (SSARSs) in special circumstances, points out pitfalls that frequently occur in compilation and review engagements, and summarizes new professional pronouncements.

Proposed Assembly Service

.02 In September 1995, the Accounting and Review Services Committee issued an exposure draft of a proposed SSARS titled *Assembly of Financial Statements for Internal Use Only.* The proposed Statement would provide an optional exemption from the requirements of SSARS No. 1, *Compilation and Review of Financial Statements* (AR section 100), if the CPA assembles financial statements for a client who agrees to restrict the distribution of the statements to internal use only. The proposed Statement defines the assembly of financial statements as:

> Providing various manual or automated bookkeeping or data processing services the output of which is in the form of financial statements intended for internal use only. The function of assembling financial statements may include preparing a working trial balance, assisting in adjusting the books of account, and consulting on accounting matters. Assembly does not refer to the mere typing or reproduction of client-prepared financial statements.

.03 The proposed Statement introduces a new type of financial statement service for nonpublic entities and does not preclude an accountant from performing a compilation engagement in accordance with SSARS No. 1 (AR section 100). SSARS No. 1 (AR section 100) requires that an accountant at least compile financial statements that he or she submits to a client or others, and report on them accordingly.

.04 The proposed Statement would require that an accountant establish a written understanding with his or her client that includes the following:

- A description of the nature and limitations of the services to be performed
- A confirmation of management's representation and agreement that the financial statements are for internal use only
- A statement that the engagement cannot be relied upon to disclose errors, irregularities, or illegal acts

An illustrative engagement letter, setting forth the understanding with the client, is included in Appendix A of the proposed Statement.

.05 The accountant would not be required to report on assembled financial statements. However, the proposed Statement would provide the accountant with the option of enclosing a transmittal letter with the financial statements, if the contents of the letter were limited to the following:

- An identification of the financial statements enclosed
- A reference to the fact that the financial statements are for internal use only pursuant to the terms of the engagement letter
- Comments of a business advisory nature to which the accountant wishes to draw the client's attention

To reduce the risk of misunderstanding, language or style similar to that used in a compilation report is to be avoided. An sample transmittal letter is included in Appendix B of the proposed Statement.

.06 The proposed Statement also provides the accountant with the option of placing a legend on each page of the financial statements indicating that the statements are restricted to internal use and referring the reader to the engagement letter.

.07 Proponents of the proposed assembly service believe that many nonpublic entities do not need financial statements that comply in all material respects with generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA) if the statements are for internal use only. They point out that many large public companies obtain this kind of internal information by performing a "soft close" that eliminates many of the adjustments required for GAAP financial statements. As stated previously, existing standards require that CPAs who submit financial statements to their clients or others at least compile the financial statements and report on them accordingly. If the financial statements contain departures from GAAP or an OCBOA, the CPA is required to cite those departures in a separate paragraph of the compilation report. Proponents of the proposal believe that these requirements add unnecessary time and cost to engagements.

.08 Opponents of the proposal agree that many nonpublic entities may not need financial statements that comply in *all* material respects with GAAP or an OCBOA. However, they believe that the proposed Statement does not establish a minimum level of adherence to GAAP or an OCBOA and therefore permits an unacceptably lower range of financial statement quality. They also believe that an assembly service is not needed because existing standards provide the accountant with various options for performing less complex and less time-consuming compilations.

.09 The closing date for comments on the proposed Statement is December 31, 1995. To obtain a free copy of the proposed Statement, write or fax the AICPA Order Department and request Product No. 800097. For ordering information, see "Order Department" in the "AICPA Services" section of this Compilation and Review Alert.

Alternatives to Full-Disclosure GAAP Financial Statements

.10 The requirements for a SSARS compilation include—

- Acquiring knowledge about the accounting principles and practices of the industry in which the entity operates that will enable the accountant to compile financial statements that are appropriate in form for an entity operating in that industry.
- Obtaining a general understanding of the nature of the entity's business transactions, the form of its accounting records, the stated qualifications of its accounting personnel, the accounting basis on which the financial statements are to be presented, and the form and content of the financial statements.
- Reading the compiled financial statements and considering whether they appear to be appropriate in form and free of obvious material errors.
- Reporting on the financial statements.

.11 If the financial statements contain departures from GAAP, the accountant is required to disclose the departures in his or her report. The dollar effects of GAAP departures on the financial statements must be disclosed in the report if they have been determined by management or are known as a result of the accountant's procedures. However, *the accountant is not required to determine the effects of the departures if management has not done so.* In that case, the accountant need only add a statement to the report indicating that the effects of the departures have not been determined.

.12 Even with the limited requirements of a compilation, some practitioners believe that a standard compilation service provides certain clients with more information than they need. Those practitioners should be aware that existing standards enable practitioners to perform several scaled-down versions of the standard compilation service that might better suit certain clients' needs. SSARS No. 1 (AR section 100) provides the accountant with the option of compiling financial statements that omit substantially all of the disclosures required by GAAP or an OCBOA. In this kind of engagement, the CPA need only be concerned with measurement departures and may omit all of the disclosures required by GAAP or an OCBOA, as long as the report is modified to alert financial statement users to the omission of the disclosures. Paragraphs 19 through 21 of SSARS No. 1 (AR section 100.19-.21) provide performance and reporting guidance for such engagements.

.13 A second option is for the CPA to compile financial statements using an OCBOA such as the cash basis, and to omit substantially all disclosures. Such financial statements generally will be less complex and will require less preparation time. Another option is for the accountant to compile OCBOA financial statements with substantially all disclosures omitted at interim periods, and GAAP financial statements with full disclosures at year end.

.14 If a CPA compiles cash-basis interim financial statements with substantially all disclosures omitted, the compilation report generally will not change from period to period because only items representing departures from the cash basis would have to be identified in the compilation report, and such departures are extremely rare. Following is an illustrative compilation report for cash-basis financial statements that omit substantially all disclosures, including disclosure of the basis of accounting:

> I (We) have compiled the accompanying statement of assets, liabilities, and equity—cash basis of XYZ Company as of December 31, 19XX, and the related statement of revenue collected and expenses paid for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The financial statements have been prepared on the cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.
>
> A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.
>
> Management has (The owners have) elected to omit substantially all of the disclosures ordinarily included in financial statements prepared on the cash basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Company's assets, liabilities, equity, revenue, and expenses. Accordingly, these financial statements are not designed for those who are not informed about such matters.

Note that the last sentence in the first paragraph of the illustrative report discloses the basis of accounting used in the financial statements. This sentence is necessary if the financial statements do not disclose the basis of accounting used. Paragraph 20 of SSARS No. 1 (AR section 100.20) requires that the basis of accounting be disclosed in the accountant's report if it has not been disclosed in the financial statements. (For additional information about OCBOA financial statements, see the "Other Comprehensive Basis of Accounting (OCBOA) Financial Statements" section of this Compilation and Review Alert.)

.15 A third option is for the CPA to compile GAAP financial statements and predetermine, in consultation with the client, which adjustments will be made to the financial statements and which adjustments will be omitted, based on the client's needs. For example, it may be decided that pension and bonus accruals will be made at year end but not at interim periods. In those circumstances, the CPA may draft, in advance, pro forma interim compilation reports listing (but not quantifying) all planned GAAP departures. This option enables the CPA to compile less complex financial statements that are accompanied by a report alerting financial statement users to the departures in the statements. In conjunction with this approach, a client may use the gross profit method of estimating the valuation of ending inventory at interim periods and other estimates provided for in Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting* (AC I73).

.16 Finally, a fourth option is for the CPA to provide his or her client with monthly reports containing only selected information requested by the client. This information may consist of selected account balances, such as cash or accounts receivable; operating information, such as the number of meals served during a particular month; or a combination of financial and operating information. Interpretation No. 8 of SSARS No. 1, "Reports on Specified Elements, Accounts, or Items of a Financial Statement" (AR section 9100.27-.28), excludes presentations of elements, accounts, or items of a financial statement from the applicability of SSARS No. 1 (AR section 100) because that standard provides guidance on the compilation and review of financial statements, and presentations of specified elements, accounts, or items of a financial statement are not financial statements. Thus, the accountant is not required to report on such presentations unless the accountant is engaged to do so under AICPA Statement on Auditing Standards (SAS) No. 62, *Special Reports* (AU section 623), SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622), or AICPA Statement on Standards for Attestation Engagements (SSAE) No. 4, *Agreed-Upon Procedures Engagements* (AT section 600).

Agreed-Upon Procedures Engagements

.17 In September 1995, the AICPA's Auditing Standards Board (ASB) issued SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600). SAS No. 75 (AU section 622) supersedes SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement.* Both standards are effective for reports dated after April 30, 1996, with earlier application encouraged.

.18 The similarity between the two new standards has led to calling them "the mirror standards;" however, there is an important difference between these standards. SAS No. 75 (AU section 622) is applicable if a practitioner applies agreed-upon procedures to specified elements, accounts, or items of a financial statement, and SSAE No. 4 (AT section 600) generally is applicable if a practitioner applies agreed-upon procedures to nonfinancial statement subject matter, for example, reviewing employee personnel files to determine whether each employee meets the minimum education requirements specified for that position in the company's manual. Another difference between the two standards is that SSAE No. 4 (AT section 600) requires a written assertion from management as a condition of engagement performance and SAS No. 75 (AU section 622) does not because assertions are considered to be embodied in the elements, accounts, or items of a financial statement, if the basis of accounting is clearly evident.

.19 Although SAS No. 75 (AU section 622) is lodged in the auditing standards, a CPA is not required to compile, review, or audit the financial statements or components of the financial statements in order to apply agreed-upon procedures to the components. In an SAS No. 75 (AU section 622) engagement, the accountant applies procedures that have been agreed upon by the specified users to elements, accounts, or items of a financial statement, and issues a report describing his or her procedures and findings. SAS No. 75 (AU section 622) defines a specified element, account, or item of a financial statement as accounting information that is part of but significantly less than a financial statement. The accounting information may be directly identified in the financial statement (accounts receivable) or it may be derived from analysis (accounts receivable aged over 30 days), aggregation (total expenses in December), summarization (assets, liabilities, and owners' equity), or mathematical computation (average monthly sales). It may also include quantitative information derived from the accounting records that is not expressed in monetary terms, for example, the number of units of inventory.

.20 In an SSAE No. 4 (AT section 600) engagement, the practitioner performs agreed-upon procedures on the subject matter of an assertion. SSAE No. 4 (AT section 600) defines an assertion as any declaration or set of related declarations taken as a whole by a party responsible for it. An example of an assertion by management is, "All checks that cleared through the ABC bank account during May 1995 were signed by two authorized signers, as that term is defined in the ABC bank resolution." Although this assertion relates to a component of a financial statement, the engagement would be performed under SSAE No. 4 (AT section 600) because it addresses compliance with the firm's policies.

.21 Both standards were issued because there was wide diversity in the performance of agreed-upon procedures engagements, and also because existing guidance did not address significant issues related to these engagements.

.22 The new standards provide guidance on the following:

- The conditions for performing agreed-upon procedures engagements
- The nature, timing, and extent of the procedures
- The responsibilities of practitioners and specified users
- Reporting on procedures performed and related findings

Both SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) provide detailed reporting guidance, including illustrative reports. These standards also provide guidance on combined reporting, that is, reporting when the practitioner is engaged to perform agreed-upon procedures as part of or in addition to another form of service, for example, performing agreed-upon procedures and a compilation of financial statements. CPAs who perform agreed-upon procedures in conjunction with a compilation or review engagement should be aware that the agreed-upon procedures standards limit the distribution of the reports to specified users; therefore, including or combining an agreed-upon procedures report with a compilation or review report restricts the distribution of all the included reports to the specified users.

.23 Both SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) prohibit practitioners from expressing negative assurance in agreed-upon procedures reports. An example of a statement expressing negative assurance is the following:

> Nothing came to my attention that caused me to believe that all checks that cleared through the ABC bank account during May 1995 were not signed by two authorized signers, as that term is defined in the ABC bank resolution.

The ASB has prohibited the expression of negative assurance in agreed-upon procedures reports because such language could cause users to conclude that a practitioner is communicating assurance beyond the findings in his or her report. The ASB has decided that negative assurance should be reserved for review level engagements. The predecessor agreed-upon procedures standards permitted practitioners to express negative assurance in agreed-upon procedures reports.

Representation Letters

.24 A CPA is required to obtain a representation letter from his or her client when performing a SSARS review engagement for an interim or annual period. This requirement was established in November 1992 and is specified in paragraph 28 of SSARS No. 1 (AR section 100.28) as follows:

> The accountant is required to obtain a representation letter from members of management whom the accountant believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered in the representation letter. Normally, the chief executive officer and chief financial officer should sign the representation letter.

The illustrative representation letter shown in Appendix D of SSARS No. 1 (AR section 100.55) would have the client state to the best of his or her knowledge and belief that the financial statements present the financial position, results of operations, and cash flows of the entity in conformity with GAAP. Many clients are uncomfortable about making such a representation because their limited knowledge of accounting principles leads them to believe that they have no basis for making such a representation.

.25 Here is a modification of the illustrative representation letter in Appendix D of SSARS No. 1 (AR section 100.55) designed to make clients feel more comfortable about signing a representation letter. (Deletions from the illustrative representation letter in Appendix D of SSARS No. 1 (AR section 100.55) are shown with strike-throughs, and new language is shown in bold-faced italics.)

[Date of accountant's report]

[To the Accountant]

In connection with your review of the [identification of financial statements] of [name of client] as of [date] and for the [period of review] for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your review.

1. The financial statements referred to above present the financial position, results of operations, and cash flows of [name of client] in conformity with generally accepted accounting principles. ***We are responsible for the fair presentation in the financial statements of the financial position, results of operations, and cash flows of [Name of client] in conformity with generally accepted accounting principles [Other basis of accounting]. However, because of our limited expertise with generally accepted accounting principles, including financial statement disclosure, we have engaged you to advise us in fulfilling that responsibility.*** In ~~that~~ connection, ***with the review of the aforementioned financial statements,*** we specifically confirm that—

The remaining representations in the illustrative representation letter in Appendix D (AR section 100.55) are unchanged. However, practitioners should remember that the representation letter in Appendix D (AR section 100.55) is presented for illustrative purposes only and should be tailored to the circumstances of the specific review engagement.

.26 Another way of making a client feel more at ease about signing a representation letter is to familiarize the client with the purpose and contents of a representation letter. The Auditing Standards Division of the AICPA has prepared a pamphlet, entitled "The Representation Letter in a SSARS Review Engagement," that is intended for clients who are unfamiliar with representation letters and who may not have signed one before. The pamphlet is reprinted as Appendix A to this Compilation and Review Alert. Copies of the pamphlet may be ordered from the AICPA Order Department (Product No. 055120HU, $17.50 per 25 copies for members/$20 per 25 copies for nonmembers). For ordering information, see "Order Department" in the "AICPA Services" section of this Compilation and Review Alert.

Personal Financial Statements

.27 CPAs are frequently engaged to compile or review the personal financial statements of individuals or families applying for credit; performing income tax, retirement, gift, or estate planning; or providing public disclosure about their financial affairs; for example, individuals seeking public office. Accountants engaged to compile or review personal financial statements should be aware of several professional standards that are applicable to these engagements.

.28 AICPA Statement of Position (SOP) 82-1, *Accounting and Financial Reporting for Personal Financial Statements*, establishes the accounting standards for GAAP-basis personal financial statements. The SOP requires that assets be stated at their estimated current values and liabilities at their estimated current amounts at the date of the financial statements. Paragraph 12 of the SOP defines estimated current values of assets in personal financial statements as the amount at which the item could be exchanged between a buyer and seller, each of whom is well informed and willing, and neither of whom is compelled to buy or sell. If the costs of disposing of the assets are material, they are considered in determining the estimated current values. Paragraph 27 of the SOP defines the estimated current amount of a liability as the discounted amount of cash to be paid.

.29 The estimated current values of assets and the estimated current amounts of liabilities are ordinarily determined by looking to recent transactions involving similar assets and liabilities in similar circumstances. However, if such information is not available, other methods of valuing the assets and liabilities may be used such as the capitalization of past or prospective earnings, the use of liquidation values, the adjustment of historical cost based on changes in a specific price index, the use of appraisals, and the use of the discounted amounts of projected cash receipts and payments. The method used for valuing assets and liabilities should be followed consistently from period to period unless the facts and circumstances indicate a need to change to a different method.

.30 SSARS No. 1 (AR section 100) is applicable to the compilation and review of personal financial statements. Paragraph 2.03 of the AICPA *Personal Financial Statements Guide* indicates that, ordinarily, an accountant can compile personal financial statements based on his or her client's representations about the estimated current values and amounts of assets and liabilities. However, when compiling personal financial statements, the accountant should at least obtain an understanding of the methods by which the client determined the values and amounts of significant assets and liabilities, and consider whether the methods are appropriate in light of the nature of each asset or liability.

.31 Although SOP 82-1 requires that assets and liabilities be recognized on an accrual basis for the financial statements to be in conformity with GAAP, a client may present financial statements using an OCBOA such as the cash, income tax, or historical-cost basis, as long as either the financial statements or the accountant's report discloses the basis of accounting used. Footnote 6 of SSARS No. 1 (AR section 100.04) refers the reader to paragraph 7 of SAS No. 62 (AU section 623.07) which indicates that if an OCBOA is used, the titles of the financial statements should be modified to reflect the basis of accounting used. For example, if the statements are prepared using the historical-cost basis, the title of the statement of financial condition (equivalent to a balance sheet) could be modified to read, "Balance Sheet—Historical Cost Basis," and if the statements are prepared using the tax basis, the title of the statement of financial condition could be modified to read, "Statement of Assets and Liabilities—Income Tax Basis."

.32 The AICPA *Personal Financial Statements Guide* (Product No. 011133HU, $28 for members/$31 for nonmembers) provides detailed guidance about accounting, performance, and reporting aspects of engagements involving personal financial statements. For ordering information, see "Order Department" in the "AICPA Services" section of this Compilation and Review Alert.

.33 SSARS No. 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (AR section 600), may also be applicable to engagements involving personal financial statements. SSARS No. 6 (AR section 600) provides an exemption from SSARS No. 1 (AR section 100) for personal financial statements included in written personal financial plans if the following conditions exist:

a. The accountant establishes an understanding with the client, preferably in writing, that the financial statements—

(i) Will be used solely to assist the client and the client's advisers in developing 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.

.34 The following is an example of the report that is issued when an accountant uses the exemption provided by SSARS No. 6 (AR section 600).

> The accompanying Statement of Financial Condition of X, as of December 31, 19XX, was prepared solely to help you develop your personal financial plan. Accordingly, it may be incomplete or contain other departures from generally accepted accounting principles 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.

Each of the personal financial statements should include a reference to the accountant's report.

Graphs Accompanying Financial Statements

.35 Graphs depict quantitative trends and relationships in a simple and succinct way. The advent and availability of easy-to-use computer software capable of generating graphs has resulted in an increase in the inclusion of graphs in financial-statement presentations, and has prompted accountants to inquire about their reporting responsibility for graphs accompanying financial statements in compilation and review engagements.

.36 Graphs accompanying financial statements may depict information—

- Identified in the financial statements, for example, a pie chart depicting the various components of sales, general, and administrative expenses.
- Derived from the accounting records, for example, a bar graph depicting sales by product line.
- Derived from sources outside the financial statements and accounting records, for example, a pie chart depicting square feet of selling space by product line.

.37 Although SSARS No. 1 (AR section 100) does not specifically address the topic of reporting on graphs accompanying financial statements, paragraph 43 of SSARS No. 1 (AR section 100.43) describes the accountant's reporting responsibility for information accompanying the basic financial statements for supplementary analysis purposes. Because SSARS No. 1 (AR section 100) does not define the phrase "information for supplementary analysis purposes," many practitioners interpret this phrase broadly to include graphs accompanying the financial statements.

.38 Paragraph 43 of SSARS No. 1 (AR section 100.43) states that an accountant may compile supplementary information if the basic financial statements have been compiled, and may either compile or review supplementary information if the basic financial statements have been reviewed. However, a practical and conservative approach would be to compile, rather than to review, graphs accompanying financial statements because of the absence of authoritative standards and criteria for these presentations.

.39 Although paragraph 43 (AR section 100.43) provides reporting guidance for compiled supplementary information, it does not provide guidance on the procedures to be performed. It would seem that the accountant is to adapt and apply the compilation procedures applied to financial statements to the supplementary information. The following are some of the procedures an accountant might consider performing when compiling graphs accompanying financial statements:

- Read the title, captions, and numerical information included in the graph to determine whether that information agrees with the information presented in the financial statements.

- Consider whether the graph's pictorial representation agrees with the quantities and relationships it purports to represent. For example, comparative financial statements might indicate that the increase in net income from 1994 to 1995 is 10 percent, and the captions in the bar graph might accurately identify the amount of net income in each year. However, the graph might be drawn so that the increase in the height of the 1995 bar is significantly greater than 10 percent.

If the accountant concludes that there is a material inconsistency between the graph and the financial statements, the accountant should determine whether the financial statements, the graph, or both require revision. If the accountant concludes that either or both require revision, the accountant should ask the client to revise the incorrect or misleading information. If the information is not revised to eliminate the problem, the accountant should consider revising the report to describe the inconsistency or misleading information or should consider withdrawing from the engagement.

Financial Statements Submitted in Litigation Support Engagements Involving Bankruptcy and Reorganization

.40 CPAs who provide litigation services in the areas of bankruptcy and reorganization may be asked to prepare financial presentations for their client's submission to the court. An example of such a presentation is the monthly operating report that must be submitted to the court by the trustee or debtor in possession in a Chapter 11 bankruptcy proceeding. The monthly operating report and other similar financial presentations may be deemed financial statements and ordinarily, submission of such financial statements would require that the accountant at least compile the financial statements in accordance with SSARS No. 1 (AR section 100). However, Interpretation No. 20 of SSARS No. 1, "Applicability of Statements on Standards for Accounting and Review Services to Litigation Services" (AR section 9100.76-.79), exempts such financial statements from the applicability of SSARS if the following apply:

1. The statements are submitted in conjunction with litigation services that involve pending or potential formal legal or regulatory proceedings before a trier of fact.[1]

2. The services are in connection with the resolution of a dispute between two or more parties.

3. One of the following four criteria is met.

   a. The service consists of being an expert witness.

   b. The service consists of being a trier of fact or acting on behalf of one.

   c. The accountant's work under the rules of the proceedings is subject to detailed analysis and challenge by each party to the dispute.

   d. The 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.

In legal bankruptcy or reorganization proceedings, the representatives of the creditors, debtors, lenders, stockholders, and other parties-in-interest are provided with access to the financial statements submitted to the court and also have the opportunity to analyze and challenge the financial statements. This would meet the criteria in item *c* above, and because the first two criteria are also met, would exempt the financial statements from the applicability of SSARS No. 1 (AR section 100).

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

.41 It should be noted that SSARS No. 1 (AR section 100) would be applicable to financial statements submitted in conjunction with litigation services if, under the rules of the proceedings (1) the parties did *not* have the opportunity to analyze and challenge the accountant's work, or (2) if the CPA were specifically engaged to compile the financial statements.

Campaign Reports

.42 Candidates running for elected office generally are required by state or federal law to file a report with the applicable state or federal regulatory agency indicating the amounts and sources of contributions received, and the amounts and purposes of expenditures made during a specified period. Recently, the Auditing Standards Division of the AICPA received an inquiry about a CPA's reporting responsibility when engaged to prepare a campaign report for a candidate running for public office.

.43 The state campaign report that was brought to our attention included, in addition to several other preprinted forms, a form requiring the following information:

- Subtotals of each type of receipt, and a total of all receipts
- Subtotals of each type of disbursement, and a total of all disbursements
- A financial summary beginning with funds on hand at the beginning of the period, adding total receipts for the period, subtracting total disbursements for the period, and ending with total funds on hand at the end of the period

.44 Paragraph 4 of SSARS No. 1 (AR section 100.04) defines a financial statement as—

> A presentation of financial data, including accompanying notes derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles.

Further, paragraph 2 of SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AR section 300.02), defines a prescribed form as the following:

> 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.

Based on these two definitions, the financial presentation included in the campaign report is a prescribed-form financial statement that should be compiled in accordance with SSARS No. 3 (AR section 300).

.45 If the CPA is serving as treasurer for the candidate or campaign committee, the CPA should not compile the financial statements. A compilation report is used by an outside accountant to report on financial statements that are the representations of another party. As treasurer, the CPA is a member of management and should not report on his or her own representations.

Performing a Lower Level of Service

.46 Practitioners frequently ask whether they may accept an engagement to perform a lower level of service on financial statements they have previously audited or reviewed, or whether they may compile financial statements that omit substantially all disclosures required by GAAP or an OCBOA after having compiled, reviewed, or audited full-disclosure financial statements. This situation is to be differentiated from a step-down request that involves changing the level of service while the engagement is in process.

.47 Paragraph 5 of SSARS No. 1 (AR section 100.05) states that an accountant who performs more than one service on the same set of financial statements (for example, a compilation and an audit), should issue a report on the highest level of service rendered.

.48 Interpretation No. 3 of SSARS No. 1, "Reporting on the Highest Level of Service" (AR section 9100.06-.12), further clarifies this guidance by stating the following:

- An accountant who performs more than one service on the same set of financial statements (for example, a compilation and an audit) will not be required to issue a compilation and an audit report. The accountant need only issue the report on the highest level of service performed (the audit report).
- An accountant may accept an engagement to perform a higher level of service on financial statements that he or she previously compiled or reviewed.

SSARS provides fairly clear guidance on matters related to performing a *higher* level of service, but is less clear on the question of whether an accountant may perform a *lower* level of service.

.49 Some practitioners are reluctant to compile financial statements they have previously audited or reviewed because the accountant's compilation report will read, "I have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them." They conclude that the disclaimer in the report would be misleading to financial statement users because the accountant has, in fact, audited or reviewed the financial statements. These practitioners believe that the aforementioned disclaimer precludes the accountant from compiling financial statements after auditing or reviewing them. The Auditing Standards Division interprets the disclaimer in the compilation report to be engagement-specific and, therefore, concludes that the disclaimer refers only to the financial statements that accompany the accountant's report.

.50 Practically, this matter should only present a problem if the accountant is engaged to compile financial statements that omit substantially all disclosures after compiling, reviewing, or auditing full-disclosure financial statements, because compiled, reviewed, and audited financial statements should all contain the same information. Such a request might arise, for example, if a client wishes to provide its vendors with compiled financial statements that omit substantially all disclosures.

.51 Paragraph 19 of SSARS No. 1 (AR section 100.19) provides indirect guidance on this matter. It states that an accountant may compile financial statements that omit substantially all disclosures provided the omission of the disclosures is indicated in the report and is not, to the accountant's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use the financial statements. If the accountant believes that the client's intent is to mislead users, the accountant should not comply with the request. However, if the accountant concludes that it is not the client's intent to mislead users, it would be appropriate to compile financial statements with substantially all disclosures omitted after having compiled, reviewed, or audited full-disclosure financial statements.

.52 Additional guidance is found in a footnote to paragraph 5 of SSARS No. 1 (AR section 100.05) indicating that an accountant who has reviewed financial statements may subsequently issue a compilation report on financial statements for the same period if they are included in a prescribed form that calls for departure from GAAP.

Common Compilation and Review Engagements Deficiencies

.53 Following are deficiencies that were frequently noted in recent peer and quality review letters of comment on compilation and review engagements and, where applicable, a reference to the appropriate professional standard.

Common Reporting Deficiencies

.54 The accountant's report—

- Did not refer to all periods presented in the financial statements. Paragraph 2 of SSARS No. 2, *Reporting on Comparative Financial Statements* (AR section 200.02), requires that the accountant's report cover each period presented if comparative financial statements are presented.
- Did not disclose the basis of accounting used when the financial statements were prepared using a comprehensive basis of accounting other than GAAP and the financial statements did not disclose the basis. Paragraph 20 of SSARS No. 1 (AR section 100.20) requires that the basis of accounting be disclosed in the accountant's report if the financial statements are compiled in conformity with a basis of accounting other than GAAP, and the statements do not disclose the basis of accounting.
- Did not refer to accompanying supplementary information. Paragraph 43 of SSARS No. 1 (AR section 100.43) requires that the accountant clearly indicate in his or her report the degree of responsibility he or she is taking with respect to supplementary information accompanying the financial statements.
- Made reference to financial statement titles that were different from the titles of the financial statements presented.
- Departed from the revised report wording established by SSARS No. 7. SSARS No. 7, *Omnibus Statement on Standards for Accounting and Review Services* (AR section 100.14 and .32), revised the wording of the SSARS compilation and review reports to clarify that the standards referred to in these reports are SSARSs. SSARS No. 7 (AR section 100.14 and .32, respectively), prescribe the required elements of a compilation and review report.
- For GAAP-basis financial statements, did not indicate that a statement of cash flows had been omitted. FASB Statement No. 95, *Statement of Cash Flows* (AC C25), requires a statement of cash flows as part of a full set of financial statements for all business enterprises.

Common Financial Statement Deficiencies

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- Interim GAAP-basis financial statements omitted provisions for income taxes, depreciation, and pensions, and the accountant's compilation or review report did not identify the omissions.
- OCBOA financial statements contained unmodified GAAP-basis titles such as "Balance Sheet" and "Income Statement." Footnote 6 of SSARS No. 1 (AR section 100.04) refers the reader to paragraph 7 of SAS No. 62 (AU section 623.07) for guidance on suitable titles for OCBOA financial statements.
- Each page of compiled or reviewed financial statements did not include a reference to the accountant's report. Paragraphs 16 and 43, respectively, of SSARS No. 1 (AR section 100.16 and .43) require that each page of compiled or reviewed financial statements include a reference such as "See Accountant's Compilation (Review) Report."
- Financial statements included improper classifications of noncurrent assets as current, or demand notes payable as long term.
- The notes to financial statements containing only selected disclosures were not appropriately labeled. Paragraph 19 of SSARS No. 1 (AR section 100.19) states, "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 Generally Accepted Accounting Principles Are Not Included."

Common Financial Statement Disclosure Deficiencies

.56 Financial statement disclosures concerning the following matters were omitted or incomplete:

- Related party transactions
- Pension plans
- Leases
- Current and deferred income taxes
- Concentrations of credit risk
- The amount of cash paid for interest and income taxes if the statement of cash flows was prepared using the indirect method

To avoid the inadvertent omission of required disclosures, many practitioners use a disclosure checklist that typically consists of a number of brief questions or statements accompanied by references to authoritative pronouncements. Checklists may be firm-generated or purchased from the AICPA or commercial publishers. The AICPA sells a generic corporation checklist and many industry-specific checklists. For additional information about these checklists, consult the *AICPA Catalogue of Publications*. A free catalogue may be obtained from the AICPA Order Department. For ordering information, see "Order Department" in the "AICPA Services" section of this Compilation and Review Alert.

Quality Control Deficiencies

.57 Quality control deficiencies included the following matters:

- Failure to document the firm's compliance with its independence policies and procedures
- Failure to document the resolution of independence questions
- Failure to document consultation that took place
- Little or no continuing professional education in areas related to the firm's practice
- Failure to perform, or inadequate inspection of the firm's accounting and auditing practice
- Failure to appropriately use reporting and disclosure checklists or other procedures to ensure that all required disclosures were made in the financial statements or that the appropriate report was issued in the circumstances
- Failure to perform or document analytical procedures and inquiries of management in a review engagement

Merger of AICPA Practice-Monitoring Programs

.58 In 1988, AICPA members approved an amendment to the Institute's bylaws requiring all AICPA members engaged in the practice of public accounting to practice only with a firm enrolled in an approved practice-monitoring program. Each of the approved programs requires a firm to have an independent review of its accounting and auditing practice every three years. The objectives of the programs are achieved through the performance of reviews tailored to the size of the firm and the nature of its practice. Generally, firms that perform audits of historical or prospective financial statements have on-site reviews, while firms that only perform compilation or review engagements have off-site reviews of selected reports on those services, unless they elect to have an on-site review.

.59 In 1988, a new program called the Quality Review Program was formed. Effective April 3, 1995, that program was combined with the Private Companies Practice Section (PCPS) Peer Review Program. The combined practice-monitoring program is now known as the AICPA Peer Review Program and is administered by the individual state societies in accordance with standards and procedures established by the AICPA Peer Review

Board. Firms that are members of the SEC Practice Section (SECPS) of the AICPA Division for CPA Firms are monitored under the SECPS Peer Review Program, administered by the AICPA.

.60 Some of the more significant changes resulting from the merger of the programs are outlined below:

- Reviews for PCPS member firms are now administered by the state societies.
- Peer reviews of PCPS member firms with 10 or fewer professional staff ordinarily test only four of the nine quality control elements (independence, consultation, supervision, and professional development); the objectives of the other five elements are considered during the review of selected accounting and auditing engagements. PCPS member firms were previously reviewed for compliance with all nine of the quality control elements, including the inspection element.[2]

.61 All firms are required to enroll in either the AICPA's Peer Review Program or the SECPS Peer Review Program and firms that perform *even one* audit, review, or compilation engagement also must have a review of their firm's practice.

Other Comprehensive Basis of Accounting (OCBOA) Financial Statements

.62 SAS No. 62 (AU section 623) indicates that financial statements may be prepared using a comprehensive basis of accounting other than GAAP. It defines an OCBOA as one of the following four:

1. A basis of accounting used to comply with the requirements of a governmental regulatory agency, such as a basis of accounting used by insurance companies to comply with the rules of a state insurance commission
2. A basis of accounting that the entity uses to file its income tax return
3. The cash receipts and disbursements basis of accounting and modifications of the cash basis having substantial support, such as recording depreciation on fixed assets or accruing income taxes
4. A definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting

.63 The two most frequently used OCBOAs are cash and tax. One of the problems encountered by OCBOA financial-statement preparers is the absence of authoritative accounting standards for these bases of accounting. This results in a great deal of variation in practice. For example, the cash basis of accounting, in its pure form, recognizes revenues and expenses based on the receipt and disbursement of cash. Since all cash disbursements are treated as expenses, the purchase of fixed assets or inventory would be recorded as an expense rather than as an asset. In practice, the pure cash basis of accounting is rarely used. Paragraph 4*c* of SAS No. 62 (AU section 623.04) sanctions variation in the cash basis of accounting because it states that modifications of the cash basis having substantial support, such as recording depreciation on fixed assets or accruing income taxes, are considered OCBOAs.

.64 AICPA Technical Practice Aid *Financial Statements Prepared Under an Other Comprehensive Basis of Accounting (OCBOA)* includes a section entitled "Substantial Support for Modifications in Cash Basis" (AICPA, *Technical Practice Aids*, vol. 1, section 1500.05), which clarifies the meaning of the term *substantial support* with respect to modifications of the cash basis of accounting. It states that ordinarily a modification has substantial support if it is equivalent to the accrual basis of accounting for that item and if the method is not illogical, such as recording revenue on the accrual basis and recording purchases and other costs on the cash basis.

.65 Modifications of the cash basis of accounting that have evolved through common usage and that are recognized as having substantial support in practice are recording—

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[2] In August 1995, the ASB issued an exposure draft of two proposed Statements on Quality Control Standards (SQCS) that would supersede SQCS No. 1, *System of Quality Control of a CPA Firm* (QC section 10). One of the proposed standards, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, would replace the nine specific quality control elements with five broad quality control elements.

- Property, plant, and equipment purchases as assets.
- Accumulated depreciation.
- Inventory purchases as an asset.
- Liabilities arising from the receipt of borrowed cash.
- Liabilities for payroll and withholding taxes not deposited with the IRS or a state or local governmental agency.
- Liabilities for income taxes.

Other matters to keep in mind when preparing OCBOA financial statements are addressed in the following sections.

Consistency

.66 When using an OCBOA, management should be consistent in its application to the financial statements as a whole. For example, use of the cash basis for expenses and liabilities, and the modified cash basis for revenues and receivables (accruing these items), would obviously result in misleading financial statements.

Financial-Statement Titles

.67 OCBOA financial-statements titles should alert readers to the basis of accounting used in the financial statements. Paragraph 7 of SAS No. 62 (AU section 623.07) states that the terms *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 conformity with GAAP. Cash-basis financial statements titles such as *Statement of Assets and Liabilities Arising From Cash Transactions* or *Statement of Revenue Collected and Expenses Paid* make it clear that the financial statements have been prepared on the cash basis.

Financial-Statement Disclosures

.68 The use of an OCBOA does not eliminate the need for adequate disclosures in financial statements. SSARS No. 7 clarified existing practice by adding a footnote to SSARS No. 1 (AR section 100.04) indicating that the source of guidance for evaluating the adequacy of disclosure in financial statements prepared in conformity with an OCBOA is paragraphs 9 and 10 of SAS No. 62 (AU section 623.09 and .10). Those paragraphs require that OCBOA financial statements include "all informative disclosures that are appropriate for the basis of accounting used." In essence, OCBOA financial statements should include the same disclosures as would be required for similarly presented items in GAAP statements. The AICPA has prepared a nonauthoritative publication, *Guide to Cash and Tax Basis Financial Statements* (Product No. 006700HU, $36.50 for members/$40 for nonmembers), that provides a comprehensive discussion of recognition, measurement, and disclosure issues faced by preparers of cash and tax-basis financial statements, supplemented by the results of a survey of two thousand members of the AICPA's Private Companies Practice Section as to their experiences on these issues. Various practice aids are included in the Guide, such as illustrative cash and tax-basis financial statements, financial-statement disclosure checklists, and illustrative accountants' reports.

Compiling or Reviewing Financial Statements Previously Compiled or Reviewed Using a Different Basis of Accounting

.69 A client may, for example, engage a CPA to compile GAAP financial statements in one year (1994) because such statements are needed to obtain bank financing, and in the following year (1995) when the client is no longer applying for credit, engage the CPA to compile comparative tax-basis financial statements for the current year and the previous year (1995 and 1994). If such an engagement is performed, two financial statements with different bases of accounting (GAAP and tax) will have been issued for the same period (1994). Practitioners have asked whether they may perform such engagements and, if so, how their compilation and review reports are affected.

.70 Although SSARS does not address this question, nothing in SSARS precludes the accountant from performing such an engagement. Relevant guidance in this area may be gleaned from SAS No. 62 (AU section 623) which provides guidance on reporting on financial statements prepared in conformity with a comprehensive basis of accounting other than GAAP. Footnote 33 of SAS No. 62 (AU section 623.31) primarily addresses situations in which GAAP financial statements have been issued in previous years, and the entity changes the basis of accounting used in the current year. Footnote 33 (AU section 623.31) indicates that in such situations the auditor is not required to add an explanatory paragraph to the report describing the change. However, the auditor may add an explanatory paragraph to the report to highlight (1) a difference in the basis of presentation used from that in prior years or (2) that another report has been issued on the entity's financial statements prepared in conformity with another basis of presentation (for example, if cash basis financial statements have been issued in addition to GAAP financial statements). Drawing a parallel from the guidance in the audit literature, it would appear that the accountant need not modify his or her compilation report in this situation; however, if the accountant wishes to, he or she may add a paragraph to the report indicating that another report has been issued on the entity's financial statements prepared in conformity with another basis of accounting.

.71 If two sets of financial statements with different bases of accounting have been issued for the same period, it is particularly important that readers be aware of the basis of accounting used in each set of financial statements. Ordinarily, the basis of accounting is disclosed in the notes to the financial statements. However, in financial statements that omit substantially all disclosures required by GAAP or an OCBOA, the basis of accounting may not be disclosed in the financial statements. Paragraph 20 (AR section 100.20) and Interpretation No. 12 (AR section 9100.41-.45) of SSARS No. 1, "Reporting on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles," ensure that the basis of accounting is disclosed to financial statement users by requiring that it be disclosed in the accountant's report if it is not disclosed in the financial statements.

Independence and Client Services

.72 For many small businesses, the CPA serves as the primary business consultant and may unknowingly provide services ancillary to a compilation or review engagement that impair the accountant's independence. A CPA is precluded from issuing an audit or review report on the financial statements of an entity to which he or she is not independent, but may compile such financial statements. If the accountant is not independent in a compilation engagement, the following paragraph should be added to the compilation report:

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

.73 The following are examples of client services that might impair an accountant's independence if performed during the period covered by the financial statements, during the engagement period, or at the time an opinion is expressed:

- Serving as a director or officer of the client organization
- Acting in a capacity equivalent to a member of the client's management or an employee
- Serving as a trustee of a client's pension or profit-sharing trust
- Having the authorization to sign or cosign checks on a client's bank account, even if such activity is never performed
- Providing valuation or actuarial services to a client if significant judgments are not made or approved by the client or if the client is not in a position to have informed judgment about the results of the services

- Providing services to a client involving the hiring of personnel in which the accountant has undue involvement in or identification with management functions, for example, making hiring decisions and supervising client personnel beyond the initial instruction and training period

- Providing payroll services to a client if the accountant assumes the role of management (Management, not the accountant, should be responsible for determining which employees are to be paid and the amounts they will be paid. The accountant may calculate the payroll, transmit payroll information to a payroll service, record the payroll, and complete payroll tax returns based on information provided by management. However, the accountant should not sign payroll checks or payroll tax returns.)

- Providing manual or computer bookkeeping or data-processing services to a client in a manner that impairs the accountant's independence; Interpretation 101-3, "Accounting Services" of Rule 101 of the AICPA *Code of Professional Conduct* (ET section 101.05), states that a practitioner providing such services to a client must meet the following three requirements to be considered independent:

  1. The client must accept responsibility for the financial statements as his or her own. This means that the client must be sufficiently informed about the entity's activities, financial condition, and the applicable accounting principles used to record transactions. If management is not sufficiently informed about such matters, the CPA should discuss them with the client.

  2. The accountant must not assume the role of employee or management. For example, the accountant should not execute transactions, have custody of assets, or exercise authority on behalf of the client. The client must prepare the source documents for transactions in sufficient detail to clearly identify the nature and amount of the transactions. The accountant should not make changes to this basic data without the concurrence of the client.

  3. If financial statements are prepared from books and records that the accountant has maintained, the accountant must comply with the applicable standards for audits, reviews, or compilations.

Accountants Forum

.74 The AICPA has established an on-line computer forum known as the "Accountants Forum" that enables participants to access information and communicate with other participants, the AICPA, and state societies via the CompuServe Information Network. The Accountants Forum was launched on June 30, 1995, and contains the following components:

- *Library*—Contains nonauthoritative professional information developed by the AICPA and thirty-five participating state CPA societies, such as exposure drafts of proposed standards, practice aids, newsletters, and information about AICPA activities, such as task force and committee meetings. (Users are able to search and download *Library* files.)

- *Message Center*—Functions as a bulletin board through which participants may post public messages, questions, and responses

- *Conference Center*—Enables individuals or groups to conduct informal on-line conversations, as well as formal moderated conferences

- *Catalog*—Enables members to access AICPA and state society catalogs, order advertised products, and register for conferences and CPE courses (available in late 1995)

- *Research Database*—Enables users to access and search authoritative professional literature (available in late 1995)

Forum users also have unlimited access to CompuServe's other services, including e-mail, travel reservations, news services, and other reference sources. Those who already use CompuServe can access the Accountants Forum by entering the "GO AICPA" command. To sign up for a CompuServe account, call (800) 524-3388 and ask for the "AICPA package" or "Representative 748." Users are charged $9.95 per month for CompuServe (including five free hours of on-line time) plus $2.95 per hour thereafter.

GAAP for Compiled or Reviewed Financial Statements

.75 Although there are different reporting and performance standards for compilation, review, and audit engagements, the accounting principles to be followed for compiled or reviewed financial statements are the same as those for audited financial statements.

.76 An exception to that rule is found in SSARS No. 1 (AR section 100), which permits the accountant to compile financial statements that omit substantially all of the disclosures required by GAAP. If the accountant compiles such financial statements, a special compilation report is issued that alerts readers to the fact that the disclosures have been omitted.

.77 Footnote 3 of SSARS No. 1 (AR section 100.04) states that the GAAP hierarchy presented in SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AU section 411), is also applicable to compilations and reviews of financial statements performed under SSARS. A summarization of the GAAP hierarchy is reproduced in the following table.

Nongovernmental Entities	*State and Local Governments*
Established Accounting Principles	
a. FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins	a. GASB Statements and Interpretations, plus AICPA and FASB pronouncements if made applicable to state and local governments by a GASB Statement or Interpretation
b. FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position	b. GASB Technical Bulletins, and the following pronouncements if specifically made applicable to state and local governments by the AICPA: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position
c. Consensus positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins	c. Consensus positions of the GASB Emerging Issues Task Force* and AICPA Practice Bulletins if specifically made applicable to state and local governments by the AICPA
d. AICPA accounting interpretations, "Qs and As" published by the FASB staff, as well as industry practices widely recognized and prevalent	d. "Qs and As" published by the GASB staff, as well as industry practices widely recognized and prevalent
*Other Accounting Literature***	
Other accounting literature, including FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; GASB Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids;* and accounting textbooks, handbooks, and articles	Other accounting literature, including GASB Concepts Statements; pronouncements in categories (a) through (d) of the hierarchy for nongovernmental entities when not specifically made applicable to state and local governments; FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids;* and accounting textbooks, handbooks, and articles

Because several standard-setting bodies establish GAAP, there is no single publication that includes all of the GAAP pronouncements; however, the following publications contain pronouncements included in levels *a* through *d* of the GAAP hierarchy (must know GAAP) and—if acquired and maintained—should provide accountants with an appropriate accounting library.

FASB Original Pronouncements—Accounting Standards

.78 This two-volume set contains the original text of accounting pronouncements. It includes FASB Statements of Financial Accounting Standards and Interpretations, APB Opinions, AICPA Accounting Research

* As of the date of this section, the GASB had not organized such a group.

** In the absence of established accounting principles, the auditor may consider other accounting literature, depending on its relevance in the circumstances.

Bulletins, FASB Technical Bulletins, and AICPA Accounting Interpretations. The pronouncements are arranged chronologically and the text includes a topical index (Product No. 005045HU, $87 for members).

AICPA Technical Practice Aids (Including Statements of Position)

.79 Statements of Position and Practice Bulletins issued by the Accounting Standards Executive Committee (AcSEC) are included in this text. This publication also contains a selection of nonauthoritative audit, review, compilation, and accounting questions answered by the AICPA's Technical Information Service (Product No. 005055HU, $62.50 for members).

FASB Emerging Issues Task Force Abstracts

.80 This text contains a summary of the proceedings of the FASB's Emerging Issues Task Force (EITF). Each abstract summarizes the accounting issues involved and the results of the discussion, including any consensus reached on the issue. *EITF Abstracts* are available from the FASB by calling (203) 847-0700, ext. 10 (Product No. EAB94, $27.20 for members and academics/$34 for nonmembers). The 1995 edition of *EITF Abstracts* will be available in December 1995.

FASB Staff Qs and As

.81 *Qs and As* are published by the FASB staff and provide guidance on the implementation of FASB Statements. The following *Qs and As* are available from the FASB (product numbers are shown in parentheses):

- *A Guide to the Implementation of Statement 87 on Employers' Accounting for Pensions* (Product No. PQA87)
- *A Guide to the Implementation of Statement 88 on Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (Product No. PQA88)
- *A Guide to the Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (Product No. LQA91)
- *A Guide to the Implementation of Statement 106 on Employers' Accounting for Postretirement Benefits other than Pensions* (Product No. PQA106)
- *A Guide to the Implementation of Statement 109 on Accounting for Income Taxes* (Product No. TQA109)

The FASB staff is currently developing *Qs and As* for FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), which will be available by the end of 1995.

.82 Copies of *Qs and As* are available from the FASB ($8.80 for members and academics/$11 for nonmembers).

Compilations and Reviews of Governmental Entities

.83 Practitioners who compile or review the financial statements of state and local governmental entities should supplement their professional libraries with the *Codification of Governmental Accounting and Financial Reporting Standards.* This text contains current authoritative accounting and financial reporting standards for state and local governmental entities. GASB Statements, Interpretations, and Technical Bulletins are included. To order call the FASB at (203) 847-0700, ext. 10 (Product No. GCD95, $45.00 for members and nonmembers/$36 for academics and students).

AICPA Audit and Accounting Guides

.84 These guides summarize the practices applicable to specific industries and describe relevant matters, conditions, and procedures unique to these industries. The accounting guidance included in AICPA Audit and Accounting Guides is in the GAAP hierarchy as authoritative GAAP. When an accountant compiles or reviews the financial statements of an entity, SSARS No. 1 (AR section 100) requires that the accountant have or acquire a level of knowledge of the accounting principles and practices of the industry in which the entity operates. Although the audit guidance included in the guides may not be relevant to practitioners performing compilation and review engagements, the accounting guidance, illustrative financial statements, and industry background included in the guides should help accountants acquire knowledge of a specific industry. Guides are available for the following industries.

Agricultural Producers and Agricultural Cooperatives (Product No. 012143HU)

Airlines (Product No. 013179HU)

Banks (Product No. 011174HU)

Brokers and Dealers in Securities (Product No. 012177HU)

Casinos (Product No. 013146HU)

Certain Nonprofit Organizations (Product No. 013165HU)

Colleges and Universities (Product No. 013323HU)

Common Interest Realty Associations (CIRAs) (Product No. 012484HU) (This guide contains a chapter on compilations and reviews of CIRAs.)

Construction Contractors (Product No. 012092HU)

Credit Unions (Product No. 012049HU)

Employee Benefit Plans (Product No. 012334HU)

Entities With Oil and Gas Producing Activities (Product No. 012087HU)

Federal Government Contractors (Product No. 012434HU)

Finance Companies (Product No. 012462HU)

Investment Companies (Product No. 012139HU)

Property and Liability Insurance Companies (Product No. 011917HU)

Providers of Health Care Services (Product No. 012427HU)

Savings Institutions (Product No. 012103HU)

State and Local Governmental Units (Product No. 012055HU)

Stock Life Insurance Companies (Product No. 012035HU)

Voluntary Health and Welfare Organizations (Product No. 012158HU)

Copies of Audit and Accounting Guides are available from the AICPA Order Department ($28 for members/$31 for nonmembers). For ordering information, see "Order Department" in the "AICPA Services" section of this Compilation and Review Alert.

Electronic Pronouncements

.85 The following professional standards are available in electronic format for computer use.

AICPA Pronouncements

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- *Professional Standards*—Subscription (Product No. G01030HU, $162.50 for members/$200 for nonmembers) or Annual Edition (Product No. 016990HU, $98.75 for members/$108.50 for nonmembers)
- *Technical Practice Aids*—Subscription (Product No. G01031HU, $162.50 for members/$180.55 for nonmembers) or Annual Edition (Product No. 016971HU, $97.50 for members/$107.50 for nonmembers)
- *Audit and Accounting Guides*—Subscription (Product No. G01009HU, $299 for members/$370 for nonmembers)
- *Index to Accounting and Auditing Pronouncements*—Subscription (Product No. G0100HU, $96 for members/$120 for nonmembers) or Annual Edition (Product No. 016993HU, $60 for members/$66 for nonmembers)

These products are compatible with computer systems that have the following specifications:

- IBM PC or 100 percent compatible systems
- DOS 2.0 (or higher)
- 512 K RAM minimum
- Single diskette and hard drives

Disks are available in 3½" (1.44MB) or 5¼" (1.2MB) sizes. Subscribers receive updates approximately four times a year. To order, call the AICPA Order Department at (800) TO-AICPA (menu selection #1).

Financial Accounting Standards Board Pronouncements

.87 Windows and DOS versions of the Financial Accounting Research System (FARS) are available from the FASB. The FARS annual service includes the following:

- *Original Pronouncements*—FASB Statements, Interpretations, Technical Bulletins, Concept Statements, ARBs 43-51; APB Opinions and Statements; AICPA Accounting Interpretations and Terminology Bulletins.
- *Current Text*—Integration of financial accounting and reporting standards arranged by topic for general and industry standards.
- *EITF Abstracts*—Full text of abstracts of issues considered by the Emerging Issues Task Force. It also includes an EITF topical index.
- *Implementation Guides*—Questions and answers from FASB Special Reports and other published implementation guidance.
- *Comprehensive Topical Index*—References are linked to the appropriate sections in the items listed above.

Purchasers receive updates approximately four times a year.

.88 FARS for Windows is designed to be loaded on a hard drive and is available on CD-ROM or on diskettes (currently ten diskettes). FARS for Windows is compatible with computer systems that have the following specifications:

- Intel-compatible 80386 processor or greater
- Four MB of RAM (8MB or more recommended)
- Microsoft Windows™ 3.1 running in enhanced mode
- Fixed disk (hard drive) containing 25 megabytes of free disk space
- VGA monitor
- Mouse or other Microsoft-compatible input device

For single-user systems, the cost for FARS for Windows is $448 for members[3] and academics; for all others, the cost is $560.

.89 For network installation, the cost is based on concurrent usage. Users must have a reasonable mechanism or process in place to assure that the number of concurrent users of FARS does not exceed the number of concurrent users declared for the network. The cost for the first user is $448 for members and academics and $560 for all others. For each additional user, the cost is $396 for members and academics and $495 for all others. CD-ROM or one set of ten diskettes with documentation is provided for each network. The DOS version is on diskette only.

.90 For information about the DOS version of FARS or for technical questions about FARS for Windows, call (203) 847-0700 extension 575. For ordering information call (203) 847-0700, extension 558.

Recent GAAP Pronouncements

Authoritative Accounting Pronouncements Becoming Effective in 1995

.91 As noted earlier, the accounting principles to be followed for compiled or reviewed financial statements are the same as those for audited financial statements. Many authoritative accounting pronouncements became effective in 1995, or have 1995 delayed effective dates for certain reporting entities. Following is a brief overview of some of the pronouncements becoming effective in 1995 that practitioners performing compilation and review engagements should be aware of. When applying these pronouncements, practitioners should refer to the complete professional standard.

- FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other than Pensions* (AC P16 and P40), is effective for fiscal years beginning after December 15, 1992, but has a two-year delayed effective date of December 15, 1994, for plans outside the United States and for nonpublic employers that sponsor defined benefit postretirement plans with no more than 500 participants. Statement No. 106 (AC P16 and P40) applies to all forms of postretirement benefits other than pensions, but focuses principally on postretirement health care benefits. The Statement (AC P16 and P40) requires accrual of the expected cost of providing postretirement benefits to employees, their beneficiaries, and covered dependents during the years in which employees render service. The FASB has published *A Guide to Implementation of Statement 106 on Employers' Accounting for Postretirement Benefits Other Than Pensions.* This publication is available from the FASB (203) 847-0700, extension 10, Product No. PQA106; $8.80 for members and academics/$11 for nonmembers.
- FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), extends existing fair-value disclosure practices for some instruments by requiring all entities to disclose the fair

[3] This means members of the Financial Accounting Foundation and the Accounting Research Association of the AICPA.

value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. If estimating fair value is not practicable, the Statement (AC F25) requires disclosure of descriptive information pertinent to estimating the value of a financial instrument. Appendix A of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), provides examples of instruments that are included in and excluded from the definition of a financial instrument. Statement No. 107 (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1992, except for entities with less that $150 million in total assets. For those entities, the effective date is for fiscal years ending after December 15, 1995.

- FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC D22 and I08), and the related pronouncement, FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (AC I08), are both effective for financial statements for fiscal years beginning after December 15, 1994. FASB Statement No. 114 (AC D22 and I08) addresses the accounting by creditors for impairment of a loan by specifying how allowances for credit losses related to certain loans should be determined. It requires that impaired loans, that are within the scope of the Statement (AC D22 and I08), be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent. The Statement (AC D22 and I08) defines a loan as impaired if, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (both the contractual interest payments and the principal payments) according to the terms of the loan agreement.

  FASB Statement No. 118 (AC I08) amends FASB Statement No. 114 (AC D22 and I08) to allow a creditor to use existing methods for recognizing interest income on an impaired loan. It also amends the disclosure requirements in Statement No. 114 (AC D22 and I08) to require disclosure of information about the recorded investment in certain impaired loans and about how a creditor recognizes interest income related to those impaired loans.

- FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made* (AC C67), and FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations* (AC C25 and No5), are both effective for fiscal years beginning after December 15, 1994, except for not-for-profit organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 15, 1995. Statement No. 116 (AC C67) establishes accounting standards for contributions and applies to all entities that receive or make contributions. Generally, contributions received, including unconditional promises to give, are recognized as revenues in the period received at their fair values. Contributions made, including unconditional promises to give, are recognized as expenses in the period made at their fair values. Conditional promises to give, whether received or made, are recognized when they become unconditional, that is, when the conditions are substantially met. The Statement (AC C67) allows certain exceptions for contributions of services and works of art, historical treasures, and similar assets.

  Statement No. 117 (AC C25 and No5) establishes standards for general-purpose external financial statements provided by not-for-profit organizations. It requires that those statements include a statement of financial position, a statement of activities, and a statement of cash flows. It also requires classification of an organization's net assets and its revenues, expenses, gains, and losses based on the existence or absence of donor-imposed restrictions. For implementation guidance on FASB Statement Nos. 116 (AC C67) and 117 (AC C25 and No5), refer to "Implementing FASB 116 and 117," by Martha L. Benson, Alan S. Glazer, Henry R. Jaenicke, and Kenneth D. Williams, *Journal of Accountancy* (New York: AICPA, September 1995).

- FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), requires disclosures about the amounts, nature, and terms of derivative financial instruments that are not subject to Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. It also amends FASB Statements No. 105 (AC F25) and 107 (AC F25) to require that distinction in certain disclosures required by those Statements (AC F25). FASB Statement No. 119 (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1994, except for entities with less than $150 million in total assets. For those entities, the Statement (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1995. For additional guidance on derivatives and FASB Statement No. 119 (AC F25), refer to the following:

    — Winograd, Barry N., and Robert H. Herz."Derivatives: What's an Auditor to Do?" *Journal of Accountancy* (New York: AICPA, June 1995).

    — Molvar, Roger H.D., and James F. Green."The Question of Derivatives." *Journal of Accountancy* (New York: AICPA, March 1995).

    — *Derivatives—Current Accounting and Auditing Literature,* A Report Prepared by the Financial Instruments Task Force of the Accounting Standards Executive Committee, AICPA (Product No. 014888).

- FASB Statement No. 121, *Accounting for the Impairment of Long-lived Assets and for Long-Lived Assets to be Disposed Of* (AC D22 and I08), requires that long-lived assets and certain identifiable intangibles (including goodwill) to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. In performing the review for recoverability, the entity should estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. The Statement (AC D22 and I08) requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets that are covered by APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets that are covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of carrying amount or net realizable value. FASB Statement No. 121 (AC D22 and I08) is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is not permitted. Impairment losses resulting from the application of this Statement (AC D22 and I08) should be reported in the period in which the recognition criteria are first applied and met. The initial application of this Statement (AC D22 and I08) to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

- FASB Statement No. 123, *Accounting for Stock-Based Compensation*, was issued in October 1995 and establishes financial accounting and reporting standards for stock-based employee compensation plans. The FASB's "Stock-Based Compensation" project included the reconsideration of APB Opinion No. 25, *Accounting for Stock Issued to Employees* (AC C47), and related authoritative pronouncements. In June 1993, the FASB issued an exposure draft titled *Accounting for Stock-Based Compensation*. The proposed accounting differed considerably from existing practice and was quite controversial. Particularly at issue was the tentative conclusion to require recognition of compensation expense for certain fixed-price stock options at the time they are issued. The proposed standard required that compensation cost be measured at the fair value of the option or other stock-based award at the date it is granted, using an option-pricing model. Strong opposition to the proposed standard came from a wide group of constituencies. In December 1994, the FASB decided to drop the requirement for expense recognition and to encourage, rather than require, companies to recognize the expense. Reporting entities that do not recognize compensation expense in accordance with the Statement will be required to disclose the difference between compensation cost included in net income and the related cost that would have been recognized in the income statement if the fair-value based method had been used. The accounting provisions of FASB Statement No. 123 are effective for transactions entered into in fiscal years that begin after December 15, 1995, though they may be adopted on issuance. The disclosure requirements of FASB Statement No. 123 are effective for financial statements for fiscal years beginning after December 15, 1995, or for an earlier fiscal year for which this Statement is initially adopted for recognizing compensation cost. Pro forma disclosures required for entities that elect to continue to measure compensation cost using APB Opinion No. 25 (AC C25), must include the effects of all awards granted in fiscal years that begin after December 15, 1994. Pro forma disclosures for awards granted in the first fiscal year beginning after December 15, 1994, need not be included in financial statements for that fiscal year but should be presented subsequently whenever financial statements for that fiscal year are presented for comparative purposes with financial statements for a later fiscal year.

- SOP 93-7, *Reporting on Advertising Costs* (Product No. 014804HU, $8.50 for members/$9.50 for nonmembers), was issued by the AICPA's AcSEC in December 1993 and provides for increased comparability in accounting for advertising costs. The Statement requires that advertising costs be expensed either as incurred or the first time the advertising occurs except for certain direct-response advertising (for example, direct-mail advertising), which is capitalized if certain conditions are met. Capitalized direct-response advertising is amortized ratably over the period during which the reporting entity expects to receive benefits from the specific advertising. At each balance-sheet date, an entity assesses the realizability of the carrying amount of capitalized advertising. If the carrying amount exceeds the remaining expected future net revenues, the excess is reported as advertising expense in the current period. The SOP also requires that financial statements include certain disclosures about advertising. SOP 93-7 is effective for fiscal years beginning after June 15, 1994.

- SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (Product No. 014882HU, $8.50 for members/$9.50 for nonmembers), amends and makes uniform the guidance on reporting of related entities in the AICPA Audit and Accounting Guides, *Audits of Colleges and Universities* and *Audits of Voluntary Health and Welfare Organizations* and in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations.* SOP 94-3 provides that the decision about whether the financial statements of a reporting not-for-profit organization and those of one or several other entities (either not-for-profit organizations or business entities) are to be consolidated should be based on the nature of the relationship between the entities. That relationship also affects the disclosures that the reporting organization is required to make. The guidance in SOP 94-3 focuses on investments in majority-owned for-profit subsidiaries and financially interrelated not-for-profit organizations. SOP 94-3 is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117 (AC C25) before its effective date, earlier application of the SOP is encouraged.

- SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (Product No. 014880HU, $8.50 for members/$9.50 for nonmembers), was issued by the AcSEC in December 1994 to improve disclosures of the risks and uncertainties confronting entities in a volatile business environment and to provide users with an early warning of those risks and uncertainties. The SOP is applicable to all nongovernmental entities that prepare financial statements in conformity with GAAP.[4] The SOP requires disclosure of the nature of an entity's operations and requires that an entity disclose its major products or services, its principal markets, and the locations of the markets. If the entity operates in more than one business, the entity is required to disclose the relative importance of its operations in each business, and the basis for that determination. The SOP also requires that all entities include an explanation in their financial statements indicating that the preparation of financial statements in conformity with GAAP requires the use of management's estimates. These first two disclosures are required in all financial statements. The third type of disclosure required by the SOP is designed to provide information about sensitive estimates in the financial statements and is made only when known information available prior to the issuance of the financial statements indicates that (1) it is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term (within one year of the balance-sheet date) due to one or more future confirming events, and (2) the effect of the change would be material to the financial statements. Some examples of recorded amounts or disclosures that may be based on estimates that are particularly sensitive to change in the near term include inventory and equipment subject to rapid technological obsolescence, valuation allowances for commercial and real estate loans, litigation-related obligations, and amounts reported for long-term obligations, such as amounts reported for pensions and post-employment benefits. If the criteria are met, the disclosure must describe the nature of the uncertainty and indicate that it is reasonably possible that the estimate will change in the near term. If the estimate involves a contingency covered by FASB Statement No. 5, *Accounting for Contingencies* (AC C59), the disclosure also should include an estimate of the possible loss or range of loss, or state that an estimate cannot be made. The final requirement of the SOP addresses risks and uncertainties arising from an entity's current vulnerability due to certain concentrations. An example of a concentration is a manufacturer who depends on one supplier for materials and whose business would be significantly disrupted by the loss of that supplier. Disclosure of concentrations is required if based on information known to management prior to the issuance of the financial statements, (1) the concentration existed at the date of the financial statements, (2) the concentration makes the enterprise vulnerable to the risk of a near-term severe impact (a significant financially disruptive effect on the normal functioning of the entity), and (3) it is at least reasonably possible that the events that could cause the severe impact will occur in the near term. The content of the disclosure is not generally specified; however, it should inform users of the nature of the risk involved. For concentrations of labor subject to collective bargaining agreements, and for operations outside an entity's home country, certain specified information must be disclosed. The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which the SOP is first applied. Early application is encouraged but not required.

- Practice Bulletin 14[5], *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships* (Product No. 033160HU, $6.50 for members/$7.25 for nonmembers), provides guidance on applying existing accounting literature to limited liability companies and limited liability partnerships (hereinafter referred to as limited liabilities companies or LLCs). LLCs combine the limited liability aspect of corporations with the flow-through tax attributes of partnerships. Because an LLC is formed under state law, its characteristics may vary depending on the state in which it is organized. However, LLCs generally have the following characteristics:

— An LLC is an unincorporated association of two or more "persons."

— Its members have limited personal liability for the debts and obligations of the entity.

[4] The applicability of the SOP to financial statements prepared using an OCBOA is not clear. Paragraph B-47 of the SOP indicates that the issue of the SOP's applicability to financial statements prepared using an OCBOA is a pervasive one that goes beyond the scope of the SOP.

[5] SAS No. 69 (AU section 411) identifies AICPA practice bulletins as authoritative (i.e., "must know") accounting principles.

— It is classified as a partnership for federal income tax purposes and thus lacks at least two of the four corporate characteristics which include limited liability, free transferability of interests, centralized management, and continuity of life.

Practice Bulletin 14 is effective for financial statements issued after May 31, 1995.

Authoritative Accounting Pronouncements Issued in 1995

.92 Following is a list of various authoritative accounting pronouncements issued from January 1, 1995 to November 1, 1995, and their effective dates.

Statements of Financial Accounting Standards and Interpretations Issued by the FASB[6]

.93 To order copies, call the FASB at (203) 847-0700, ext. 10.

	Description	*Effective Date*
FASB Statement No. 120 (AC I08)	*Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*	Financial statements for fiscal years beginning after December 15, 1995
FASB Statement No. 121 (AC I08)	*Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to be Disposed of*	Financial statements for fiscal year beginning after December 15, 1995.
FASB Statement No. 122 (AC Mo4)	*Accounting for Mortgage Servicing Rights*	Should be applied prospectively in fiscal years beginning after December 15, 1995, to transactions in which a mortgage banking enterprise sells or securitizes mortgage loans with servicing rights retained and to impairment evaluations of all amounts capitalized as mortgage servicing rights, including those purchased before the adoption of the Statement.
FASB Statement No. 123	*Accounting for Stock-Based Compensation*	The accounting requirements of this Statement are effective for transactions entered into in fiscal years that begin after December 15, 1995, though they may be adopted on issuance. (See Statement for effective dates for disclosure requirements.)
FASB Interpretation No. 41[7] (AC B10)	*Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*	Financial statements issued for periods ending after December 15, 1994.

[6] See the Audit Risk Alert *State and Local Governmental Industry Developments—1995* [AAM section 8070] for recently issued Statements of the Governmental Accounting Standards Board.

[7] FASB Interpretation No. 41 (AC B10) was issued in December 1994.

EITF Consensus Positions

.94 To order copies of the following publications, call the FASB at (203) 847-0700, ext. 10.

	Description	*Date Consensuses Reached*
EITF Issue No. 94-1	*Accounting for Tax Benefits Resulting From Investments in Affordable Housing Projects*	November 17, 1994 May 18-19, 1995
EITF Issue No. 94-3	*Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*	May 19, 1994 November 17, 1994 January 19, 1995
EITF Issue No. 94-5	*Determination of What Constitutes All Risks and Rewards and No Significant Unresolved Contingencies in a Sale of Mortgage Loan Servicing Rights under Issue No. 89-5*	September 21-22, 1994 November 17, 1994 January 19, 1995
EITF Issue No. 94-6	*Accounting for the Buyout of Compensatory Stock Options*	September 21-22, 1994 November 17, 1994 January 19, 1995
EITF Issue No. 94-7	*Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*	September 20-21, 1995
EITF Issue No. 94-9	*Determining a Normal Servicing Fee Rate for the Sale of an SBA Loan*	January 19, 1995
EITF Issue No. 94-10	*Accounting by a Company for the Income Tax Effects of Transactions among or with its Shareholders under FASB Statement No. 109*	July 20-21, 1995
EITF Issue No. 95-2	*Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party*	July 20-21, 1995
EITF Issue No. 95-3	*Recognition of Liabilities in Connection with a Purchase Business Combination*	May 18-19, 1995
EITF Issue No. 95-4	Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease	July 20-21, 1995
EITF Issue No. 95-5	*Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights*	July 20-21, 1995
EITF Issue No. 95-6	*Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation*	July 20-21, 1995 September 20-21, 1995
EITF Issue No. 95-7	*Implementation Issues Related to the Treatment of Minority Interests in Certain Real Estate Investment Trusts*	September 20-21, 1995
EITF Issue No. 95-8	*Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Company in a Purchase Business Combination*	September 20-21, 1995
EITF Issue No. 95-9	*Accounting for Tax Effects of Dividends in France in Accordance with FASB Statement No. 109*	September 20-21, 1995
EITF Issue No. 95-10	*Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109*	July 20-21, 1995
EITF Issue No. 95-12	*Pooling-of-Interests with a Common Investment in a Joint Venture*	September 20-21, 1995 [8]
EITF Issue No. 95-13	*Classification of Debt Issue Costs in the Statement of Cash Flows*	September 20-21, 1995

[8] The EITF plans to discuss this issue further at its November 15-16, 1995 meeting.

EITF Issue No. 95-14	*Recognition of Liabilities in Anticipation of a Business Combination*	September 20-21, 1995 [9]

Statements of Position and Practice Bulletins Issued by the AICPA

.95 To order copies, call the AICPA Order Department at (800) TO-AICPA. The cost is $8.50 members/$9.50 nonmembers. Product numbers are shown in parentheses.

	Description	*Effective Date*
SOP 94-5 (014883HU)	*Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*	Financial statements issued for periods ending after December 15, 1994.
SOP 94-6 (014880HU)	*Disclosure of Certain Significant Risks and Uncertainties*	Financial statements issued for fiscal years ending after December 15, 1995.
SOP 95-1 (014889HU)	*Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*	Financial statements for fiscal years beginning after December 15, 1995.
SOP 95-2 (014808HU)	*Financial Reporting by Nonpublic Investment Partnerships*	Financial statements issued for fiscal years beginning after December 15, 1995.
Practice Bulletin No. 14 (033160HU)	*Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships*	Financial statements issued after May 31, 1995.

Financial-Statement Disclosure Overload

.96 One of the recommendations in a 1994 report by the AICPA Special Committee on Financial Reporting (the Jenkins Committee) was that standard setters and regulators expand their efforts to eliminate disclosures that are less useful. Recently, much has been written and said on the topic of financial-statement disclosure overload, and many users and preparers of financial statements are calling for improvements in this area.

.97 The FASB is addressing a number of the concerns of the Jenkins Committee report in its current projects while calling for academic and other research on disclosure issues. In November 1995, the FASB issued a prospectus titled *Disclosure Effectiveness.* The Prospectus asks readers to consider possible changes to current disclosure requirements (1) to reduce the cost of preparing and disseminating disclosures while providing users with the information they need and (2) to eliminate disclosures that are not useful for decision making. The FASB is encouraging all interested parties to comment on the Prospectus and plans to host a seminar late in 1995 to bring interested parties together to discuss the topic of financial statement disclosures.

.98 In January 1995, the PCPS Executive Committee agreed to examine this issue and established a Special Task Force on Standards Overload (the Special Task Force). The Special Task Force has developed recommendations and prepared a report entitled *Report of the PCPS Special Task Force on Standards Overload.* This report will now be considered by the PCPS Executive Committee, the AICPA, the FASB, and the profession as a whole.

Auditing Standards Division Publications Relevant to SSARS Engagements

.99 The following publications are published by the Auditing Standards Division and are available from the AICPA Order Department. For ordering information, see "Order Department" in the "AICPA Services" section of this Compilation and Review Alert.

Codification of Statements on Standards for Accounting and Review Services

.100 *Statements on Standards for Accounting and Review Services* (SSARSs) are the standards by which compilation and review engagements are performed. (057166HU; $13 for members/$14.25 for nonmembers.)

[9] See footnote 8.

Codification of Statements on Auditing Standards

.101 *Codification of Statements on Auditing Standards* includes SAS Nos. 1-73 and SSAE Nos. 1-3. Practitioners performing compilation and review engagements may need to consult the auditing standards because the SASs are the only source of authoritative accounting guidance in areas such as subsequent events and evaluation of the adequacy of going-concern disclosure. In addition, SSARS frequently refer the reader to the SASs for amplification of topics mentioned in SSARS. (Product No. 059025HU, $52 for members/$57.25 for nonmembers.)

AICPA Services

Order Department

.102 To order AICPA products, call: (800) 862-4272 (menu selection #1); write: AICPA Order Department, HU, P.O. Box 2209, Jersey City, NJ 07303-2209; fax: (800) 362-5066. Prices do not include shipping and handling. When ordering, please specify the product number to ensure that you receive the correct publication.

Technical Information Hotline

.103 The AICPA Technical Information Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call: (800) 862-4272 (menu selection #2).

Ethics

.104 Members of the AICPA's Professional Ethics Division answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call: (800) 862-4272 (menu selection #4).

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.105 This Compilation and Review Alert replaces *Compilation and Review Alert—1994.*

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Appendix

The Representation Letter in a SSARS Review Engagement (A pamphlet prepared by the Auditing Standards Division)

About the time your accountant completes the review of your entity's financial statements, you will be asked to sign a letter that, at first glance, may appear formidable, but really isn't. As management, you are asked to acknowledge that you, rather than the accountant, have primary responsibility for the financial statements and that to the best of your knowledge these statements are correct. The letter does not change or add to your fundamental responsibilities, nor does it relieve the accountant of any of his or her responsibilities. It simply clarifies the traditional roles that management and the accountant perform. Accountants refer to such letters as *representation letters*. The standards for review engagements, *Statements on Standards for Accounting and Review Services* (SSARS), now require that accountants obtain a representation letter from their review clients.

This pamphlet is for individuals who are unfamiliar with a representation letter and who may not have been asked to sign one before. Its purpose is to anticipate and answer your questions.

Why Is a Representation Letter Required?

The accountant's review report lends credibility to financial statements that are used by bankers, investors and others. The accountant must comply with rigorous standards that govern the process and procedures of a review. Those standards are established by the American Institute of Certified Public Accountants' Accounting and Review Service Committee, composed of CPAs, most of whom are practicing certified public accountants. Their recommendations are developed over extended periods and are widely circulated for comment to thousands of people, including regulatory bodies.

In November 1992, the Accounting and Review Services Committee issued SSARS No. 7, which makes obtaining a client representation letter a required procedure in a review engagement. That is why you will be asked to sign a representation letter.

What Are Management's Responsibilities?

Financial statements are management's representation. You as the manager of an entity have access to the most detailed information about the entity and have daily, first-hand exposure to transactions and other events reported in the financial statements.

As part of your stewardship role in management, you are responsible for the selection of accounting principles when alternatives are available. This is true even though you may be unfamiliar with the intricacies of accounting practices.

The accountant usually advises you in the preparation of financial statements and often drafts them for you, but this does not dilute your responsibility. The accountant makes inquiries and performs analytical procedures to review the financial statements and issues a review report on them. However, that does not lessen your responsibility for those statements.

A representation letter documents information relating to your knowledge of the entity and your intentions. It complements other procedures the accountant performs to review the financial statements.

Does a Representation Letter Benefit Management?

Yes, a representation letter has several benefits for management. It avoids misunderstandings and provides a checklist for important matters that affect the financial statements.

During the review, you will respond to many of the accountant's questions. For example, after identifying related party transactions, the accountant routinely asks whether management has knowledge of any other such transactions not already disclosed. Another example is an accountant's reliance on management's representation that it has title to all owned assets. The purpose of putting these representations in writing is to confirm the continued appropriateness of the information obtained in discussions with management.

Does Signing a Representation Letter Alter Responsibilities?

No. It simply affirms a responsibility that already exists. The representation letter does not lessen the accountant's responsibilities, whether for the conduct of the review or for the accountant's report on the financial statements. The representations made in a representation letter do not displace other essential review procedures. An inability to perform essential procedures would constitute a limitation on the scope of the review even if management were to provide representations covering such matters.

It is important that questions regarding representations be thoroughly explored and answered to the full satisfaction of all concerned. The accountant cannot issue a review report without this letter of representation. Without this letter in hand, the accountant is left to wonder if management has withheld information. Certainly, this might raise doubts in the accountant's mind about the reliability and completeness of management's oral responses to the accountant's inquiries.

Management Should Understand the Importance of the Representation Letter

The representation letter is not just "another form" to be signed. It is important to the accountant even though, year after year, its form and substance may go unchanged. Typically, it contains condensed but significant and wide-ranging representations. Even though the representation letter may be drafted by the accountant for your signature, the representations it contains are yours, and you should understand the full implications of statements in the letter.

Illustrative Representation Letter

The illustrative representation letter included in SSARS No. 1 (AR section 100) is reproduced in this pamphlet. The letter is addressed to the CPA firm. Because the accountant is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the letter will probably bear the same date as the accountant's report. That date marks the completion of all significant review procedures.

(Date of Accountant's Report)

(To the Accountant)

In connection with your review of the (identification of financial statements) of (name of client) as of (date) and for the (period of review) for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your review.

1. The financial statements referred to above present the financial position, results of operations, and cash flows of (name of client) in conformity with generally accepted accounting principles. In that connection, we specifically confirm that—

   a. The company's accounting principles, and the practices and methods followed in applying them, are as disclosed in the financial statements.

   b. There have been no changes during the (period reviewed) in the company's accounting principles and practices.

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

d. There are no material transactions that have not been properly reflected in the financial statements.

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

f. There are no 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, and there are no other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.

g. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.

h. There are no related party transactions or related amounts receivable or payable that have not been properly disclosed in the financial statements.

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

j. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

2. We have advised you of all actions taken at meetings of stockholders, board of directors, and committees of the board of directors (or other similar bodies, as applicable) that may affect the financial statements.

3. We have responded fully to all inquiries made to us by you during your review.

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

Review of Financial Statements—Illustrative Representation Letter

A review of financial statements consists principally of inquiries of company personnel and analytical procedures applied to financial data. As part of a review of financial statements, the accountant is required to obtain a written representation from his or her client to confirm the oral representations made to the accountant. The enclosed representation letter is included for illustrative purposes only. The accountant may decide, based on the circumstances of the review engagement, that other matters should be specifically included in the letter and that some of the representations included in the illustrative letter are not necessary.

It would be worthwhile to discuss the letter with your accountant so that all agree as to the meaning and significance of the representations. Ask for an explanation of unfamiliar terms or phrases. (You may want definitions included in the letter.) Make sure any changed circumstances are reflected in the current year's letter and that generalizations not applicable to your entity have not been included inadvertently.

Finally, keep in mind these words which usually appear in the opening paragraph:

we confirm, to the best of our knowledge and belief...

The representations do not constitute a guarantee that the information given is correct but rather that it is, in good faith, your best knowledge and belief.

AAM Section 8020

Credit Union Industry Developments—1995/96

Industry and Economic Developments

.01 Despite the United States economy's slow growth during 1995, the credit union industry continues to experience rapid growth in consumer lending, while loan chargeoffs remain at record low levels. Slower growth in deposits, however, has contributed to tighter liquidity and declining interest rate spreads. These factors, as well as continuing trends of cost control and consolidation within the industry, have various implications for audit risk.

Financial Trends

.02 Because loan chargeoffs are at such low levels, the National Credit Union Administration (NCUA) is encouraging federal credit unions to adopt risk-based lending strategies, whereby credit unions approve loans with higher credit risk in return for higher interest rates. Changing credit or documentation standards to accommodate new products or new strategies may increase audit risk associated with estimates of loan losses.

.03 Growth in loan portfolios also has tightened liquidity at many credit unions. Liquidity for funding portfolio activities typically comes from deposits, borrowings, or sales of assets such as securities. In recent years, mutual funds and other competing investments, as well as the strong performance of the stock market, have made it more difficult for credit unions to attract new deposits and have shifted funds away from existing deposits. Because borrowing funds from other institutions or other independent sources usually increases a credit union's cost of funds, deposits have been a primary funding source for portfolio growth, resulting in higher loan-to-deposit ratios. The importance of deposits as a funding source (and the value of related member relationships as opportunities to offer other products) has kept credit unions from lowering deposit rates to the same degree as other decreases in market interest rates. Rather than lowering deposit rates to market rates, many credit unions have had to choose between maintaining or raising deposit rates and using higher cost borrowings to support portfolio growth, thereby contributing to narrower interest-rate spreads.

.04 Credit unions that are heavily invested in fixed-rate assets (or variable-rate assets subject to caps on interest-rate increases) may face narrower spreads in a rising-rate environment. This situation is exacerbated when such credit unions have large volumes of money market or other short-term, rate-sensitive deposit liabilities that are subject to greater liquidity risk because those liabilities must be repriced at the higher interest rates. Auditors should be alert to the effect on audit risk of pressure to maintain or improve interest-rate spreads. Auditors also should be alert to the effects interest-rate increases could have on borrowers' ability to repay variable-rate loans.

.05 Some credit unions may sell securities or loans for liquidity to support portfolio growth. Auditors should consider the effect of such sales on management's intent for, classification of, and valuation of securities and loans for financial reporting purposes. Auditors also should be alert to the effect of sales with recourse on credit risk and recognition of gains and losses.

Consolidation and Restructuring

.06 Consolidation and restructuring within the industry have continued during 1995 as credit unions attempt to control costs. Related reductions in staff or elimination or merger of duties increase the potential for weaknesses in knowledge of or adherence to internal controls. Such changes also may result in a lack of personnel to carry out control procedures. Auditors should be alert to such matters when considering a credit union's internal control structure.

.07 Credit unions also continue to achieve efficiency and reduced operating expenses through shared-branch networks. Under shared-branch arrangements, credit unions are able to minimize the cost of doing business as well as provide their members with multiple locations by sharing branch facilities and staff with other, unrelated credit unions. Certain audit risks may arise from shared-branch arrangements. See the "Audit Issues and Developments" section of this Audit Risk Alert for a further discussion of the audit risks related to shared branches.

Legislative and Regulatory Developments

.08 Laws and implementing regulations affect the areas and ways in which credit unions operate by creating standards with which those credit unions must comply. Also, some laws and regulations directly address the responsibilities of auditors. Auditors should be generally familiar with certain laws and regulations because of their effect on auditors'—

- Acceptance of engagements in the industry.
- Development of the expected conduct and scope of an engagement.
- Responsibility for detection of errors, irregularities, and illegal acts.
- Evaluation of contingent liabilities and related disclosures.
- Consideration of a credit union's ability to continue as a going concern.

.09 Also, AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), requires that auditors consider matters, such as government regulations, affecting the industry in which the entity operates. For that purpose, being familiar with the nature and purpose of regulatory examinations—including the differences and the relationship between examinations and financial statement audits—is helpful for auditors. An understanding of the regulatory environment in which credit unions operate also is necessary to complement the auditor's knowledge of existing regulatory requirements. Because the regulatory environment is continually changing, the auditor should be aware of relevant regulatory changes and consider their implications in the audit process.

.10 Following are legislative and regulatory developments of particular significance in audits of the financial statements of credit unions. Other legislative and regulatory matters covering other policy areas, such as regulations for fair lending practices or the Community Reinvestment Act, are not within the scope of this document. Auditors should be alert to the effect of legislative and regulatory developments on contingent liabilities, and planned mergers or acquisitions, and the direct and material effects of such developments on the determination of amounts in the credit union's financial statements. This Audit Risk Alert does not provide a comprehensive discussion of each issue. Readers should not substitute a reading of this Alert for a complete reading of related laws, regulations, rulings, or other documents where appropriate (see the "Information Sources" section herein). This Alert refers to related publications of the NCUA and other entities as appropriate.

Legislative Development

.11 On June 28, 1995, the Credit Union Reform and Enhancement Act (S. 883) (the Bill), introduced by Senator Alfonse D'Amato (R-NY), chairman of the Senate Banking Committee, and ranking Democrat Paul Sarbanes from Maryland, was approved by the Senate Banking Committee. The purpose of the Bill is to amend the Federal Credit Union Act to enhance the safety and soundness of federally insured credit unions.

.12 The Bill would grant NCUA authority to limit the investment activities in which federally insured, state-chartered credit unions may engage. The Bill also would authorize NCUA to close federally insured, state-chartered credit unions that are insolvent or bankrupt after prior consultation with the state regulator; to institute a timely conservatorship by eliminating the current thirty-day waiting period; and to set minimum capital standards and limits on loans to a single borrower.

.13 In addition, the Bill would prohibit federal credit unions from investing in non-federally insured, state-chartered credit unions. Further, it would preclude certain corporate credit unions from accepting deposits from their federally insured credit union members, as well as prohibit federal credit unions from participating in loan syndication or asset securitization programs at state-chartered, non-federally insured credit unions.

.14 Although the Bill would authorize NCUA to curtail certain investment activities of federally insured, state-chartered credit unions, a grandfather clause was included to preserve federally insured, state-chartered credit unions' right to continue non-federally approved activities in which they already are involved.

.15 If enacted, the Bill may subject certain state-chartered credit unions to additional regulations that may have a direct and material effect on the financial statements. For example, it may require a credit union to divest of certain high-risk investments. It also may restrict or force the disposition of certain investments of some federal credit unions (see the "Regulatory Developments" section of this Audit Risk Alert for a further discussion of the divestiture issue). Therefore, auditors should be alert to any new developments in this area.

Regulatory Developments

.16 *Divestiture of High-Risk Investments.* NCUA regulations permit federal credit unions to invest in certain mortgage-related derivatives, such as collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs). However, part 703.5(g)(I) of the NCUA Rules and Regulations prohibits federal credit unions from purchasing fixed-rate CMOs or REMICs that fail any one of the three parts of the NCUA's high-risk securities test (HRST): (1) average life test, (2) average life sensitivity test, and (3) price sensitivity test (see *Federal Register*, vol. 58, no. 124, June 30, 1993). In addition, part 703.5(j) of the NCUA Rules and Regulations requires that the price sensitivity test be applied to fluctuating or adjustable-rate CMOs or REMICs. The NCUA may seek the early disposition of investments that fail one or more parts of the HRST at or after purchase if they are believed to constitute a significant threat to a credit union's continued sound operation.

.17 In April 1995, the NCUA issued Letter to Credit Unions No. 169 (Letter No. 169) to clarify the NCUA's position on divestiture of CMOs and REMICs that fail one or more parts of the HRST. The guidelines in Letter No. 169 also are intended to assist credit unions in their analyses of potential investments. It requires a credit union that discovers it is holding securities that fail one or more parts of the HRST to immediately dispose of those securities or, within five business days of discovery, develop and submit to NCUA a written action plan that at a minimum includes:

- An asset/liability management (ALM) modeling analysis that demonstrates the impact that both holding and selling the failed instruments will have on earnings, liquidity, and capital.
- Evidence of the credit union's ability to hold the failed instrument(s) and manage the risks under plus or minus 300 basis points interest-rate shocks.
- An individual dollar loss figure for each failed security that will trigger their sale.
- A monthly log of market bids offered for the failed securities.
- A monthly monitoring process to evaluate the stress test results for all CMOs and REMICs.

.18 NCUA examiners will assess the credit union's action plan, considering the reasonableness of the plan and the credit union's ability to manage the balance sheet risk. Specific factors that examiners will focus on will be the ability of the credit union officials to:

- Satisfactorily explain the securities characteristics and risks to the examiner.
- Obtain and adequately evaluate the security's market pricing, cash flows, and test modeling.
- Define, explain, and document how the failed securities fit into the credit union's ALM strategy.

- Analyze the impact that either holding or selling the failed securities will have on earnings, liquidity, and capital in different interest-rate scenarios.
- Demonstrate the likelihood that the failed securities may again pass the high-risk security tests at a future date.

After a review of the above factors, the examiner and the credit union management should agree on whether divestiture is appropriate and necessary. If the examiner does not feel that a suitable action plan has been developed, the credit union will be required to sell the failed CMOs or REMICs in accordance with a written directive that will be given to the credit union by NCUA.

.19 Such forced dispositions can negatively affect a credit union's liquidity, earnings, and capital positions. Because such restrictions and requirements can affect the classification and valuation of assets, auditors should assess the risk that any violations of such rules and regulations might result in a material misstatement of a credit union's financial statements, in accordance with SAS No. 54, *Illegal Acts by Clients* (AU section 317). See the "Audit Issues and Developments" section of this Audit Risk Alert for a further discussion of noncompliance with regulatory requirements.

.20 *Revised Supervisory Committee Regulations.* In late 1995, the NCUA expects to expose for public comment a revised Supervisory Committee Regulation, Part 701.12, "Audits and Verifications". The proposed regulation would specify the requirements for performing annual credit union supervisory committee audits and verification of members' accounts.

.21 The requirement for all federal credit unions to have made an annual supervisory committee audit would be satisfied by one or a combination of the following:

1. An audit of the credit union's financial statements performed by an independent auditor in accordance with generally accepted auditing standards (GAAS)
2. An agreed-upon procedures engagement performed by an independent auditor in accordance with SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622)
3. A supervisory committee audit performed by a compensated auditor (as defined) other than a certified public accountant in accordance with applicable GAAS (as defined)
4. A supervisory committee audit performed by the supervisory committee or its designated, uncompensated representative in accordance with applicable GAAS

.22 The proposed rule would require that any engagement by a compensated auditor to perform any or all parts of a supervisory committee audit be evidenced by an engagement letter. The proposed rule also specifies what must be included in the engagement letter.

.23 The proposed rule would require the auditor to provide a written report of the supervisory committee audit, a written report of any reportable conditions noted during the normal course of the audit, and a written report of any irregularities or illegal acts noted during the normal course of the audit. It also would require that the auditor provide access to all working papers related to the supervisory committee audit, including audit programs. Failure to provide such access may result in rejection of the audit as inadequate by the NCUA and administrative actions against the credit union. Auditors should refer to Interpretation No. 1 of SAS No. 41, *Working Papers,* titled "Providing Access to or Photocopies of Working Papers to a Regulator" (AU section 9339.01—.15).

.24 *Truth-in-Savings Disclosures.* In 1993, the NCUA issued a final rule (the Rule) on Truth-in-Savings Regulation, Part 707, to implement the Truth-in-Savings Act of 1992. Credit unions had until January 1, 1995, to comply with the Rule.

.25 In the year of adoption, the Rule may substantially change the way certain credit unions calculate the interest they pay on deposit accounts. It limits credit unions to calculating interest based on the daily balance or the average daily balance in a deposit account. Before issuance of the Rule, many credit unions used either the rollback or par value method to calculate interest on deposits. Under the rollback method, interest is calculated based on the lowest continuous balance after a specified date. Using the par value method, credit unions pay interest on par value increments, such as $5 shares, rather than on actual account balances.

.26 For many credit unions that were using either of those methods to calculate interest, a change to comply with the Rule may significantly increase the interest they pay on deposit accounts. Because violation of the Rule could cause a material misstatement of a credit union's financial statements, auditors should consider testing whether interest is calculated according to its provisions. See SAS No. 54 (AU section 317) for a further discussion of the auditor's responsibility regarding illegal acts that can have a direct and material effect on the determination of financial statement amounts.

Other Regulatory Matters

.27 Following are descriptions of recent actions that involve laws and regulations addressed in required management compliance assertions and related attestation procedures.

.28 *HUD Annual Lender Recertification Requirements.* Credit union subsidiaries that are mortgagees under certain mortgage insurance programs administered by the United States Department of Housing and Urban Development (HUD) should be aware of certain requirements for annual audits of financial statements. HUD Mortgagee Letter 95-6 provides additional information.

.29 *Lender Reports.* In 1992, Congress amended the Higher Education Act of 1965 (HEA) to require compliance engagements for lenders that participate in Federal Family Education Loan (FFEL) programs. Many credit unions are subject to the requirements because they participate as lenders in these FFEL programs, which include the Federal Stafford Loan Program (formerly the Guaranteed Student Loan Program), the Federal Supplemental Loans for Students Program, the Federal PLUS Program, and the Federal Consolidation Loan Program.

.30 In late 1992, the United States Department of Education (ED) issued implementing regulations, specifying that they would define procedures for conducting the engagements in a guide the ED's Office of the Inspector General (OIG) would develop. The regulations made the reporting requirement effective for fiscal years beginning after July 23, 1992. The OIG issued the Guide *Compliance Audits (Attestation Engagements) of Federal Family Education Loan Program at Participating Lenders* in March 1995.

.31 The Guide generally requires an examination of management assertions about compliance with certain requirements for preparation of the *Lender's Interest and Special Request and Reports* (ED Form 799), performed, in part, in accordance with AICPA Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AT section 500). The HEA also requires that the engagements be performed in accordance with the United States General Accounting Office's (GAO's) *Government Auditing Standards,* which include general standards for an external quality control review and for continuing education requirements.

.32 In a September 14, 1995, letter, the ED extended the due date for reports from lenders with portfolios equal to or less than $5 million (as defined) until June 30, 1996.

.33 Auditors may wish to discuss the reporting requirements with clients.

.34 *Exceptional Performance Standards Reports.* Beginning July 1, 1995, the HEA allows credit unions participating as lenders in FFEL programs voluntarily to seek "exceptional performance" status based on their performance collecting delinquent and defaulted FFEL program loans. An exceptional performance designation by the Secretary of Education makes a lender eligible to be reimbursed 100 percent for insurance claims submitted for twelve months from the date the ED notifies the lender of the designation. 34 Code of Federal Regulations

Subpart 682.415(a)(2) establishes qualifications for exceptional performance status, including a required report on a compliance audit of the lender's loan portfolio that reports a compliance performance percentage of 97 percent or higher (as defined). The ED's OIG is preparing a guide that would specify procedures to be performed and reported on in accordance with SSAE No. 3 (AT section 500) and the GAO's *Government Auditing Standards*. The guide also would include procedures for sampling and calculating the performance compliance percentage.

.35 Auditors may wish to discuss the reporting requirements with clients.

Audit and Accounting Guide

.36 The AICPA Credit Unions Committee currently is revising the AICPA Audit and Accounting Guide *Audits of Credit Unions* to conform appropriate accounting guidance to the revised AICPA Audit and Accounting Guide *Banks and Savings Institutions*, which will be issued in early 1996. The proposed Credit Unions Guide is expected to be exposed for public comment in late 1996. It will incorporate new accounting and financial reporting requirements issued by the Financial Accounting Standards Board (FASB) and the AICPA's Accounting Standards Executive Committee (AcSEC) and new auditing standards issued by the AICPA's Auditing Standards Board (ASB) since issuance of the current Credit Unions Guide, which will be superseded.

Audit Issues and Developments

Asset Quality and Valuation Issues

.37 Auditors of the financial statements of credit unions, especially those adopting new or more aggressive lending strategies, should give special attention to credit quality issues surrounding the loans those credit unions extend. Auditors also should give special attention to other asset quality issues related to real estate; troubled debt restructurings; foreclosed assets and other real estate owned; off-balance-sheet financial instruments; and other assets. Auditors should obtain sufficient competent evidence to evaluate the adequacy of management's loan loss allowance and liabilities for other credit exposures. The subjectivity of determining such amounts, combined with the issues discussed in the "Industry and Economic Developments" section herein, reinforces the need for careful planning and execution of audit procedures in this area, as well as evaluation of results of those procedures.

.38 Lack of an effective system to evaluate credit exposure and other sources of impairment, or failure of a credit union to document adequately its criteria and methods for determining loan loss allowances, may suggest a reportable condition or a material weakness in the credit union's internal control structure over financial reporting. These deficiencies generally would (1) increase the degree of judgment auditors and regulatory examiners must apply in evaluating the adequacy of management's related allowances and liabilities and (2) increase the likelihood that differences in judgments will result. The guidance in SAS No. 57, *Auditing Accounting Estimates* (AU section 342), is useful when considering this area. *Audits of Credit Unions* and the AICPA Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks* (Product No. 021050) are other sources of information on auditing estimated credit losses.

.39 Auditors also should be alert to valuation issues related to classification and impairment of securities and other credit union investments.

.40 Paragraph 16 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80.115), requires that, for individual securities classified either as available-for-sale or held-to-maturity (as defined), a credit union determine whether a decline in fair value below the amortized cost basis is other than temporary. Paragraph 69 of FASB Statement No. 115 (AC I80) says that "if the sale of a held-to-maturity security occurs without justification, the materiality of that contradiction of the enterprise's previously asserted intent must be evaluated."

.41 The Corporate Credit Union Network (the Network) serves as a primary investment alternative for many credit unions. It consists of the U.S. Central Credit Union and the various corporate credit unions.

.42 The recent failure of Capital Corporate Federal Credit Union, as a result of its significant investments in CMOs, has prompted the GAO, Congress, NCUA, and others to take a closer look at the financial strength of the Network. Several corporate credit unions are invested heavily in CMOs, many of which have declined in value. The GAO found corporate credit unions had total unrealized losses of about $600 million at the end of 1994 that were related to their investments in CMOs. Auditors should be aware of the financial difficulties encountered by certain corporate credit unions and ensure their credit union clients are monitoring the financial strength of the corporate credit unions in which they invest and are evaluating those investments for impairment on a timely basis.

.43 Other factors that may affect audit risk include the credit union's exposure to interest-rate, liquidity, prepayment, and other risks. For example, credit unions heavily invested in fixed-rate assets (or variable-rate assets subject to caps on interest-rate increases) may face narrower spreads in a rising-rate environment. Auditors also should be alert to the effects interest-rate increases could have on borrowers' ability to repay loans and the effects interest-rate decreases could have on the realization of assets that are sensitive to prepayments (such as mortgage servicing rights and interest-only securities). Credit unions with large volumes of money market or other short-term deposit liabilities are subject to greater liquidity risk because those liabilities must be refinanced.

Shared Branches

.44 Under shared-branch arrangements, several unrelated credit unions minimize the cost of doing business by sharing branch facilities and staff. The computer terminals at each branch can process deposits, withdrawals, and loan payments for all credit unions in the venture. Transactions are relayed to a data-processing switch where they are reformatted and posted to the subsidiary ledgers of the individual credit unions. Auditors should be aware of the risks created by the data-processing switch. The internal control structures of credit unions participating in shared-branch arrangements should include policies and procedures, such as the timely reconciliation of account balances, that ensure the proper posting and settling of the transactions processed by the shared branches. In addition, auditors should obtain an understanding of the internal control structure policies and procedures associated with the data-processing switch sufficient to plan the audit and to determine the nature, timing, and extent of procedures to be performed. To obtain this understanding, auditors should consider obtaining a service auditor's report on policies and procedures placed in operation at the data-processing switch. See the "SAS No. 70Auditing Procedure Study" section that follows for a further discussion of service auditors' reports.

.45 Federally chartered credit unions have no restrictions on participation in shared branches. However, state-chartered credit unions may be subject to state laws that prohibit the completion of transactions across state lines.

Noncompliance With Regulatory Requirements

.46 Events of noncompliance with regulatory requirements, such as participation in impermissible activities or investments, expose credit unions to regulatory action, such as the forced disposition of those impermissible investments. Events of noncompliance may be brought to the auditor's attention during the application of normal auditing procedures, during the review of regulatory examination reports, or because of actions required by regulators.

.47 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), states in paragraph 2 (AU section 341.02) that "the auditor has a responsibility to evaluate whether there is substantial doubt 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 audited." Events of noncompliance with laws and regulations or the need to dispose of substantial assets are conditions, when considered with other factors, that could indicate substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. SAS No. 59 (AU section 341) identifies examples of other factors that the auditor may evaluate.

Electronic Funds Transfer Association Engagements

.48 Some electronic funds transfer (EFT) associations or networks require their members that process transactions to complete a "compliance review." For example, credit unions with automated teller machines that use one or more EFT associations or networks may be required to provide related auditor reports.

.49 Some EFT association requirements intend for auditors to (1) complete a questionnaire about a credit union's compliance with the EFT association's operating rules and procedures related to internal controls over security and (2) sign a certification statement that the credit union is in compliance with such operating rules and procedures.

.50 SSAE No. 3 (AT section 500) governs engagements of this nature. Auditors who are asked to perform such engagements should determine whether the actions that are required conflict with SSAE No. 3 (AT section 500). For example, certification statements may extend an auditor's responsibility significantly beyond the limits of professional standards. Sometimes, the statements prescribed by the EFT association refer to GAAS or other professional standards that do not apply to such services. Such statements also may refer to the auditor's review of compliance; however, SSAE No. 3 (AT section 500) prohibits review services related to compliance, permitting only examination (assuming certain conditions exist) or agreed-upon procedures engagements. Furthermore, compliance questionnaires often ask for responses to questions about compliance without providing sufficiently objective criteria for determining when compliance does or does not exist.

Elimination of Uncertainty Reporting

.51 The ASB has issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

.52 The amendment also would expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AU section 508.37), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

.53 The proposal does not affect the provisions of SAS No. 59 (AU section 341), which requires that the auditor add an explanatory paragraph to the auditor's report when there is substantial doubt about the entity's ability to continue as a going concern.

.54 Currently, auditors of the financial statements of credit unions may consider it necessary to add an uncertainty explanatory paragraph to their reports when there is a material uncertainty relating to possible regulatory sanctions, for example, for failure to comply with a written agreement entered into with the NCUA. If the proposed SAS is issued in final form, that requirement will be eliminated. Nonetheless, auditors reporting on financial statements that include such an uncertainty may wish to emphasize that fact by adding an emphasis of a matter paragraph to their reports. Such paragraphs, however, are optional and are added solely at the auditor's discretion.

.55 The ASB hopes to finalize this SAS late this year and to issue an SAS that would be effective for reports issued on or after June 30, 1996.

.56 Comments on the proposed SAS were due on October 20, 1995.

Mortgage Banking Engagements

.57 In May 1995, the Mortgage Bankers Association of America (MBA) released its revised *Uniform Single Attestation Program for Mortgage Bankers* (USAP). The USAP supersedes the MBA's existing program (published in 1983) with an opinion-level attestation engagement performed following SSAE No. 3 (AT section 500). Specifically, the MBA redefined the engagement to address mortgage servicing companies' compliance with the USAP's specified minimum servicing standards. The USAP will be effective for fiscal years ending on or after December 15, 1995, and later, with earlier application encouraged.

.58 In a September 27, 1995 letter to its members, the MBA said that commercial and multifamily loan servicers could report using the USAP, except that minimum standards V.4 and VI.1 could be omitted from management's assertion and the auditor's attestation reports. In the letter, the MBA described a project under way to consider amending or expanding the USAP to explicitly address reporting by commercial and multifamily loan servicers.

.59 The USAP addresses reporting on management assertions about an entity's compliance with specified criteria. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), provides guidance on factors auditors should consider when auditing the financial statements of entities that use service organizations (such as mortgage bankers that service mortgages for others). Information about the control structure policies and procedures at mortgage bankers or other loan servicing organizations may affect assertions in the user entity's financial statements. Also, some service auditors' reports prepared according to SAS No. 70 (AU section 324) include descriptions and results of tests of operating effectiveness of specified control policies and procedures. Accordingly, those SAS No. 70 (AU section 324) reports may enable an auditor of the financial statements of a user entity to assess control risk below the maximum of relevant financial statement assertions. Readers should consult SAS No. 70 (AU section 324) for additional information on how to use a service auditor's report when auditing the financial statements of a user organization.

.60 The Federal Home Loan Mortgage Corporation (Freddie Mac) sent a September 29, 1995 letter to chief financial officers of its seller/servicers announcing that, effective immediately, Freddie Mac no longer requires an independent accountant's agreed-upon procedures attestation report on compliance with requirements of Freddie Mac's programs. The report previously was required by Freddie Mac's 1993 *Compliance Reporting Guide*. Readers should be alert to a Freddie Mac bulletin that will be issued explaining the change and clarifying Freddie Mac's other independent audit requirements.

SAS No. 70 Auditing Procedure Study

.61 A task force of the ASB has drafted an auditing procedure study that provides guidance to auditors on implementing SAS No. 70 (AU section 324). The study provides guidance to a service auditor engaged to issue a report on the control structure policies and procedures of a service organization and to user auditors engaged to audit the financial statements of an entity that uses a service organization. An example of a service organization is a bank trust department that invests and holds assets for employee benefit plans. The task force expects to issue the study in early 1996.

Agreed-Upon Procedures Engagements

.62 In September 1995, the ASB issued SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622), which supersedes SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*. The ASB also issued SSAE No. 4, *Agreed-Upon Procedures Engagements* (AT section 600), which, among other things, in amending agreed-upon procedure reports prepared in accordance with SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600):

- Prohibits negative assurance about whether management's assertion is fairly stated from being included in reports on agreed-upon procedures.
- Clarifies that SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AU section 322), does not apply to agreed-upon procedures engagements.

- States that the concept of materiality does not apply to agreed-upon procedures engagements unless the definition of materiality is agreed to by the specified users.

SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) are effective for reports dated after April 30, 1996, with earlier application encouraged.

.63 Among other significant provisions, SSAE No. 4 (AT section 600) also requires a written management assertion as a condition of engagement performance.

.64 Appendix B to *Audits of Credit Unions* entitled "Suggested Guidelines for CPA Participation in Credit Union Supervisory Audits" provides guidance for performing supervisory committee audits in accordance with SAS No. 35. The AICPA Credit Unions Committee will consider the need for changes in that guidance due to changes in professional standards in connection with the revision of *Audits of Credit Unions.* Auditors should consult SAS No. 75 (AU section 622) for engagements that fall within its scope.

.65 SSAE No. 4 (AT section 600) will affect engagements to report on agreed-upon procedures relating to management assertions about compliance by credit unions with EFT association requirements and FFEL program requirements (see the "Legislative and Regulatory Developments" section of this Audit Risk Alert). Auditors should be alert to the effects of SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) on these and similar engagements.

Accounting Issues and Developments

Refund of NCUSIF Deposit

.66 Under the Federal Credit Union Act, the NCUA must refund to credit unions insured by the National Credit Union Share Insurance Fund (NCUSIF) the amount by which the equity of the NCUSIF exceeds 1.3 percent, its normal operating level.

.67 For the first time since the fund was restructured in 1986, NCUA expects to refund deposits in excess of its normal operating level to credit unions insured by the NCUSIF. NCUSIF equity reached 1.3 percent in May 1995 and is expected to exceed 1.3 percent by September 30, 1995, the end of the insurance year.

.68 Auditors should determine whether such refunds are properly accounted for. Paragraph 10.18 of *Audits of Credit Unions* requires that any cash payments received by a credit union in connection with the reduction in the equity of the NCUSIF be reported as current-period income *in the period in which it is determined that a distribution will be made.* If it is determined before the credit union's year end that a distribution will be made, income should be accrued in the credit union's year-end financial statements.

Mortgage Servicing Rights

.69 FASB Statement No. 122, *Accounting for Mortgage Servicing Rights* (AC Mo4), amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (AC Mo4), to require that a mortgage banking enterprise recognize as separate assets rights to service mortgage loans for others, however those servicing rights are acquired. A mortgage banking enterprise may acquire mortgage servicing rights through either the purchase or origination of mortgage loans. Auditors of federally chartered credit unions should be aware that the NCUA regulations prohibit federal credit unions from purchasing mortgage servicing rights. A credit union that acquires mortgage servicing rights through the origination of mortgage loans and sells or securitizes those loans with servicing rights retained is required by FASB Statement No. 122 (AC Mo4) to allocate the total cost of the mortgage loans to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on their relative fair values if it is practicable to estimate those fair values. If it is not practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights), the Statement (AC Mo4) requires that the entire cost of purchasing or originating the loans should be allocated to the mortgage loans (without the mortgage servicing rights) and no cost should be allocated to the mortgage servicing rights.

.70 FASB Statement No. 122 (AC Mo4) requires that a credit union assess its capitalized mortgage servicing rights for impairment based on the fair value of those rights. The Statement (AC Mo4) requires that a credit union should stratify its mortgage servicing rights that are capitalized after the adoption of the Statement (AC Mo4) based on one or more of the predominant risk characteristics of the underlying loans. The Statement (AC Mo4) requires that impairment should be recognized through a valuation allowance for each impaired stratum.

.71 FASB Statement No. 122 (AC Mo4) applies prospectively in fiscal years beginning after December 15, 1995, to transactions in which a credit union sells or securitizes mortgage loans with servicing rights retained and to impairment evaluations of all amounts capitalized as mortgage servicing rights, with earlier application encouraged. The Statement (AC Mo4) prohibits retroactive capitalization of mortgage servicing rights retained in transactions in which a credit union originates mortgage loans and sells or securitizes those loans before the adoption.

.72 In July 1995, the FASB staff announced that the Board agreed to clarify the transition provisions of FASB Statement No. 122 (AC Mo4), noting in FASB's Action Alert No. 95-21 that:

> . . . earlier application is encouraged as of the beginning of a fiscal year for which annual financial statements or annual financial information has not been issued or as of the beginning of an interim period within that fiscal year for which interim financial statements or interim financial information has not been issued. For example, Public Company X issued financial information for the first quarter. In the second quarter, management of Public Company X has two choices for early adoption: (1) adopt as of the beginning of the fiscal year because annual financial statements or annual financial information has not been issued for that fiscal year or (2) adopt as of the beginning of the second quarter because interim financial statements or interim financial information has not been issued for that quarter.

Impairment of Long-Lived Assets

.73 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). FASB Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the credit union estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.

.74 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.75 Paragraph 16 of FASB Statement No. 121 (AC I08.135) states that assets to be disposed of that are within the scope of that Statement (AC I08), such as other real estate owned, should "not be depreciated (amortized) while they are held for disposal."

.76 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. (Earlier application is encouraged.) Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle. (See "Foreclosed Assets" in the "Accounting Issues and Developments" section herein.)

.77 Auditors of credit unions should be aware that the current industry climate of consolidations and mergers have increased the likelihood that events or changes in circumstances that indicate that assets have been impaired may have occurred. For example, a merger may result in duplication of branch locations within certain geographic areas that would compete for member business. In these instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.78 In considering a credit union's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57 (AU section 342).

Disclosures About Derivatives

.79 In October 1994, the FASB issued Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25). FASB Statement No. 119 (AC F25) requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. Although federal credit unions are prohibited from investing in derivative financial instruments as defined by FASB Statement No. 119 (AC F25), fixed-rate loan commitments and certain variable-rate loan commitments have characteristics similar to options and, therefore, fall within the scope of that Statement (AC F25).

.80 The Statement (AC F25) also amends existing requirements of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), and FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25). The Statement (AC F25) requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 (AC F25.115P) encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

.81 FASB Statement No. 119 (AC F25) was effective for financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations, the Statement (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1995.

.82 The FASB Special Report *Illustrations of Financial Instrument Disclosures* contains illustrations of the application of FASB Statements No. 105 (AC F25), No. 107 (AC F25), and No. 119 (AC F25).

Income Recognition on Impaired Loans

.83 In October 1994, the FASB issued Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (AC I08), which amends FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC I08), to allow creditors to use existing methods for recognizing interest income on impaired loans. To accomplish that, it eliminates the provisions in FASB Statement No. 114 (AC I08) that describe how creditors should report income on impaired loans.

.84 FASB Statement No. 118 (AC I08) does not change the provisions in FASB Statement No. 114 (AC I08) that require creditors to measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral-dependent.

.85 FASB Statement No. 118 (AC I08) also amends the disclosure requirements in FASB Statement No. 114 (AC I08) to require disclosure of information about the recorded investment in certain impaired loans and about how creditors recognize interest income related to those loans.

.86 FASB Statement No. 118 (AC I08) is effective concurrent with the effective date of FASB Statement No. 114 (AC I08), that is, for financial statements for fiscal years beginning after December 15, 1994.

Contributions

.87 A number of credit unions receive substantial contributions (for example, use of facilities and utilities, telephone services, data processing, mail services, payroll processing services, pension administration services and pension plan contributions, and other materials and supplies) from their sponsoring organizations. A number of credit unions also rely on volunteers to provide various services to their members; other credit unions are staffed exclusively by volunteers.

.88 In June 1993, the FASB issued Statement No. 116, *Accounting for Contributions Received and Contributions Made* (AC C67), which establishes accounting standards for contributions and applies to all entities, including credit unions, that receive or make contributions. FASB Statement No. 116 (AC C67) generally requires that contributions received, including unconditional promises to give, be recognized as revenues in the period received at their fair values. Contributions of services should be recognized if the services received (1) create or enhance nonfinancial assets or (2) require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation. FASB Statement No. 116 (AC C67) has some specific disclosure requirements for contributed services and the Statement (AC C67) is generally effective for financial statements issued for fiscal years beginning after December 15, 1994.

.89 FASB Statement No. 116 (AC C67) also requires additional disclosures that apply *only* to not-for-profit organizations and provides for a delayed effective date for certain small not-for-profit organizations. Auditors should be aware that credit unions are *not* considered not-for-profit organizations for purposes of this Statement (AC C67).

.90 Auditors should consider whether contributions that require recognition in accordance with FASB Statement No. 116 (AC C67) are identified as such and are properly valued, recorded, and disclosed in the financial statements.

.91 In June 1995, the NCUA issued Letter to Credit Unions No. 171, which establishes a regulatory accounting position with regard to FASB Statement No. 116 (AC C67). NCUA believes that the donation of assets and services by a sponsor to a credit union is a reciprocal transfer because the sponsor gets the fringe benefit to its employees of on-site financial services. Therefore, such donations would not be required to be accounted for in accordance with the provisions of FASB Statement No. 116 (AC C67). NCUA will not take exception to a credit union's decision to follow FASB Statement No. 116 (AC C67), as long as it is followed consistently.

Impairment of a Loan

.92 In May 1993, FASB Statement No. 114 (AC I08) was issued to address the accounting by creditors for impairment of certain loans. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Statement (AC I08) is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller balance homogeneous loans that are collectively valued for impairment (for example, credit-card, residential mortgage, and consumer installment loans), loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115 (AC I80). It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms, including groups of smaller balance homogeneous loans that may otherwise have been excluded from the scope of the Statement (AC I08).

.93 FASB Statement No. 114 (AC I08) requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent. The impairment is recognized by creating or adjusting a valuation allowance for the impaired loan with a corresponding charge to bad debt expense.

.94 The Statement amends FASB Statement No. 5, *Accounting for Contingencies* (AC C59), to clarify that a creditor should evaluate the collectibility of both the contractual interest and contractual principal of all receivables in assessing the need for a loss accrual. The Statement (AC I08) also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (AC D22), to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions. Auditors should be aware that this Statement (AC I08) may have limited application to credit unions that do not engage in business lending.

.95 The Statement (AC I08) applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

Offsetting

.96 APB Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7 (AC B10.101-103), says that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), defines *right of setoff* and specifies what conditions must be met to permit offsetting. FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* (AC B10), modifies FASB Interpretation No. 39 (AC B10) to permit offsetting in the statement of financial position of payables and receivables that represent repurchase agreements and reverse repurchase agreements and that meet all of the conditions specified therein. FASB Interpretation No. 41 (AC B10) was effective for financial statements issued for periods ending after December 15, 1994.

Consensus Decisions of the FASB's Emerging Issues Task Force (EITF)

.97 The EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to credit unions. A description of issues discussed during the year follows; readers should consult detailed minutes for additional information.

- EITF Issue No. 95-5, *Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights*, addresses certain issues related to sales of and mortgage loan servicing rights.

- EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination,* addresses what types of direct, integration, or exit costs to accrue as liabilities in a purchase business combination and when to recognize those costs.

- EITF Issue No. 95-2, *Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party,* addresses what constitutes a significant economic penalty to a consolidated entity under EITF Issue No. 91-1, *Hedging Intercompany Foreign Currency Risks.*

- EITF Issue No. 94-9, *Determining a Normal Servicing Fee Rate for the Sale of an SBA Loan,* discusses how, when applying EITF Issue No. 88-11, *Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold,* an enterprise should determine a normal servicing fee rate for United States Small Business Administration (SBA) loans without a major secondary market maker. A secondary issue is how to account for a change in the normal servicing fee rate.

- EITF Issue No. 94-5, *Determination of What Constitutes All Risks and Rewards and No Significant Unresolved Contingencies in a Sale of Mortgage Loan Servicing Rights under Issue No. 89-5,* involves accounting for transfers of mortgage servicing rights.

.98 Appendix D to the *EITF Abstracts* contains EITF discussions of technical matters that have long-term relevance and do not relate specifically to a numbered EITF Issue. Readers should be alert to the following topics of recent discussion:

- Appendix D-45, *Implementation of FASB Statement No. 121 for Assets to Be Disposed Of,* contains FASB staff views on issues relating to implementation of FASB Statement No. 121 (AC I08).

- Appendix D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value,* contains a FASB staff announcement concerning implementation of FASB Statement No. 115 (AC I80).

- Appendix D-43, *Assurance That a Right of Setoff is Enforceable in a Bankruptcy under FASB Interpretation No. 39,* contains FASB staff views on that subject.

.99 Readers should consult the minutes for the following issues to understand the effect of issuance of FASB Statement No. 122 (AC Mo4) on related consensuses.

- EITF Issue No. 88-11, *Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold*

- EITF Issue No. 86-39, *Gains from the Sale of Mortgage Loans with Servicing Rights Retained*

- EITF Issue No. 86-38, *Implications of Mortgage Prepayments on Amortization of Servicing Rights*

.100 Readers should consult the minutes for the following issues to understand the effect of issuance of FASB Statement No. 121 (AC I08) on related consensuses.

- EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*

- EITF Issue No. 90-16, *Accounting for Discontinued Operations Subsequently Retained*

- EITF Issue No. 90-6, *Accounting for Certain Events Not Addressed in Issue No. 87-11 Relating to an Acquired Operating Unit to Be Sold*

- EITF Issue No. 87-11, *Allocation of Purchase Price to Assets to Be Sold*

- EITF Issue No. 84-28, *Impairment of Long-Lived Assets*

Risks and Uncertainties

.101 In December 1994, AcSEC issued Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires credit unions to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires credit unions to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.102 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Besides valuation allowances for business and real estate loans, examples of similar estimates that may be included in financial statements of credit unions include, but are not limited to, the following:

- Impairment of long-lived assets, for example, marginal branches.
- Estimates involving assumed prepayments, for example, discounts or premiums on financial assets (such as securities or loans), mortgage servicing rights and excess servicing receivables, and mortgage-related derivatives.
- Lives of goodwill and identifiable intangible assets.

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of credit unions in accordance with paragraph 21 of the SOP include the following:

- Sale of a substantial portion of or all receivables or loan products to a single customer.
- Loss of approved status as a seller to a third party.
- Concentration of revenue from mortgage banking activities.

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

.103 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

Foreclosed Assets

.104 Certain provisions of SOP 92-3, *Accounting for Foreclosed Assets,* are inconsistent with provisions of FASB Statement No. 121 (AC I08). AcSEC is considering actions that it should take on SOP 92-3; however, FASB Statement No. 121 (AC I08) takes precedence for transactions within its scope.

SEC Staff Accounting Bulletin

.105 Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 94, *Recognition of a Gain or Loss on Early Extinguishment of Debt,* expresses SEC staff views about the period in which a gain or loss is recognized on the early extinguishment of debt. While credit unions are not public entities subject to the reporting requirements of the SEC, SAB No. 94 may provide useful guidance to credit unions.

Information Sources

.106 Further information on matters addressed in this Audit Risk Alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.107 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine; others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.108 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.109 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.110 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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.111 This Audit Risk Alert supersedes *Credit Unions Industry Developments—1994.*

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.112 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272	*24-Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Federal Home Loan Mortgage Corporation (Freddie Mac)	*Customer Service* 8200 Jones Branch Drive McLean, VA 22102-3107 (800) FREDDIE			
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700, ext. 444
Mortgage Bankers Association of America	*Publications Department* 1125 15th Street, NW Washington, DC 20005-2766 (800) 793-MBAA, ext. 3	*MBA Fax on Demand* This service is available only to MBA members. For more information, call (800) 793-MBAA.		
National Credit Union Administration	*Office of Public and Congressional Affairs* 1775 Duke Street Alexandria, VA 22314-3428 (703) 518-6300		*NCUA Bulletin Board* All information is available to guest users (703) 518-6480	NCUA Newsline (800) 755-1030 (703) 518-6339 (Washington, DC area)
U.S. Department of Education	*Federal Student Aid Information Center* (800) 433-3243			
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250(f)		*U.S. Government Printing Office Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account. User assistance line: (202) 512-1530 (202) 512-1387(d) Telnet via internet. federal.bbs.gpo.gov 3001	

AAM Section 8030
Health Care Industry Developments—1995/96

Industry and Economic Developments

.01 The Congressional debates on health care focused nationwide attention on the health care industry in 1994. That scrutiny became the catalyst that forced health care providers to openly embrace cost containment and efficiency enhancement and adopt corporate strategies such as mergers, restructurings, and the realignment of facilities and personnel. This climate has continued in 1995. Perhaps the most notable response to the pressure to control costs is the continuing movement toward a managed care environment in which physicians, insurers, and other health care providers are creating integrated delivery systems and networks that combine inpatient, outpatient, and physician services into one organization. The change from a fee-for-service system of care to a managed care, capitated environment means that health care providers will assume more of the financial risk of treating patients. Providers are also beginning to share additional underwriting risks for health care services with other health care providers. Such arrangements are new to many providers and the financial risk of entering into unprofitable health care delivery contracts may be increased if the provider is unfamiliar with operating in a managed care environment.

Specific Industry Conditions

.02 *Hospitals.* The industry-wide shift toward managed care and vertical integration have reduced the demand for inpatient hospital services. In an effort to compete and survive, many hospitals have begun to become part of larger networks that enable them to provide a complete continuum of care to their patients. Hospitals that are unable to adapt to the changing environment may jeopardize their ability to generate sufficient revenues to remain financially viable.

.03 *Nursing Homes.* The nursing home segment of the health care industry is experiencing unprecedented pressure to contain costs and yet maintain high clinical outcome levels. This climate has been created by increased competition of specialty subacute units, cost-effective assisted living units, and home health or personal care agencies. In addition, the advent of managed care with its integrated delivery systems has forced a number of nursing homes to scramble to retain market share and identify compatible network partners. These factors may increase audit risk as providers attempt to enhance their financial performance in order to attract or retain network partners. Accordingly, auditors should be alert to issues relating to the collectibility of patient receivables, off-balance-sheet risk due to managed care contracts, related-party disclosures, and the reasonableness of accounting estimates.

.04 *Continuing Care Retirement Communities.* Continuing care retirement communities (CCRCs) have only recently begun to experience the impact of the sweeping market developments that have affected the delivery and financing of health care services. Developments such as the following are changing both the number and demographics of CCRC residents:

- Continuing pressure for earlier discharge from hospitals has resulted in more incoming residents who have higher acuity levels and longer life expectancies
- Long-term insurance policies that provide some of the protection that traditionally has been offered by CCRCs have reduced the demand for new CCRC enrollments
- Increased sophistication in estate planning has created a "poor-on-paper" population that some CCRCs may be required (either by mission or by contract) to serve without payment

These factors may affect accounting estimates, such as future net cash flows and expected number of residents, that are significant to the financial statements of CCRCs. Auditors reviewing a CCRC's *obligation to provide future services* should carefully consider these factors and should consult AICPA Statement of Position (SOP) 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities.*

.05 These and other developments that may affect audits of financial statements of health care organizations are discussed in the "Audit Issues and Developments" section of this Audit Risk Alert.

Regulatory and Legislative Developments

OMB Circulars A-110 and A-133

.06 In August 1994, the Department of Health and Human Services adopted U.S. Office of Management and Budget (OMB) Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations.* The circular adopts the audit requirements of OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions,* making it applicable to all universities, hospitals, and not-for-profit organizations receiving federal financial assistance. OMB Circular A-133 currently exempts hospitals not affiliated with institutions of higher education.

.07 In March 1995, the OMB issued proposed revisions to OMB Circular A-133 that would change the definition of nonprofit organizations to include nonprofit hospitals and thus require all nonprofit hospitals to adhere to the audit requirements currently in existence for other nonprofit organizations receiving federal financial assistance (*Federal Register* [March 17, 1995]).

Internal Revenue Service Developments

.08 Auditors should be aware of relevant tax laws and regulations and their potential effect on health care organizations and their financial statements. An organization's failure to maintain its tax-exempt status could have serious tax consequences and affect both its financial statements and related disclosures, and it could possibly require modification of the auditor's report. Failure to comply with tax laws and regulations could be an illegal act that may have either a direct and material effect on the determination of financial statement amounts (for example, the result of an incorrect accrual for taxes on unrelated business income) or a material indirect effect on the financial statements that would require appropriate disclosures (for example, the result of a potential loss of tax-exempt status). AICPA Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AU section 317), discusses the nature and extent of the consideration an auditor should give to the possibility of illegal acts and provides guidance on the auditor's responsibilities if a possible illegal act is detected.

.09 The Internal Revenue Service (IRS) continues to focus its attention on large health care systems through its coordinated examination program (CEP). Violations uncovered in a CEP audit may result in (1) tax assessments (including interest and penalties) and (2) loss of tax-exempt status and the inability to maintain tax-exempt financing. In recent CEP audits, the IRS has focused on issues such as the following:

- Failure to withhold FICA and income taxes for research fellows, interns, and residents at teaching hospitals
- Private inurement
- Noncompliance with Medicare and Medicaid antikickback statutes
- Unrelated business income
- Violations of tax-sheltered annuity plans
- Incorrect classifications of independent contractors/employees

Issues such as these can have a material effect on the tax provisions and liabilities recorded in the financial statements of health care providers and, therefore, require close scrutiny by auditors.

Department of Justice False Claims Act Investigation

.10 Under Medicare payment regulations, diagnostic tests performed within a certain number of hours of an admission (currently, 72 hours) are reimbursed as part of the inpatient admission and cannot be billed separately. Hospitals that submit inappropriate billings are subject to the provisions of the Medicare False Claims Act (Act). In addition to reimbursing the Medicare program for the inappropriate billings, hospitals are subject to significant civil penalties under the Act. Certain hospitals in Pennsylvania were the first to be targeted by a Department of Justice investigation claiming millions of dollars in inappropriate billings. Although a settlement has been reached with the Pennsylvania hospitals, the Department of Justice plans to expand its investigation to other states in the near future. Auditors of hospitals should consult Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies* (AC C59), and SAS No. 54 (AU section 317) when evaluating the accounting and reporting implications of this issue.

Shalala Versus Guernsey Memorial Hospital

.11 Usually, revenue and the related receivables for health care services are recorded in the accounting records of health care providers on an accrual basis at the provider's full established rates. Provisions for contractual adjustments (that is, the difference between established rates and third-party payor reimbursements) and discounts are recognized on an accrual basis and deducted from gross service revenue to determine net service revenue. Medicare is a primary third-party payor to health care providers.

.12 In March 1995, the U.S. Supreme Court held in the case of Shalala v. Guernsey Memorial Hospital that the Secretary of Health and Human Services (HHS) is not required to adhere to generally accepted accounting principles (GAAP) in making Medicare provider reimbursement decisions. The issue in the case was whether Guernsey Memorial Hospital was entitled to full Medicare reimbursement for its advance refunding loss in the year the loss was sustained (as determined in accordance with GAAP), or whether the refunding loss should have been recognized and reimbursed over the remaining life of the old debt (as prescribed by HHS guidelines). The court concluded that HHS guidelines prevail over GAAP requirements. As a result, Medicare reimbursements for losses on defeasance of debt must be amortized and reimbursed over the life of the bonds rather than reimbursed in their entirety in the year the debt was extinguished. To emphasize this position, the Health Care Financing Administration issued a final rule on June 27, 1995, clarifying the concept of "accrual basis of accounting" to indicate that expenses must be incurred by a provider of health care services before Medicare will pay its share of those expenses. Auditors should consider the effect of these developments when reviewing the amount and timing of reimbursable costs recorded by health care providers.

Proposed Reductions in Medicare and Medicaid Growth

.13 In May 1995, the House of Representatives passed the 1996 budget reconciliation, which would mandate that Medicare growth be reduced from 10 percent to 5 percent annually. The resolution would cut $282 billion from Medicare and $184 billion from Medicaid over seven years. The Senate version would cut $256 billion from Medicare and $202 billion from Medicaid over seven years. Both proposals would transform the Medicaid program into a program of block-grants to be given to the states. If the proposals are signed into law, these cuts will have substantial effects on the future revenue streams of many health care providers.

Audit Issues and Developments

New Alliances and Networks and Resulting Business Combinations

.14 In response to the pressure to contain health care costs, health care providers are establishing new alliances and networks with other providers and insurers to gain operating and functional efficiencies. Auditors should consider the audit implications of these new alliances and networks when gaining an understanding of an entity's business in accordance with SAS No. 22, *Planning and Supervision* (AU section 311). (SAS No. 22 (AU section 311) requires auditors to "obtain a level of knowledge of the entity's business that will enable him to plan and perform his audit in accordance with generally accepted auditing standards.") For example, certain alliances may violate federal antitrust laws as well as Medicare fraud and abuse guidelines. In addition, such arrangements could result in unrelated business income and private inurement, both of which could jeopardize the tax-exempt status of not-for-profit health care organizations.

.15 *Creation of Related Party Transactions.* SAS No. 22 (AU section 311) also states that auditors should consider matters such as government rules and regulations that affect the industry in which an entity operates. Auditors of health care organizations that have become part of larger alliances or networks should be mindful that the establishment of such networks and alliances may result in the creation of related parties as defined in FASB Statement No. 57, *Related Party Disclosures* (AC R36). Auditors should also consider the accounting and reporting ramifications of the rules and regulations such as the following:

- IRS rules on tax-exempt status, especially rules relating to private inurement and unrelated business income
- Medicare and Medicaid rules, especially those relating to business combinations (for example, depreciation recapture, asset step-up)
- Correspondence from the client's attorneys concerning matters such as antitrust issues, fraud and abuse concerns, and litigation or investigations in process
- State laws regarding business combinations of not-for-profit and for-profit organizations

.16 Auditing and reporting guidance that may pertain to networks and alliances is provided by the following authoritative literature:

- Accounting Principles Board (APB) Opinion No. 16, *Business Combinations* (AC B50), APB Opinion No. 17, *Intangible Assets* (AC I60), and APB Opinion No. 29, *Accounting for Nonmonetary Transactions* (AC N35)
- FASB Statement No. 57 (AC R36)
- SAS No. 45, *Omnibus Statement on Auditing Standards—1983,* "Related Parties" (AU section 334)
- FASB Emerging Issues Task Force (EITF) Issue No. 86-29, *Nonmonetary Transactions: Magnitude of Boot and the Exceptions of the Use of Fair Value*
- AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*
- AICPA SOP 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services,* and SOP 90-8
- Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*

In addition, auditors should be aware of the following exposure drafts that discuss, among other things, business combinations:

- Proposed AICPA Audit and Accounting Guide *Health Care Organizations* (chapter 11)
- Proposed GASB Statement, *The Financial Reporting Entity—Affiliated Organizations*

.17 As mentioned in the "Industry and Economic Developments" section of this Audit Risk Alert, hospitals that are unable to become part of a larger network or alliance may jeopardize their ability to generate sufficient revenues to remain financially viable. Auditors of hospitals should carefully consider the audit risk implications relating to the financial statements of such hospitals and should consider the provisions of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), which requires auditors to evaluate, based on the results of audit procedures performed, whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time (not to exceed one year beyond the date of the financial statements being audited).

Increased SEC Scrutiny of Purchase Price Accounting by Health Care Entities

.18 The increased number of mergers and acquisitions among health care organizations has heightened the relevance of purchase price accounting to the health care industry. The staff of the Securities and Exchange Commission (SEC) has expressed concern regarding a number of issues relating to purchase accounting, including purchase price allocation, goodwill amortization, and contingent consideration. Auditors of health care providers should be aware of the staff's concerns when they audit health care organizations that are registered with the SEC.

.19 *Purchase Price Allocation.* In the service sector of the economy in which tangible assets often are not significant, such as in the health care management sector, the SEC staff has noted a number of instances in which identifiable intangible assets are not being valued separately and amortized in accordance with APB Opinion No. 16 (AC B10). (APB Opinion No. 16 (AC B10) requires that all identifiable assets purchased in an acquisition transaction be assigned a portion of the cost of the acquired company.) As they evaluate the propriety of accounting and reporting of intangibles, auditors should focus on allocations to purchased intangibles such as management contracts, workforce in place, and covenants not to compete.

.20 *Goodwill Amortization.* In a speech made at the *AICPA National Conference on SEC Developments* in January 1995, the SEC staff indicated that there are a number of industry factors that make it difficult to assert that an acquired business in the health care industry will survive and provide a competitive advantage for periods as long as forty years. These factors include the following:

- Significantly increased competition
- Industry consolidation
- Changing third-party reimbursement requirements
- Technological innovation
- An uncertain regulatory future

When these issues exist, the SEC staff believes that a useful life of as few as ten years is often appropriate and will challenge a useful life of more than twenty years. Auditors of health care entities undergoing purchase acquisitions should be aware of the SEC staff's concerns when reviewing amortization lives assigned to goodwill.

.21 *Contingent Consideration.* Merger agreements frequently include provisions for contingent consideration, often referred to as an "earn-out," which provides for additional amounts to be paid to the selling shareholders contingent on the occurrence of specified events or transactions in the future. Such provisions may give rise to questions about whether the additional amounts should be accounted for as additional purchase price or as compensation expense. This issue may be particularly relevant in the acquisition of a health care provider if the owners of the selling company may be physicians or other health care professionals who continue to be employed by and provide health care services on behalf of the combined entity after the acquisition.

.22 This issue was recently addressed in EITF Issue No. 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination.* The EITF reached a consensus that the determination of whether contingent consideration should be recorded as part of the purchase price or as compensation expense is a matter of judgment that will depend on the relevant facts and circumstances. Auditors should carefully analyze the facts and circumstances of the contingent consideration arrangement, including the various indicators described in the EITF consensus, in assessing management's judgment as to whether payments are additional consideration or compensation.

Risk-Related Issues in a Managed Care Environment

.23 Health care providers at all levels are assuming a greater share of the risk associated with underwriting health care services. In doing so, they share the incentive to provide quality health care at the most reasonable cost. Common forms of contracts include per diem (per day) and capitation (per enrollee) rate schemes with shared risk incentive pools. Agreements can cover all or portions of health care services and may include only referred patients or all patients both in and out of the area.

.24 As health care organizations shift from fee-for-service medicine into capitation contracting, significant changes in their revenue and expense recognition policies follow, resulting in issues similar to those faced by prepaid health plans. For example, in many cases, revenues are generated as a result of an agreement to provide health care rather than from the actual provision of services. Furthermore, the costs of providing health care services under the terms of the contract should be accrued as services are rendered, including estimates of the costs of services rendered but not yet reported. Auditors should be alert to the implications of this shift in the income-earning process and consider its impact on the accounting policies and procedures of the health care organizations they audit. For example, close attention should be given to the effect of managed care contracts on an entity's liability for Incurred But Not Reported (IBNR) accruals, risk pool settlements, and risks and uncertainties disclosures. In addition, as prepaid health care providers, hospitals and physician groups subcapitate to other provider organizations, consideration should be given to the viability of the capitated providers, as the contracting entity may be obligated in the event of financial failure of subcapitated entities.

.25 Guidance on accounting and financial reporting issues associated with capitation contracts is found in SOP 89-5, which is included as an appendix to the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services.* Auditors of health care providers that participate in managed contract arrangements should carefully consider whether management is properly applying the accounting treatment set forth in SOP 89-5. Auditors may also find the guidance in SAS No. 57, *Auditing Accounting Estimates* (AU section 342), useful in auditing the accounting estimates that relate to participation in such arrangements.

Audit Issues Facing Nursing Homes

.26 Increased competition, along with factors such as continuing pressure to contain costs and operate in a managed care, network environment, have created for nursing homes many of the same audit issues that exist in other facets of the health care industry (for example, compliance with SOP 89-5 and proper accounting for and disclosure of business combinations). In addition, auditors of nursing homes should consider the audit risk relating to the collectibility of receivables from new third-party payors such as health maintenance organizations (HMOs) and other managed-care organizations. These payors often impose unfamiliar restrictions on payments to nursing homes. Such restrictions include preadmission qualification, periodic assessments, waiting periods, deductibles, and coverage limitations and may affect the collectibility of receivables recorded by nursing homes.

Audit Issues Facing Physician Groups

.27 Like other health care organizations discussed above, physician groups have entered the age of networking, consolidating, and risk sharing. Physician groups are—

- Joining provider networks under various contractual relationships.
- Acquiring other providers.

- Entering into risk-sharing contracts with insurers and other providers.
- Restructuring physician compensation contracts.
- Self-insuring professional liability risks.
- Changing corporate structures.

Many of these new arrangements create audit risks because of their effect on the realization of assets and the creation or assumption of new liabilities. Such audit risks may be of particular importance to auditors of those physician groups that maintain their accounting records on the cash or tax basis of accounting but are required to report externally in conformity with GAAP. Their accounting records may fail to include the effects of these arrangements on the realization of assets or recognition of liabilities.

Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance

.28 In February 1995, the AICPA's Auditing Standards Board (ASB) issued SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AU section 801), to provide general guidance to practitioners engaged to perform compliance audits of recipients of governmental financial assistance. SAS No. 74 (AU section 801) supersedes SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*, and is effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994. SAS No. 74 (AU section 801) reduces the level of detail provided at the auditing standard level. The detailed audit and reporting guidance previously in SAS No. 68 is now provided in SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards.* Accordingly, these changes were intended to have no effect on the conduct of the audit.

.29 SAS No. 74 (AU section 801) continues to recognize three levels of audits—generally accepted auditing standards (GAAS), *Government Auditing Standards,* and certain other federal requirements—of recipients of governmental financial assistance. SAS No. 74 (AU section 801) is applicable when the auditor is engaged to perform an audit under GAAS, and under *Government Auditing Standards,* and in certain other circumstances involving governmental financial assistance, such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations.

.30 In 1993, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AT section 500). Audit regulations have been issued by federal agencies and departments requiring compliance attestation engagements in accordance with SSAE No. 3 (AT section 500) (for example, the U.S. Department of Education relating to student financial assistance). SSAE No. 3 (AT section 500) does not apply to audits performed in accordance with *Government Auditing Standards* and audits within the scope of SAS No. 68. However, there was confusion and a divergence of opinion as to when SAS No. 68 applied and when SSAE No. 3 (AT section 500) applied. Thus, SAS No. 74 (AU section 801) also clarifies the applicability of SSAE No. 3 (AT section 500) to compliance audits of recipients of governmental financial assistance. SAS No. 74 (AU section 801) states that SSAE No. 3 (AT section 500) provides guidance for engagements related to management's assertion about an entity's compliance with the requirements of specified laws, regulations, rules, or contracts not involving governmental financial assistance. In addition, SAS No. 74 (AU section 801) amends SSAE No. 3 (AT section 500) to state that SSAE No. 3 (AT section 500) does not apply to engagements for which the objective is to report in accordance with SAS No. 74 (AU section 801), unless the terms of the engagement specify an attestation report under SSAE No. 3 (AT section 500).

.31 SAS No. 74 (AU section 801) also provides general guidance to the auditor to—

- Apply the provisions of SAS No. 54 (AU section 317) relative to detecting misstatements resulting from illegal acts related to laws and regulations that have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of governmental entities and other recipients of governmental financial assistance.
- Perform a financial audit in accordance with *Government Auditing Standards,* issued by the Comptroller General of the United States.
- Perform a single or organization-wide audit or a program-specific audit in accordance with federal audit requirements.
- Communicate with management if the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of his or her engagement.

.32 Auditors of health care providers that receive governmental financial assistance should also be alert to the 1994 Revision of *Government Auditing Standards,* commonly referred to as the "Yellow Book", as issued by the Comptroller General of the U.S. The 1994 Revision provides guidance (rather than requirements) on the auditor's consideration of internal controls for the control environment, safeguarding controls, controls over compliance with laws and regulations, and control risk assessment. It does not establish new responsibilities for testing controls. Some of the more important changes made in the 1994 Revision deal with the following:

- Submission of peer review reports
- Commenting on the status of prior year control weaknesses and other matters
- Responsibility for detection of noncompliance with contract or grant agreement provisions
- Working paper documentation
- Communication of additional services available on controls and compliance
- Report content
- Direct reporting of irregularities and illegal acts
- Applicability of the Yellow Book to other attest engagements

The Audit Risk Alert *State and Local Governmental Developments—1995* [AAM section 8070] contains a detailed discussion of the revisions to the Yellow Book.

Derivatives

.33 Recent years have seen a growing use of innovative financial instruments, commonly referred to as derivatives, that often are very complex and can involve a substantial risk of loss. Health care organizations may use derivative financial instruments both as speculative investment vehicles and as risk management tools. As interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments obtain their value have increased in volatility, a number of entities have incurred significant losses as a result of their use. The use of derivatives almost always increases audit risk. Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditors' approach to achieving related audit objectives may differ because certain derivatives are not generally recognized in the financial statements.

.34 It is essential that auditors understand both the economics of derivatives used by the entities whose financial statements they audit and the nature and business purpose of the entities' derivatives activities. In addition, auditors should carefully evaluate the accounting for any such instruments, especially those reported at amounts other than fair value. To the extent the derivatives qualify as financial instruments as defined in FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and*

Financial Instruments with Concentrations of Credit Risk (AC F25), No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), the disclosure requirements set forth in those statements must be met. When derivatives are accounted for as hedges of on-balance-sheet assets or liabilities or of anticipated transactions, auditors should carefully review the appropriateness of the use of hedge accounting, particularly considering whether the criteria set forth in applicable accounting literature are met.

.35 The SEC staff has indicated in public speeches and in letters of comment to registrants during the year that publicly held companies should disclose the nature and purpose of certain commodity-based derivatives activities, the nature and terms of certain commodity-based derivatives used, and the accounting methods used even when such derivatives do not meet the definition of financial instruments set forth in the FASB Statements cited above.

.36 Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1995/96* [AAM section 8010]. Also, see in the "Accounting Issues and Developments" section—"Disclosures About Derivatives" of this Audit Risk Alert. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations.

Environmental Issues

.37 Environmental remediation liability laws, written at all levels of government, have exposed health care providers to an increased vulnerability to environmental claims. The Resource, Conservation and Recovery Act, Superfund, along with various clean air and water acts, may be used to hold health care providers liable for the remediation of environmental contamination. Superfund, for example, legally empowers the U.S. Environmental Protection Agency to seek recovery from current and previous owners or operators of a particular contaminated site, or anyone who generated or transported hazardous substances to such a site. The use of nuclear medicines and other potentially hazardous substances by health care providers as well as the disposition of hazardous waste may create environmental cleanup issues.

.38 The accounting literature applicable to accounting for environmental remediation liabilities includes FASB Statement No. 5 (AC C59), FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (AC C59), and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10). In addition, guidance is included in the consensuses reached in EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal,* Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination,* and Issue No. 93-5, *Accounting for Environmental Liabilities.*

.39 Auditors of publicly held health care providers should be aware of the SEC's Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies.* The SAB provides the SEC staff's interpretation of current accounting literature related to the following:

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in the estimation of the extent of environmental liabilities
- The appropriate discount rate for environmental liabilities, if discounting is appropriate
- Financial statement disclosures of exit costs and other items and disclosure of certain information outside the basic financial statements

Audit Risk Alert—1995/96 [AAM section 8010] contains further discussion of issues relating to environmental remediation matters. Also, refer to the "Accounting Issues and Developments" section of this Audit Risk Alert for information on AICPA Exposure Draft: *Proposed Statement of Position on Environmental Remediation Liabilities.*

Elimination of Uncertainty Reporting

.40 The ASB has issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

.41 The amendment would also expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AU section 508.37), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

.42 The proposal does not affect the provisions of SAS No. 59 (AU section 341), which requires that the auditor add an explanatory paragraph to the auditor's report when there is substantial doubt about the entity's ability to continue as a going concern.

.43 The ASB hopes to finalize this SAS late this year and to issue an SAS that would be effective for reports issued on or after June 30, 1996. Comments on the proposed SAS were due on October 20, 1995.

Accounting Issues and Developments

Impairment of Long-Lived Assets

.44 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). FASB Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

.45 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets that are covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.46 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. Restatement of previously issued financial statements is not permitted by the Statement. The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.47 Auditors of health care organizations should be aware that the current industry climate of restructurings, mergers and realignments have increased the likelihood that events or changes in circumstances that indicate that assets have been impaired may have occurred. For example, a merger may result in the reduction of services provided by a particular entity within the combined organization and significantly reduce its ability to generate future cash flows. Even more significant may be the health care provider that is left out of the integrated delivery system in a particular geographic area and loses its ability to compete. In these instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.48 In considering a health care organization's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57 (AU section 342).

Disclosures About Derivatives

.49 In recent years, health care providers have become increasingly involved in the use of derivative financial instruments both as speculative investment vehicles and as risk management tools.

.50 In October 1994, the FASB issued Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25). FASB Statement No. 119 (AC F25) requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 (AC F25) and No. 107 (AC F25).

.51 The Statement requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 (AC F25.115P) encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

.52 FASB Statement No. 119 (AC F25) was effective for financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations, the Statement (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1995.

.53 The FASB Special Report, *Illustrations of Financial Instruments Disclosures,* contains illustrations of the application of FASB Statements No. 105 (AC F25), No. 107 (AC F25), and No. 119 (AC F25).

Risks and Uncertainties

.54 In December 1994, the AICPA's Accounting Standards Executive Committee (AcSEC) issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires nongovernmental health care organizations to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires organizations to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.55 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to changes in the near term. Examples of similar estimates that may be included in financial statements of health care organizations include, but are not limited to, the following:

- Inventory subject to rapid change, for example, prosthetic devices
- Specialized equipment subject to technological obsolescence, for example, hospital diagnostic equipment

- Capitalized computer software costs
- Environmental remediation-related obligations
- Litigation-related obligations, for example, fraud and abuse actions by regulators
- Contingent liabilities for obligations of other entities, for example, an obligated group
- Amounts reported for long-term obligations such as amount reported for pensions and postemployment benefits
- Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets
- Amounts reported for long-term contracts

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of health care organizations in accordance with paragraph 21 of the SOP include the following:

- Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor
- Concentrations in revenue from particular products, services, or fund-raising events
- Concentrations in the available sources of supply of material, labor, or services, or of licenses or other rights used in the entity's operations
- Concentrations in the market or geographic area in which an entity conducts its operations

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

.56 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

.57 In June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities*. The proposed SOP provides that:

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 (AC C59) are met, and it includes benchmarks to aid in determining when those criteria are met.
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent the employees are expected to devote time to the remediation effort.
- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site, and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- Measurement of the liability should be based on enacted laws and existing regulations, policies, and remediation technology.

- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed, and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and clean-up laws and the need to consider various individual state and other non-United States government requirements.

.58 Comments on the exposure draft were due by October 31, 1995.

Health Care Audit Guide Project

.59 In April 1995, the AICPA Health Care Committee issued an exposure draft of a proposed Audit and Accounting Guide *Health Care Organizations* that would supersede the existing Audit and Accounting Guide *Audits of Providers of Health Care Services* as well as SOP 89-5 and SOP 90-8. The proposed Guide incorporates the guidance in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made* (AC C67), and FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations* (AC C25 and No5).

.60 The proposed Guide will apply to organizations whose principal operations consist of providing or agreeing to provide health care services and that derive all or almost all of their revenues from the sale of goods of services; it also applies to organizations whose primary activities are the planning, organization, and oversight of such organizations, such as parent or holding companies of health care providers. The Guide will apply to health care organizations that are one of the following:

1. Investor-owned businesses
2. Not-for-profit organizations that have no ownership interest and are essentially self-sustaining from fees charged for goods or services
3. Governmental entities

Comments on the proposed Guide were due August 14, 1995. The AICPA expects to issue a final Guide in the second quarter of 1996.

Not-for-Profit Accounting Pronouncements and Projects

.61 The following section discusses recently issued accounting pronouncements and projects affecting not-for-profit health care organizations:

.62 *Investments.* In March 1995, the FASB released an exposure draft of a proposed FASB Statement, *Accounting for Certain Investments Held by Not-for-Profit Organizations.* The Statement would require the following:

- Investments in equity securities with readily determinable fair values and all investments in debt securities should be reported at fair value, with gains and losses included in a statement of activities.
- A not-for-profit organization should disclose certain information about its investments and return on its investments.
- In the absence of donor stipulations or laws to the contrary, losses of an endowment fund that is created by a donor stipulation requiring investment of the gift in perpetuity or for a specified term should reduce temporarily restricted net assets to the extent that donor-imposed restrictions on net appreciation of the fund have not been met before the loss occurs. Any remaining loss would reduce unrestricted net assets.

The proposed Statement would be effective for annual financial statements issued for years beginning after December 31, 1995, with earlier application encouraged. Comments were due June 30, 1995.

.63 *AcSEC Projects.* AcSEC has issued one SOP and released two exposure drafts that provide or propose guidance for not-for-profit health care organizations as follows:

- SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*
- Exposure Draft, *Accounting for the Costs of Joint Activities*
- Exposure Draft, *Proposed Audit and Accounting Guide Not-for-Profit Organizations*

Governmental Not-for-Profit Accounting Issues

.64 The following accounting pronouncements and projects of the GASB may affect governmental health care organizations. Governmental health care organizations are legally created public corporations (or bodies corporate and politic) or organizations otherwise controlled by a state or local governmental unit.

Recently Issued GASB Statements

- GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Activities*
- GASB Statement No. 21, *Accounting for Escheat Property*
- GASB Statement No. 22, *Accounting for Taxpayer-Assessed Tax Revenues*
- GASB Statement No. 23, *Accounting and Reporting for Refundings of Debt Reported by Proprietary Activities*
- GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*
- GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Disclosures for Defined Contribution Plans*
- GASB Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*
- GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*
- GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*
- GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*

Recent GASB Exposure Drafts Issued

- *The Financial Reporting Entity—Affiliated Organizations*
- *Disclosure of Conduit Debt Obligations, an Interpretation of NCGA Statement 1*

GASB Technical Bulletins and Implementation Guides

- Implementation Guide to GASB Statement No. 14, *The Financial Reporting Entity*
- *Technical Bulletin 94-1, Disclosures about Derivatives and Similar Debt and Investment Transactions*

A detailed summary of these documents can be found in the Audit Risk Alert, *State and Local Governmental Developments—1995* [AAM section 8070]. This Risk Alert also contains valuable information on current issues and audit risks facing governmental entities.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

.65 The AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services* is available through the AICPA's loose-leaf subscription service. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of Audit and Accounting Guides as they appear in the service are printed annually. As discussed above, the Health Care Committee has issued an exposure draft of an Audit and Accounting Guide *Health Care Organizations* that will supersede *Audits of Providers of Health Care Services.*

Health Care Financial Reporting Checklist

.66 The AICPA's Technical Information Service has published a revised version of *Checklists and Illustrative Financial Statements for Health Care Providers,* a nonauthoritative practice aid for preparers or reviewers of financial statements of health care entities.

Technical Practice Aids

.67 *Technical Practice Aids* is an AICPA publication that includes questions received by the AICPA's Technical Information Service on various subjects and the service's response to those questions. Section 6400 of *Technical Practice Aids* contains questions and answers specifically pertaining to health care entities. *Technical Practice Aids* is available both as a subscription service and in hardback form.

National Health Care Conference

.68 Each summer the AICPA and the Healthcare Financial Management Association cosponsor a National Health Care Conference that is specifically designed to update practitioners and health care financial executives on significant accounting, legal, financial, and tax developments affecting the health care industry. Information on the conference may be obtained by calling the AICPA Continuing Professional Education Division at (201) 938-3534.

Information Sources

.69 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.70 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.71 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.72 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.73 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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.74 This Audit Risk Alert supersedes *Health Care Industry Developments—1994.*

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.75 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250(f)		*U.S. Government Printing Office's The Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account. User assistance line: (202) 512-1530 (202) 512-1387(d) Telnet via internet: federal.bbs.gpo.gov 3001	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 3 (202) 942-7114 (tty)	World Wide Web home page: http://=www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)

Organization	General Information	Fax Services	Available Publications
Health Care Investment Analysts, Inc. (HCIA)	*Order Department* 300 East Lombard Street Baltimore, MD 21200 Attn. Customer Service (800) 568-3282		*Comparative Performance of U.S. Hospitals: The Sourcebook* *Profile of U.S. Hospitals* *Guide to the Managed Care Industry* *Guide to the Nursing Home Industry*
American Association of Homes and Services for the Aging (AAHSA)	*Order Department* AAHSA Publications, Dept. 5119 Washington, DC 20061-5119 (301) 490-0677		*Continuing Care Retirement Communities. An Industry in Action*
Center for Healthcare Industry Performance Studies (CHIPS)	*Order Department* 1550 Old Henderson Road, Suite S277 Columbus, OH 43220-3626 (800) 859-2447		*Almanac of Hospital Financial & Operating Indicators*
American Hospital Association (AHA)	*Order Department* P O Box 92683 Chicago, IL 90673-2683 (800) AHA-2626	Fax-on-Demand (312) 422-2020	*Hospital Statistics* *National Hospital Panel Survey Report*
Group Health Association of America, Inc. (GHAA)	*Order Department* 1129 20th Street, NW, Suite 600 Washington, DC 20036 (202) 778-3200	Fax-on-Demand (202) 331-7487	*HMO Industry Profile*
Interstudy Publications	*Order Department* 2901 Metro Drive, 4th Floor Minneapolis, MN 55425 (612) 858-9291	Fax-on-Demand (612) 854-5698	*Competitive Edge Industry Report for HMOs*
American Medical Association (AMA)	*Order Department* 515 N State Street Chicago, IL 60610 (800) 621-8335	Information-on-Request Fax Line (800) 621-8335	*Socioeconomics of the Medical Practice*
Medical Group Management Association	*Order Department* Denver, CO 80256-0444 (303) 397-7888	Fax-on-Demand (800) FAX-4MED	*Cost Survey* *Academic Practice Management Survey*
Healthcare Financial Management Association (HFMA)	*Order Department* Two Westbrook Corporate Center, Suite 700 Westchester, IL 60154 (202) 296-2920	Fax-on-Demand (800) 839-HFMA	*Healthcare Financial Management* (monthly publication)

AAM Section 8040
Insurance Industry Developments—1995/96

Industry and Economic Developments

.01 Over the past several years, economic conditions in the United States have exhibited signs of gradual improvement and slow growth. In 1995, bond and stock prices were on the rise; mergers, consolidations, and reorganizations continued; and U.S. companies expanded their operations into foreign markets. Generally, U.S. economy developments have had varying effects on insurance enterprises.

Property and Casualty Insurers

.02 Factors that continue to exert pressure on property and casualty operating results include emerging environmental and asbestos claims, declining profitability in a number of lines of business, and an increase in expenses for severance and operating expenses associated with reorganizations. The number of mergers and acquisitions continues to increase, as companies seek economies of scale and to position themselves in their markets. (For further discussion, see the section entitled "Mergers, Acquisitions, and Consolidations" under "Audit Issues" in this Audit Risk Alert.)

.03 *Underwriting.* Soft market underwriting conditions for property and casualty insurers persisted in 1995, for the eighth year, resulting in only a slight increase in premium growth. Many believe the traditional underwriting cycle is no longer applicable as competition and pricing pressures by insurance regulators are constant factors affecting the industry. In 1994, the competitive underwriting environment resulted in lower growth in premium volume and higher accident year combined ratio results. The results for the first two quarters of 1995 have been slightly better than 1994. Property and casualty insurers appear to be getting short-term help in the form of higher prices and rate increases. Underwriting performance of the commercial and private passenger automobile, homeowner lines of business, and, to a lesser extent, worker's compensation have improved during the past year—contributing to the improved underwriting performance of the industry.

.04 Premiums are written through three major industry sectors; agency writers, direct writers, and reinsurers. Underwriting performance has shifted within these sectors over the past few years. In recent years, agency writers have experienced less growth in premiums than direct writers. Premium volume for the direct writers increased 35 percent over the past five years and now accounts for 44 percent of the total industry's premium volume. Agency writers now account for 49 percent of the total industry volume. This indicates that direct writers have gained five points of the market share from agency writers over the past five years. Agency and direct writers, for the most part, compete in all segments of the insurance market. Some believe that most of the market share growth for direct writers results from insurance companies striving for cost effectiveness, which gives the direct writers large price advantages over agency writers, along with companies downsizing their unprofitable personal lines of business that tend to use agents more frequently.[1] Auditors should evaluate whether changes in the type of premium writers used (direct writers or agency writers) by an enterprise increases risk or creates new risks of potential errors in premium transactions and related account balances.

.05 The reinsurance industry sector represents 7 percent of the industry's premium volume. The growth of the reinsurance sector over the past several years is predominately a function of both the growth and changes in retention levels of the primary insurance companies' premium volume. The ability to rewrite primary company business, combined with other methods of limiting losses, is believed to have helped reinsurers' results improve more rapidly than those of primary companies. During hard markets, primary companies traditionally cede more to reinsurers using proportional and quota share treaties to a greater degree to grow their books of business. In a

[1] Snyder, John H., "Auto Hauls the Industry's Burdens," Best's Review, January 1995, pp. 97-98.

soft market, the process is normally reverse, with excess of loss and nonproportional business being sold. However, the abnormal growth in the reinsurance sector in this soft market can be attributed to reinsurers developing alternative market products, entering the international market and offering large excess coverage.[2] Auditors should be aware that reinsurance contracts can be complex documents and an increase in reinsurance transactions should be given more attention. (For further discussion, see the section entitled "Reinsurance Arrangements" under "Audit Issues" in this Audit Risk Alert.)

.06 *Environmental and Asbestos-Related Liabilities.* As indicated by a number of recent independent studies, the property and casualty insurance industry may have an aggregate environmental exposure ranging from $30 to $40 billion or even higher. During 1994 and continuing into 1995, these studies, along with public pressure, have increased the need for companies to improve disclosures in this area and to recognize additional liabilities in their financial statements related to such claims. In 1995, several insurers increased their environmental liabilities based on current known facts, existing laws, technology, and reasonable assumptions to recognize their expected pollution losses. (For further discussion, see the section entitled "Liabilities for Unpaid Claims" under "Audit Issues" in this Audit Risk Alert.)

.07 *Catastrophes.* Although many believe catastrophe losses were abnormally high in 1994 which contributed to flat profits, for the past six years large catastrophes have been occurring more frequently. What one would view as abnormal may now be, in fact, normal.

.08 During the first three quarters of 1995, two hurricanes caused some significant catastrophe losses. Hurricane Erin, which hit the United States in early August, caused an estimated $375 million in insured property damage, while Hurricane Opal caused an estimated $2 billion in insured property damage. Although the estimated damages caused by these two hurricanes may not be as large as the losses caused by Hurricane Andrew and the Northridge earthquake, a number of forecasters are predicting 1995 to have more tropical storms than normal. Auditors should consider the concentrations of geographic location of coverage when performing the audit.

.09 *Claim Costs.* Property and casualty insurance enterprises claim settlements are directly affected by economic factors such as price, salary, and wage levels. Insurers also are directly affected by the rising costs of physicians' services and other medical expenses, hospital care and rehabilitation, lost time and wages, and automobiles, including repair and parts. Over the past few years, a number of these costs have increased, which has directly affected the insurance company's costs. In addition, in 1995, an emerging trend has been for companies with environmental exposures to establish bulk liabilities for legal related costs.

.10 *Risk-Based Capital.* New risk-based capital standards became effective for property and casualty insurers in 1994, making it increasingly difficult for some property and casualty insurers to maintain the levels of capital and surplus that regulators believe are necessary for insurance companies to support their business and investment risks. Risk-based capital requirements continue to influence operating behavior and investment strategies. A number of companies have restructured investment and product portfolios and shifted the emphasis placed on certain lines of business. Auditors should be alert to the use of surplus-enhancing measures.

Life and Health Insurers

.11 Life insurance sales continued to be mixed for most insurers in 1995, reflecting trends of the past few years. Past trends have shown a shift from traditional policies to annuity products. However, during the past few years, uncertainty over market conditions deterred a number of consumers looking to variable annuity products to enhance their investment portfolios for their retirement needs and have looked into other investment vehicles. Fluctuations in interest rates and an increased desire for stable growth made fixed-rate products more attractive. The result has been a greater allocation of new investments, as well as a shift of existing investments, into traditional products. Among the many new products offered by life insurance enterprises are flex premium

[2] Ibid.

annuities, variable life products, and guaranteed interest contracts, which include variable options that increase separate account assets and liabilities. These products expose companies to different kinds of risks than those they have been exposed to historically. For example, stock market fluctuations could adversely affect sales and surrenders of variable products, leading to unplanned fluctuations in company cash flows. Auditors should be aware that certain economic circumstances may have an indirect effect on the sales and surrenders of certain products.

.12 Growth in separate accounts continues but is slower than in 1993 and 1994, due to the instability of interest rates in the marketplace. Individuals, who bear the risk of their investments, reacted to unstable equity markets by becoming more conservative in their views of separate account products. The negative publicity from allegations of improper sales practices and potentially misleading policyholder illustrations hampered insurers' efforts to sustain strong premium growth.

.13 *Highly Competitive Market.* Growth continues to be slow for life insurance enterprises due to changing demographics and inefficient distribution systems. A slowing economy and increased competition from banks, mutual funds, and other financial institutions for investable consumer dollars also suppressed premium growth over the last two years. The Clinton Administration is calling for legislation to allow commercial banks, securities firms, and insurance companies to merge, creating giant financial service companies that could offer everything from checking accounts to mutual funds and life insurance. Lobbying effort against the proposed legislation has been strong. Currently, insurers have been losing ground to mutual fund products that invest directly in stocks and bonds; a change in legislation may accelerate this movement. An increase in competition may restrict premium and underwriting growth, which may lead to a reduction in profits.

.14 *Interest Rates.* For most life and health insurers, profits are indirectly affected by interest rates. Changing interest rates create disintermediation. Companies attempt to manage interest rate risk by adjusting crediting rates and dividend scales. In 1994, the Federal Reserve increased the short-term interest rates, causing liquid investments to be more desirable to consumers. In 1995, many insurers were forced to raise crediting rates on interest-sensitive products to remain competitive, which decreased profit margins. Crediting rates on interest-sensitive products are linked to a number of factors including other available returns, consumer demand and sensitivity, perceived quality of the related company, as well as other policy attributes such as surrender charges. As interest rates increase, the spread narrows between policyholders' crediting rates and insurers' investment returns. Auditors should be alert to companies' interest crediting strategies.

.15 *Mutual Insurance Companies.* Mutual life insurance companies are making changes. A few mutual companies have converted to stock form in order to access equity markets for the capital needed to overhaul and expand their operations. Others are merging, bringing in new management, selling nonessential business, revamping operations, or cutting costs.

Impact of Industry and Economic Developments on Risk of Material Misstatement

.16 In planning and performing an audit, auditors should obtain knowledge of the entity's business as part of the process of assessing the risk of material misstatement in the entity's financial statements. When obtaining this knowledge, the auditor should consider factors affecting the industry in which the entity operates, including matters such as the economic environment and changes in technology. Although the economic and industry developments previously discussed affect different companies in different ways, indicators of higher overall audit risk may result from conditions such as the following:

- Unsound pricing and interest crediting strategies
- An increase in the amount of higher risk or unusual investment vehicles (for example, interest-rate swaps or securities lending)
- Pressures on profit margins

- Volatility in the financial markets or other economic conditions, which makes it difficult to assess appropriate investment returns or expense levels
- Economic conditions that increase the expectations of policyholders and contractholders regarding dividend scales or interest-crediting rates
- Use of surplus-enhancement measures
- Restructuring resulting in staff reductions
- Significant concentrations of coverage in a specific geographic location or line of business

Regulatory Developments

.17 The regulatory developments contained in this section include matters that may affect audits of statutory financial statements. All states require domiciled insurance entities to submit to the state insurance commissioner an annual statement on forms developed by the National Association of Insurance Commissioners (NAIC). The states also require that audited statutory financial statements be provided as a supplement to the annual statements. Currently, statutory financial statements are prepared using accounting principles and practices "prescribed or permitted by the insurance department of the state of domicile."

Environmental Disclosures

.18 The NAIC "Annual Statement Instructions" have been revised for 1995 to require certain additional disclosures to identify an insurance company's methodology in establishing case and incurred but not reported (IBNR) reserves for asbestos and environmental claims and to identify the amounts of such losses and loss adjustment expense reserves. Auditors should consider the adequacy of environmental reserves and disclosures in reporting on statutory financial statements of property and casualty insurers.

Reinsurance Accounting

.19 Auditors should also be aware that for 1995 statutory annual statements, credit will only be permitted for cessions to Lloyd's of London syndicates who participate in the Lloyd's of London new reinsurance trust fund arrangement.

.20 *Property and Casualty Insurers.* The NAIC's Property and Casualty Reinsurance Study Group has completely revised the reinsurance section (chapter 22) of the NAIC's *Accounting Practices and Procedures Manual.* The revisions apply the risk transfer and most of the accounting concepts of Financial Accounting Standards Board (FASB) Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (AC In6), to statutory accounting for prospective reinsurance contracts. These accounting changes are effective for 1995.

.21 The NAIC's Property and Casualty Reinsurance Study Group also finalized the accounting guidance for funded covers, as described in the FASB consensus decision in Emerging Issues Task Force (EITF) Issue No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises.* The guidance provided by the NAIC differs from EITF Issue No. 93-6 in that the NAIC's guidance for accruing liabilities in certain circumstances is more conservative. This accounting change is effective January 1, 1996, but applies to all contracts entered into, renewed, or amended on or after January 1, 1994. Auditors should be aware of these accounting changes.

.22 *Life and Health Insurers.* The NAIC Accounting Practices and Procedures Task Force issued an exposure draft of a revised reinsurance chapter (chapter 24) of the NAIC's *Accounting Practices and Procedures Manual.* The revised chapter 24 provides guidance on accounting and reporting of life reinsurance by ceding and assuming companies and on assessing risk transfer. The revisions are expected to be effective as of January 1, 1996. Auditors should be aware that there may be accounting changes as a result of such revisions.

Codification of Statutory Accounting Principles

.23 The NAIC is in the process of codifying statutory accounting practices (the codification) for certain insurance enterprises in recognition of the fact that prescribed or permitted statutory accounting practices vary widely—not only from state to state, but for insurance enterprises within a state. When the NAIC completes the codification of statutory accounting practices, it is expected that the states will require that statutory financial statements be prepared using accounting practices "prescribed in the NAIC's *Accounting Practices and Procedures Manual.*"

.24 The codification project is progressing. As part of the codification project, the NAIC is exposing a series of issue papers for public comment. As of August 31, 1995, thirty-four issue papers had been released for public comment, and at least nine more issue papers are expected to be released by the end of the year. Because the codification will not be effective by the end of the year, auditors will continue to report on statutory financial statements prepared in conformity with accounting practices prescribed or permitted by the insurance department of the state of domicile.

Changes in State Insurance Department Requirements

.25 The insurance industry is regulated by the states. Often, state insurance departments implement or amend regulations. Current significant changes in state regulations for 1995 were made by the Texas Department of Insurance. On June 22, 1995, the Texas Department of Insurance adopted Texas Administrative Code section 7.85 *Audited Financial Reports.* The regulation enables the Texas Department of Insurance to use the outside auditor's workpapers as an aid to state examiners with their required examinations. The new rule adds a number of requirements that auditors must consider in performing statutory audits of insurance enterprises. The auditor should consider the guidance in Interpretation No. 1 of AICPA Statement on Auditing Standards (SAS) No. 41, *Working Papers,* titled "Providing Access to or Photocopies of Working Papers to a Regulator" (AU section 9339.01-.15), with regard to providing access to working papers to examiners. This regulation is effective for audited statutory financial reports with audit dates as of December 31, 1995, or later. A complete copy of the regulation can be obtained through the Texas Department of Insurance. Auditors should be aware of these changes and plan their engagements accordingly. Auditors should also monitor other state regulation developments to determine whether they are applicable to their engagement.

Model Investment Law

.26 In August 1994, the NAIC issued for comment a revision of the Model Investment Law. The law would provide guidelines for insurers to follow in purchasing investments. For example, it would allow insurers to participate in derivatives transactions only for purposes of hedging and very limited speculation. It would also require boards of directors to monitor compliance with board-approved investment plans. A final model is expected to be issued by the end of 1996. Since state adoption is optional, auditors should monitor the insurance entity's state of domicile to determine whether the state adopted the finalized law.

Audit Issues

Mergers, Acquisitions, and Consolidations

.27 The U.S. insurance industry is in a consolidation mode. The industry is seeing an increased number of mergers, acquisitions, consolidations, and sales of certain lines of business, driven by a variety of factors including company strategic objectives, cost control and reduction, and diversification of products. For property and casualty insurers, problems stem from tougher regulations; stagnant growth; declining profitability in some lines of business; and huge claims related to catastrophes, asbestos, and pollution (environmental liabilities). Although past consolidation activity involved predominately smaller companies, which are most vulnerable to minimum state capital requirements and most susceptible to unexpected losses, the recent consolidations have been among a number of the larger insurance companies. For life insurers, mergers appear to be driven primarily by the need to reduce costs. In addition, heightened competition, health care reform, shifting regulatory requirements, and new technology are significant contributors. Many of the problems facing life insurance companies can be traced back to the early 1980s. To boost investors' returns, insurance companies started buying real estate, junk bonds, and other higher risk investments. Real estate devaluations throughout regions of the United States and losses in the volatile junk-bond market reduced substantially the average return on a number of these investments. Some insurers were obligated on guaranteed investment contracts, which gave investors guaranteed returns for extended periods. In addition, life insurers are facing competition from other segments of the financial services industry, such as banks and mutual funds, which traditionally have had less volatile distribution channels. Usually, when consolidation occurs, an entity changes its organizational structure and control methods. Auditors should be alert to possible changes in the entity's internal control structure and the implications of any change in control risk on the nature, timing, and extent of audit procedures. Auditors should also consider the propriety of accounting for transactions such as proper asset valuations, the amortization of goodwill, and other accounts directly affected by the streamlining transaction. In addition, auditors should maintain a heightened sense of awareness and an attitude of professional skepticism to merger candidates. Auditors should also be alert to the increased risk of material misstatement by entities attempting to appear more attractive to potential buyers.

Other Year-End Transactions and Capital Surplus

.28 A source of financial statement misstatement could be improper accounting for significant transactions at or near year end. For example, the Securities and Exchange Commission (SEC) has had a number of enforcement actions (Accounting and Auditing Enforcement Release Nos. 568, 581-583, and 616) involving sales of securities at year end for which there was an agreement to repurchase the securities after year end. Auditors should be aware of the possibility that such transactions may occur and should review purchase transactions after year end to ensure that the sales of securities are not being bought back and also to determine the appropriateness of the accounting treatment as well as the effect of the transaction on statutory capital and surplus.

Investments in Derivatives

.29 Recent years have seen a growing use of innovative financial instruments, commonly referred to as derivatives, that often are very complex and can involve a substantial risk of loss. Insurance enterprises have been entering into forward contracts, futures contracts, and options as risk management tools (hedges) or speculative investment vehicles. As interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments obtain their value have increased in volatility, a number of entities have incurred significant losses as a result of their use. The use of derivatives creates unique audit concerns and almost always increases audit risk. Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditors' approach to achieving related audit objectives may differ because certain derivatives are not generally recognized in the financial statements.

.30 It is essential that auditors understand both the economics of derivatives used by their clients and the nature and business purpose of their clients' derivatives activities. In addition, auditors should carefully evaluate their client's accounting for any such instruments, especially those carried at other than market value. To the extent the derivatives qualify as financial instruments as defined in FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), the disclosure requirements set forth in those Statements (AC F25) must be met. When derivatives are accounted for as hedges of on-balance-sheet assets or liabilities or of anticipated transactions, auditors should carefully review the appropriateness of the use of hedge accounting, particularly considering whether the criteria set forth in applicable accounting literature are met.

.31 Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1995/96* [AAM section 8010]. Also see "Disclosures About Derivatives" in the "Accounting Developments" section of this Audit Risk Alert. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations.

Investments in Collateralized Mortgage Obligations

.32 In 1995, interest rates were generally on the rise nevertheless, over the past several years, relatively low interest rates and the use of more sophisticated asset/liability management techniques have resulted in increased investments by insurance companies in collateralized mortgage obligations (CMOs) and mortgage-backed securities. Because the values of many of such instruments, particularly interest-only and principal-only securities, are extremely sensitive to changes in interest rates, a number of insurance companies have suffered substantial reductions in the value of their investment portfolios as a result of their use. Auditors should carefully consider the risks inherent in investments in these securities, and, in particular, should—

- Consider assessing management's expertise in monitoring and evaluating the risks associated with, and accounting for, the securities.
- Consider whether the insurance enterprise has set policies and procedures for investing in and accounting for such securities, which are commensurate with their complexity, and risks, and with the enterprise's business and portfolio objectives.
- Consider impacts of prepayment risks and activities on investment carrying values (FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* [AC L20]).
- Consider whether there is appropriate oversight by the board of directors.
- Consider whether unrealized losses or other factors raise any impairment concerns.

Auditors should refer to EITF Issue No. 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate,* and Issue No. 93-18, *Recognition of Impairment for an Instrument or in a Collateralized Mortgage Obligation Investment in a Mortgage-Backed Interest-Only Certificate,* for guidance as it pertains to high-risk CMOs. Auditors should take note that FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), changes the measure of impairment of the instruments addressed in EITF Issue No. 89-4 from undiscounted cash flows to fair value.

Liabilities for Unpaid Claims

.33 The liability for unpaid claims is inherently a high-risk audit area for several reasons. First, the liability is significant to property and casualty insurers' balance sheets and earnings. Second, estimating the amount to report is usually highly subjective. Finally, history shows that these estimates will continuously change for long-tailed business.

.34 A number of factors may be particularly indicative of a higher risk audit. The following include those that may exist for a number of companies in 1995.

.35 *Exposure to Environmental and Asbestos-Related Claims.* The ultimate exposure of insurers to environmental and asbestos-related claims is subject to an unusually high degree of uncertainty. Recent independent studies indicate that the property and casualty insurance industry may have an aggregate environmental exposure ranging from $30 to $40 billion or even higher. During 1994 and continuing into 1995, these studies, along with public pressure, have increased the need for companies to improve disclosures in this area and to recognize additional liabilities in their financial statements related to such claims. In 1995, several insurers have established additional liabilities for latent environmental liabilities. FASB Statement No. 113 (AC In6) requires that the assets and liabilities relating to reinsured contracts be recorded on a gross basis without netting of reinsurance receivables against claim reserves. FASB Statement No. 5, *Accounting for Contingencies* (AC C59), and the SEC's Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies*, provide that if there is at least a reasonable possibility that a loss exceeding amounts already recognized may have been incurred and the amount of the loss would be material, then the enterprise must disclose the estimated additional loss, or range of loss, or state that it cannot be estimated. The SEC staff has noted circumstances in which insurance companies have disclosed estimates of reasonably possible additional losses for environmental claims on a net basis only, that is, the reasonably possible reinsurance recoverables have been netted against the reasonably possible additional losses. The SEC staff believes that such a practice is inconsistent with FASB Statement No. 113 (AC In6) and SEC SAB No. 92. Disclosure of the gross amounts of reasonably possible losses is required; whereas disclosure of the gross amounts of the reasonably possible reinsurance recoveries may be made, but care should be exercised to avoid misleading implications as to the likelihood of realization of such recoveries. Auditors of insurance enterprises that face such claims should carefully evaluate whether the accounting and disclosure requirements of FASB Statement No. 5 (AC C59) and SEC SAB No. 92 have been met.

.36 *Estimating Environmental Claim Losses.* As indicated in SEC SAB No. 92, when estimating reserves for environmental contamination claims, an insurance enterprise should consider available evidence including a particular policyholder's prior experience in remediation of contaminated sites, other companies' clean-up experience, and data released by the Environmental Protection Agency or other organizations. The continued expansion of environmental databases has resulted in the availability of significantly more information to support a reasonable estimate of the amount of loss or range of loss. When evaluating an insurance enterprise's reserves for environmental contamination claims, the auditor should consider the evidence currently provided by the expanded environmental databases.

.37 Furthermore, the auditors of publicly held insurance companies should consider whether the disclosures are in accordance with the requirements of SEC SABs No. 87, *Views on Contingency Disclosures on Property-Casualty Insurance Reserves for Unpaid Claim Costs*, and No. 92.

.38 *Exposure to Employment-Related Claims.* Some reports indicate that the settlements of disability and discrimination claims will be significantly higher than previously anticipated.

.39 *Exposure to Breast-Implant Claims.* Some reports indicate that claims related to injuries from defective breast implants could exceed $7 billion.

.40 *Changes in Product Mix to More Long-Tail Lines of Business.* This factor would usually indicate more uncertainty in determining the ultimate exposure to claims.

.41 *Intense Price Competition and Unexplained Premium Growth.* Intense price competition may lead to unsound pricing, crediting, or dividend policies that may be evidenced in unexplained premium growth. Market pressures may lead insurers to accept unanticipated risks or to inappropriate pricing of risks, which also could affect the recoverability of deferred acquisition costs and result in premium deficiencies.

.42 *Participation in Involuntary Pools.* Insurance enterprises continue to be exposed to large amounts of claims through their participation in involuntary pools and associations. This factor may indicate increased exposure to loss development from previously reported results.

.43 SAS No. 57, *Auditing Accounting Estimates* (AU section 341), provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit of financial statements in accordance with generally accepted auditing standards. AICPA Statement of Position (SOP) 92-4, *Auditing Insurance Entities' Loss Reserves*, provides guidance to help auditors understand the loss reserving process and to develop an effective audit approach when auditing loss reserves of insurance entities.

Reinsurance Arrangements

.44 Reinsurance is an important part of many insurance companies' business, and accordingly, it is important for auditors to obtain an understanding of the reinsurance programs of the insurance companies they audit. The lack of an adequate reinsurance program may expose an insurance enterprise to risks that can jeopardize its financial stability, particularly if its risks are concentrated by type or geographic area. In contrast, excessive reinsurance coverage can significantly reduce the margins available to cover fixed expenses. In the aftermath of high catastrophe losses caused by Hurricane Hugo, Hurricane Andrew, and the Northridge earthquake, which occurred several years ago, property catastrophe coverage has been difficult to obtain. A number of insurers, both primary insurers and reinsures, have been forced to retain a higher portion of the risk and may be stimulated to enter into financial reinsurance arrangements. Significant changes in an insurer's reinsurance programs or retention limits may indicate increased audit risk. The industry has also been witnessing an evolving class of reinsurance agreements that have the characteristics of derivative financial instruments. Such contracts raise significant accounting issues including (1) whether the insurance risk criteria of FASB Statement No. 113 (AC In6) have been met (see the next section of this Audit Risk Alert for further discussion); (2) whether and how to apply deposit accounting to such contracts, if appropriate; and (3) whether the substance of the contract is that of a derivative financial instrument and the appropriate accounting therefore. A number of these new variations of traditional reinsurance contracts address the perceived lack of capital currently deployed in certain sectors of the reinsurance market, particularly catastrophe coverages, by establishing insurance risk as an asset class and thereby opening the market to investors. Auditors should be aware that these types of reinsurance arrangements may also indicate increased audit risk.

.45 *Risk-Transfer Issues.* Paragraph 9 of FASB Statement No. 113 (AC In6.172) provides the following two risk-transfer conditions, *both* of which must be met for short-duration reinsurance contracts to be accounted for as reinsurance.

a The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.

b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

Generally, contracts that do not meet the conditions for reinsurance accounting should be accounted for as deposits.

.46 The SEC staff has expressed concern that preparers of financial statements and their auditors may not be appropriately considering the provisions of paragraph 9(a) of FASB Statement No. 113 (AC In6.172) in their assessment of whether a reinsurance contract provides indemnification of insurance risk. Insurance risk is the risk arising from uncertainties about both (1) the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract (often referred to as underwriting risk) and (2) the timing of the receipt and payment of those cash flows (often referred to as timing risk). The paragraph 9(a) (AC In6.172) criterion must be met independently of the paragraph 9(b) (AC In6.172) criterion. Timing risk alone does not allow paragraph 9(a) (AC In6.172) to be met. Furthermore, satisfying paragraph 9(b) (AC In6.172) is not sufficient justification that paragraph 9(a) (AC In6.172) has been satisfied. Auditors should analyze carefully the entirety of an insurance enterprise's arrangements with its reinsurer, including provisions of the reinsurance contracts and any other related agreements, and the impact of any adjustable features on cash flows. Auditors should apply judgment in determining whether there is sufficient competent audit evidence supporting risk transfer under both paragraphs 9(a) and 9(b) of FASB Statement No. 113 (AC In6.172).

.47 For many reinsurance contracts, a great deal of judgment is involved in determining whether the risk-transfer conditions are met, particularly for multi-year retrospectively rated reinsurance contracts with one or more adjustable features and contracts with undefined terms. Such contracts have become increasingly complex, containing many varieties of terms and features that may impact the assessment of risk-transfer. Auditors should consider the guidance in EITF Issues No. 93-6 and No. 93-14, *Accounting for Multiple-Year Retrospectively Rated*

Insurance Contracts by Insurance Enterprises and Other Enterprises. As the complexity and number of terms of a reinsurance contract increase, so should auditors' professional skepticism.

.48 *Reinsurance Recoverables.* Continued publicity about defaults by a Lloyd's of London syndicate underscores that the credit risk related to ceded reinsurance arrangements continues to concern the insurance industry. The evaluation of credit risk is important in assessing audit risk related to reinsurance recoverables. The AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* discusses the controls or procedures that ceding companies should implement to evaluate and monitor the financial stability of assuming companies. An SOP, *Auditing Life Reinsurance,* provides guidance on auditing reinsurance for life and health insurance enterprises.

.49 *Disclosures About Reinsurance.* Auditors should also consider whether the disclosures of concentrations of credit risk associated with reinsurance receivables and prepaid reinsurance premiums are adequate as required by the provisions of FASB Statement No. 105 (AC F25). Furthermore, auditors of financial statements of publicly held insurance companies should be aware that the SEC staff has expressed concern about the adequacy of disclosures regarding reinsurance arrangements. The SEC staff expects registrants with material reinsurance recoverables to disclose information about the composition and quality of the asset balances. Meeting the SEC staff expectations may involve the identification of individually material reinsurers and disclosure of their related balances may be necessary. If the aggregate recoverable consists primarily of numerous small balances, breakdowns of the aggregate according to claims-paying ratings also may be necessary. Significant delinquent balances and allowances for uncollectible amounts should be disclosed, as should significant transactions and balances with related parties. If a reinsurer is a promoter of a registered offering, SEC filings may also have to include financial information about that reinsurer.

.50 *Reinsurance Arrangements and Statutory Capital and Surplus.* Paragraph 60(h) of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (AC In6.166), requires that the financial statements contain disclosures regarding the amount of statutory capital and surplus of insurance enterprises that are calculated pursuant to state-mandated statutory accounting practices. Auditors of insurance enterprises should carefully review reinsurance agreements and correspond directly with state insurance departments to obtain sufficient evidence that material amounts of reserve credits used to reduce statutory reserves and increase the insurance enterprise's statutory capital and surplus have been properly computed in accordance with state laws. Most state insurance laws prohibit insurance enterprises from recognizing reserve credits pursuant to reinsurance agreements that do not transfer a sufficient amount of risk to the reinsurer. If material amounts of reserve credits associated with reinsurance arrangements do not qualify under state law, statutory capital and surplus may be materially misstated. Further, failure to meet the state's minimum capital and surplus requirements can lead to state-imposed restrictions on the enterprise's ability to sell insurance products in the state and its ability to distribute dividends and may call into question an entity's ability to operate as a going concern. Auditors should consult SOP 94-1, *Inquiries of State Insurance Regulators,* for further guidance.

Asset Quality and Valuation Issues

.51 Though real estate markets have improved in many areas of the country and total amounts of nonperforming real estate assets and noninvestment grade bonds have declined, some insurance companies still have asset quality problems. Credit quality and other asset quality issues associated with mortgage loans, real estate portfolios, troubled debt restructurings, foreclosures and in-substance foreclosures, noninvestment grade bonds, and other assets continue to require careful attention in audits of the financial statements of insurers. The subjectivity of determining asset valuation allowances, combined with continued uncertainty regarding the recoverability of the carrying value of certain assets, reinforces the need for the careful planning and the execution of audit procedures in this area.

.52 Auditors also should be alert to valuation issues related to classification and impairments of securities. Paragraph 16 of FASB Statement No. 115 (AC I80.115), requires that for individual securities classified as either available-for-sale or held-to-maturity (as defined), an entity shall determine whether a decline in fair value below the amortized cost basis is other than temporary and provides related guidance.

.53 Paragraph 69 of FASB Statement No. 115 (AC I80) states, "if the sale of a held-to-maturity security occurs without justification, the materiality of that contradiction of the enterprise's previously asserted intent must be evaluated." The SEC staff has indicated that if held-to-maturity securities are sold for reasons other than those listed in paragraph 8 of FASB Statement No. 115 (AC I80.105), the SEC staff will challenge management's—

- Assertions regarding the classification of other held-to-maturity securities, and,
- Future assertions regarding the classification of securities purchased subsequently for an extended period of time, but no less than one year.

Restructurings

.54 Restructuring within the insurance industry continued during 1995 as companies attempted to reduce and control costs. Restructuring charges typically have a significant short-term negative impact on an enterprise's profitability, with the assumption that future earnings will be enhanced by current actions. Related staff reductions or eliminations may increase the potential for weaknesses in knowledge of or adherence to internal controls. Such changes may also result in a lack of personnel to carry out control procedures. Auditors should consider the impact of staff reductions or similar changes on the internal control structure. The FASB's EITF and SEC staff are addressing a variety of accounting issues related to restructuring charges that increase the audit risk related to amounts reported as restructuring charges. EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring),* addresses the following two issues:

1. When an employer should recognize a liability for the cost of employee termination benefits that management decides to provide to involuntarily terminated employees and what additional financial statement disclosures should be made for those charges
2. When an enterprise should recognize a liability for costs, other than employee termination benefits, that are directly associated with a plan to exit an activity (exit plan), including certain costs incurred in a restructuring and what additional financial statement disclosures should be made for those charges

Audit Developments

Letters for Underwriters

.55 The Auditing Standards Board (ASB) of the AICPA released SAS No. 76, *Amendments to Statement on Auditing Standards No. 72,* Letters for Underwriters and Certain Other Requesting Parties. SAS No. 76 provides reporting guidance and an example letter when one of the parties identified in paragraph 3, 4, or 5 of SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (AU section 634.03, .04, or .05), other than an underwriter or other party with a due diligence defense under section 11 of the Securities Act of 1933, requests a letter but does not meet the criteria in SAS No. 72 (AU section 634). The amendments in this Statement are effective for letters issued pursuant to paragraph 9 of SAS No. 72 (AU section 634.09) after April 30, 1996.

Agreed-Upon Procedures

.56 Auditors of insurance entities are often engaged to perform certain agreed-upon procedures. The ASB has observed that there is diversity in practice in performing and reporting on these engagements, and that the existing guidance does not address a number of issues that practitioners and accountants should consider.

.57 In September 1995, the ASB released SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622), and Statement on Standards for

Attestation Engagements (SSAE) No. 4, *Agreed-Upon Procedures Engagements* (AT section 600). SAS No. 75 (AU section 622) supersedes SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement.*

.58 Both SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) provide guidance on performing and reporting on applying agreed-upon procedures. The new standards provide guidance on the following:

- The conditions for performing agreed-upon procedures engagements
- The nature, timing, and extent of the procedures
- The responsibilities of practitioners and specified users
- The reporting on procedures performed and related findings

The primary difference between the two Standards is that SAS No. 75 (AU section 622) is applicable when a practitioner applies agreed-upon procedures to specified elements, accounts, or items of a financial statement, and SSAE No. 4 (AT section 600) is generally applicable when a practitioner applies agreed-upon procedures to nonfinancial statement subject matter. Another difference between the two Standards is that SSAE No. 4 (AT section 600) requires a *written* assertion from management as a condition of engagement performance and SAS No. 75 (AU section 622) does not have such a requirement because assertions are effectively embodied in the elements, accounts, or items of a financial statement, where the basis of accounting is clearly evident.

.59 Both SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) prohibit the practitioner from expressing negative assurance in agreed-upon procedures reports by stating that the practitioner should present the results of applying agreed-upon procedures in the form of findings. (The predecessor agreed-upon procedures standards permitted practitioners to provide negative assurance in agreed-upon procedures reports.) The ASB prohibits the expression of negative assurance in agreed-upon procedures reports because such language could cause users to conclude that the practitioner was communicating assurance beyond the findings in his or her report. Also, the ASB believes that negative assurance should be reserved for review-level engagements.

.60 Both SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) are effective for reports dated after April 30, 1996, with early adoption encouraged.

Reports on the Processing of Transactions by Service Organizations

.61 Insurance entities sometimes engage service organizations to perform various functions relating to claim and benefit processing, premium processing, and investment management. In April 1994, the ASB issued Interpretation No. 2 of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*, titled "Service Organizations That Use the Services of Other Service Organizations (Subservice Organizations)" (AU section 9324.04-.18).

.62 Interpretation No. 2 (AU section 9324.04-.18) provides guidance on how a user auditor's and a service auditor's procedures are affected when a service organization uses a subservice organization. It describes how a user auditor may obtain information about relevant control structure procedures at a subservice organization.

Elimination of Uncertainty Reporting

.63 The ASB has issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

.64 The amendment would also expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AU section 508.37), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

.65 The proposal does not affect the provisions of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), which requires that the auditor add an explanatory paragraph to the auditor's report when there is substantial doubt about the entity's ability to continue as a going concern.

.66 The AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* indicates that auditors of the financial statements of property and liability enterprises may consider it necessary to add an uncertainty explanatory paragraph to their reports when available historical data is not sufficient to resolve an uncertainty about the reasonableness of management's estimate of loss reserves for certain new companies, companies writing significant amounts of new lines of business, or companies with low volume of claims. If the proposed SAS is issued in final form, that requirement will be eliminated. Nonetheless, auditors reporting on property and liability insurance enterprise financial statements may wish to emphasize that fact by adding an emphasis-of-a-matter paragraph to their reports. Such paragraphs, however, are optional and are added solely at the auditor's discretion.

.67 The ASB hopes to finalize this SAS late this year and to issue an SAS that would be effective for reports issued on or after June 30, 1996, with early application permitted.

Auditor's Reports on Statutory Financial Statements

.68 The AICPA expects to issue an SOP, *Auditor's Reports on Statutory Financial Statements of Insurance Enterprises,* by the end of 1995. The SOP will address auditor's considerations in reporting on statutory financial statements of insurance enterprises. This SOP should be applied to audits of statutory financial statements for years ended on or after December 31, 1996. The SOP will—

- Rescind SOP 90-10, *Reports on Audited Financial Statements of Property and Liability Insurance Companies.*
- Discuss matters auditors should include in their reports when issuing limited or general distribution reports on statutory financial statements.
- Discuss matters auditors should evaluate when considering issuing limited or general distribution reports on statutory financial statements.
- Discuss auditor's reporting on the statutory financial statements of mutual life insurance enterprises. (See the section entitled "Mutual Life Insurance Enterprises" in the "Accounting Developments" section of this Audit Risk Alert.)

Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule

.69 The AICPA expects to issue another SOP, *Letters for State Insurance Regulators to Comply with the NAIC Model Audit Rule,* by the end of the year. The SOP will provide guidance to auditors on the form and content of communications with state insurance regulators, which is required by the NAIC *Annual Statement Instructions Requiring Annual Audited Financial Statements,* which incorporates the January 1991 *Model Rule (Regulation) Requiring Annual Audited Financial Reports* (reissued in July 1995). This SOP amends chapter 9, "Auditor's Reports," of the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* and chapter 11, "Auditors' Reports" of the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies.* This SOP should be applied to audits of statutory financial statements performed for periods ending on or after December 31, 1995.

Risk-Based Capital

.70 In response to the NAIC's implementation of a risk-based capital program for property and casualty insurance enterprises, the AICPA issued a Notice to Practitioners in the January 1995 *CPA Letter* stating that the guidance in SOP 93-8, *The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises* is also applicable to property and casualty insurance enterprises. SOP 93-8 provides guidance on the consideration of risk-based capital in the planning stage of the audit, as well as guidance on auditors' reports. The AICPA intends to incorporate the guidance of SOP 93-8 into the Audit and Accounting Guide *Audits of Property and Liability Insurance Companies.*

Accounting Developments

Long-Lived Assets

.71 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08), which establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used for long-lived assets, and certain identifiable intangibles to be disposed of. The Statement (AC I08) applies to financial statements for fiscal years beginning after December 15, 1994.

.72 The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstance indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the enterprise should estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. This Statement (AC I08) does not apply to deferred policy acquisition costs under FASB Statement Nos. 60 (AC In6) and 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (AC In6).

.73 The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets that are covered by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets that are covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of carrying amount or net realizable value.

.74 The Statement (AC I08) specifies that impairment losses resulting from its application be reported in the period in which the recognition criteria are first met. The initial application of the Statement (AC I08) to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle. (Certain provisions of SOP 92-3, *Accounting for Foreclosed Assets,* are inconsistent with provisions of FASB Statement No. 121 (AC I08). The AICPA's Accounting Standards Executive Committee (AcSEC) is considering actions to take on SOP 92-3; however, FASB Statement No. 121 (AC I08) takes precedence for transactions within its scope.) Auditors should be aware that the provisions of FASB Statement No. 121 (AC I08) may be material to certain insurance enterprises. Some examples of events or changes in circumstances that may indicate that the recoverability of the carrying amount of an asset should be assessed are as follows:

- A significant decrease in the market value of an asset
- A significant change in the extent or manner in which an asset is used or a significant physical change in an asset

- A significant adverse change in legal factors or in the business climate that could affect the value of an asset or an adverse action or assessment by a regulator
- An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset
- A current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with an asset used for the purpose of producing revenue

Mutual Life Insurance Enterprises

.75 In April 1993, the FASB issued Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises* (AC In6). The Interpretation (AC In6) clarifies that companies, including mutual life companies, that issue financial statements described as prepared "in conformity with generally accepted accounting principles" are required to apply all applicable authoritative accounting pronouncements in preparing those statements. The Interpretation (AC In6) concludes that mutual life insurance companies that prepare financial statements based on regulatory accounting practices that differ from generally accepted accounting principles (GAAP), and distribute those financial statements to regulators, should not describe these financial statements as prepared "in conformity with generally accepted accounting principles."

.76 In January 1995, the FASB issued Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts* (AC In6). This Statement (AC In6) amends FASB Interpretation No. 40 (AC In6) to defer the effective date of the general provisions of that Interpretation (AC In6) to fiscal years beginning after December 15, 1995. Nevertheless, this Statement (AC In6) does not change the disclosure and other transition provisions of FASB Interpretation No. 40 (AC In6). The disclosure requirements remain effective for fiscal years beginning after December 15, 1992, and include—

- The accounting principles and methods used to account for investments in debt and equity securities and insurance activities in accordance with APB Opinion No. 22, *Disclosure of Accounting Policies* (AC A10).
- A brief description of Interpretation No. 40 (AC In6), including its effective date and transition provisions, and that financial statements prepared on the basis of statutory accounting practices will no longer be described as prepared in conformity with GAAP after the effective date of this Interpretation (AC In6).

FASB Statement No. 120 (AC In6) extends the requirements of FASB Statement No. 60 (AC In6), No. 97 (AC In6), and No. 113 (AC In6), to mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies.

.77 FASB Statement No. 120 (AC In6) also permits stock life insurance enterprises to apply the accounting provisions of the SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises,* which is discussed in the next paragraph, to participating life insurance contracts that meet the conditions in this Statement (AC In6). The Statement (AC In6) is effective for financial statements issued for fiscal years beginning after December 15, 1995.

.78 On January 18, 1995, the AICPA issued SOP 95-1. The SOP will be effective for financial statements issued for fiscal years beginning after December 15, 1995. The SOP, which was issued jointly with FASB Statement No. 120 (AC In6), provides accounting guidance and establishes accounting for certain participating insurance contracts of mutual life insurance enterprises with the following characteristics:

- They are long-duration participating contracts that are expected to pay dividends to policyholders based on actual experience of the insurance enterprise.

- Annual policyholder dividends are paid in a manner that identifies divisible surplus and distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus (commonly referred to in actuarial literature as the contribution principle).

The SEC staff is currently considering whether to delete the Rule 7-02(b) of Regulation S-X exception, permitting statutory financial statements of mutual life insurance companies in SEC filings, such as for sponsors of variable products. Auditors should be aware of this guidance when auditing a mutual life insurance enterprise.

Disclosures About Derivatives

.79 In recent years, insurance enterprises have become increasingly involved in the use of derivative financial instruments both as speculative investment vehicles and as risk management tools.

.80 In October 1994, the FASB issued Statement No. 119 (AC F25), which requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 (AC F25) and No.107 (AC F25).

.81 The Statement (AC F25) requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 (AC F25.115P) encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

.82 FASB Statement No. 119 (AC F25) was effective for financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations, the Statement (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1995.

.83 The FASB Special Report, *Illustrations of Financial Instruments Disclosures*, contains illustrations of the application of FASB Statements No. 105 (AC F25), No. 107 (AC F25), and No. 119 (AC F25).

.84 Auditors should consider whether the disclosures made by their clients in their financial statements are adequate and appropriate in view of the new requirements.

Income Recognition on Impaired Loans

.85 In October 1994, the FASB issued Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (AC I08). FASB Statement No. 118 (AC I08) amends FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC I08), to allow creditors to use existing methods for recognizing interest income on impaired loans. To accomplish that, it eliminates the provisions in FASB Statement No. 114 (AC I08) that describe how creditors should report income on impaired loans. FASB Statement No. 118 (AC I08) does not change the provisions in FASB Statement No. 114 (AC I08) that require creditors to measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, or as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral-dependent. FASB Statement No. 118 (AC I08) also amends the disclosure requirements in FASB Statement No. 114 (AC I08) to require certain disclosures about the recorded investment in impaired loans, of the related amounts of investment income reported and received, and the creditors' policy for recognizing interest income related to those loans. FASB Statement No. 118 (AC I08) is effective concurrent with the effective date of FASB Statement No. 114 (AC I08), that is, for financial statements for fiscal years beginning after December 15, 1994, with earlier application encouraged.

Impairment of Loans

.86 In May 1993, the FASB issued Statement No. 114 (AC I08), which addresses the accounting by creditors for impairment of certain loans and applies to financial statements for fiscal years beginning December 15, 1994. The Statement (AC I08) is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller balance homogeneous loans that are collectively valued for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115 (AC I80). It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

.87 FASB Statement No. 114 (AC I08) requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent.

.88 The Statement (AC I08) amends FASB Statement No. 5 (AC C59) to clarify that a creditor should evaluate the collectibility of both the contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement (AC I08) also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (AC D22), to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

.89 Auditors should carefully consider the audit implications for applying the provisions of this Statement (AC I08). The auditors' review should consider the following among other things:

- Proper identification of all loans to which the Statement (AC I08) should be applied
- The reasonableness of estimates of future cash flows and interest rates used in discounting
- The appropriateness of amounts used to measure impairment if alternatives to present-value amounts, such as fair values of collateral or observable market prices, are used
- The relationship between the identification of impaired loans under the Statement (AC I08) and the classification of loans under regulatory classification systems
- The presentation of accrued interest receivable and its relationship to valuation allowances
- The relevance of concepts of performing and non performing assets

Offsetting

.90 In December 1994, the FASB issued Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* (AC B10). The Interpretation (AC B10) modified Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), to permit offsetting in the statement of financial position of payables and receivables that represent repurchase agreements and reverse repurchase agreements and that meet the conditions of paragraph 3 of the Interpretation (AC B10.106A). APB Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7 (AC B10.101-103), states that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FASB Interpretation No. 39 (AC B10) defines right of setoff and specifies conditions that must be met to permit offsetting. The provisions of Interpretation No. 41 (AC B10) are effective for financial statements issued for periods ending after December 15, 1994. Auditors should consider whether insurance companies have properly implemented Interpretation No. 41 (AC B10).

Disclosure of Certain Significant Risks and Uncertainties

.91 In December 1994, AcSEC issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 applies to financial statements prepared in conformity with GAAP applicable to public and nonpublic nongovernmental entities and should be considered for statutory financial statements. It requires reporting entities to include in their financial statements disclosures about the following:

- The nature of their operations
- The use of estimates in the preparation of financial statements

In addition, if specified disclosure criteria are met, SOP 94-6 requires entities to include in their financial statements disclosures about the following:

- Certain significant estimates
- Current vulnerability due to certain concentrations

.92 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of similar estimates that may be included in the financial statements of insurance enterprises include the following:

- Deferred policy acquisition costs of insurance enterprises
- Valuation allowances for commercial and real estate loans
- Liabilities for paid and unpaid claims

Examples of insurance enterprise concentrations that may be subject to disclosure if they meet the criteria of paragraph 21 of SOP 94-6 include the following:

- Reinsurance contracts with one reinsurer
- Line of business or geographic location of coverage (for example, earthquake insurance in the state of California)

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied. Auditors should be alert to the requirements of SOP 94-6 and its impact on the financial statements of the enterprise being audited. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

Financial Statement Disclosures

.93 SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises,* is effective for financial statements issued for fiscal years ending after December 15, 1994. This SOP requires insurance companies, where applicable, to make the following disclosures in their financial statements:

- The accounting methods used in their statutory financial statements that are permitted by state insurance departments rather than prescribed statutory accounting practices
- Detailed information about the development of their liabilities for unpaid claims and claim adjustment expenses

Because the scope of SOP 94-5 covers insurance enterprises as defined by FASB Statement No. 60 (AC In6), the scope of the unpaid claims disclosure should include accident and health claims, but not life insurance claims.

In-Substance Foreclosures

.94 AcSEC has withdrawn two practice bulletins about the substantive repossession of collateral because the underlying issues have been addressed in FASB Statement No. 114 (AC I08). AcSEC determined that Practice Bulletin 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed,* and Practice Bulletin 10, *Amendment to Practice Bulletin 7,* Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed, shall be superseded as of the effective date of implementation of FASB Statement No. 114 (AC I08).

.95 FASB Statement No. 114 (AC I08) clarified that paragraph 34 of FASB Statement No. 15 (AC D22.142) was intended to apply to a troubled debt restructuring or other circumstance in which a debtor surrendered property to the creditor, and the creditor was in possession of the asset with or without having to go through formal foreclosure procedures. FASB Statement No. 114 (AC I08) applies to financial statements for fiscal years beginning after December 15, 1994.

.96 Similarly, the SEC amended its interpretive guidance to inform registrants that have adopted FASB Statement No. 114 (AC I08) that they should not apply the portion of the SEC's Financial Reporting Release No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities* (*Federal Register,* May 19, 1994), that addresses the accounting for substantive repossessions of collateral.

Certain FASB Statement No. 115 Implementation Issues

.97 As a result of inquiries and comments by SEC registrants and their auditors, at the July 21, 1994, EITF meeting, the SEC staff made an announcement regarding the effects of adopting FASB Statement No. 115 (AC I80) on certain assets and liabilities. The SEC staff would expect registrants to comply with the guidance in this announcement when registrants adopt FASB Statement No. 115 (AC I80) and FASB Interpretation No. 40 (AC In6). Auditors should be aware that the FASB staff believes that both public and non public entities should comply with the guidance in this announcement. The text of this announcement is as follows:

> Currently, SEC registrants are evaluating the effect on their financial statements of adopting FASB Statement No. 115. The SEC staff has been asked whether certain assets and liabilities, such as minority interests, certain life insurance policyholder liabilities, deferred acquisition costs, and the present value of future profits, should be adjusted with a corresponding adjustment to shareholders' equity at the same time unrealized holding gains and losses from securities classified as available-for-sale are recognized in shareholders' equity. That is, should the carrying value of these assets and liabilities be adjusted to the amount that would have been reported had unrealized gains and losses been realized?
>
> This issue is not addressed specifically in the literature. However, paragraph 36(b) of FASB Statement No. 109 addresses specifically the classification of the deferred tax effects of unrealized holding gains and losses reported in a separate component of shareholders' equity. Paragraph 36(b) of FASB Statement No. 109 requires that the tax effects of such gains and losses be reported as charges or credits directly to the related component of shareholders' equity. That is, the recognition of unrealized holding gains and losses in shareholders' equity may create temporary differences for which deferred taxes would be recognized, the effect of which would be reported in a separate component of shareholders' equity along with the related unrealized holding gains and losses. Therefore, FASB Statement No. 109 requires that deferred tax assets and liabilities be recognized for the temporary differences relating to unrealized holding gains and losses as though these gains and losses actually had been realized, except the corresponding charges or credits are reported in a separate component of shareholders' equity rather than charges or credits to income in the statement of income.

> By analogy to the requirements of FASB Statement No. 109, the SEC staff believes that, in addition to deferred tax assets and liabilities, registrants should adjust other assets and liabilities that would have been adjusted if the unrealized holding gains and losses from securities classified as available-for-sale actually had been realized. That is, to the extent that unrealized holding gains or losses from securities classified as available-for-sale would result in adjustments of minority interest, policyholder liabilities, deferred acquisition costs that are amortized using the gross-profits method, or amounts representing the present value of future profits that are amortized using the gross-profits method had those gains or losses actually been realized, the SEC staff believes that such balance sheet amounts should be adjusted with corresponding credits or charges reported directly to shareholders' equity. As a practical matter, the staff, at this time would not extend such adjustments to other accounts such as liabilities for compensation to employees. The adjustments to asset accounts should be accomplished by way of valuation allowances, that would be adjusted at subsequent balance sheet dates.
>
> For example, SEC registrants should adjust minority interest for a portion of the unrealized holding gains and losses from securities classified as available-for-sale if those gains and losses relate to securities that are owned by a less-than-wholly-owned subsidiary whose financial statements are consolidated. Certain policyholder liabilities also should be adjusted to the extent that liabilities exist for insurance policies that, by contract, credit or charge the policyholders for either a portion or all of the realized gains or losses of specific securities classified as available-for-sale. Further, certain asset amounts that are amortized using the gross-profits method, such as deferred acquisition costs accounted for under FASB Statement No. 97, and the present value of future profits recognized as a result of acquisitions of life insurance entities accounted for as purchase business combinations, should be adjusted to reflect the effects that would have been recognized had the unrealized holding gains and losses actually been realized. Further, capitalized acquisition costs associated with insurance contracts covered by FASB Statement No. 60 should not be adjusted for an unrealized holding gain or loss unless a "premium deficiency" would have resulted had the gain or loss actually been realized.

This announcement should not affect reported net income. It addresses only the adjustment of certain assets and liabilities and the reporting of unrealized holding gains and losses from securities classified as available-for-sale.

Consensus Decisions of the FASB's Emerging Issues Task Force

.98 The EITF frequently discusses accounting issues involving financial instruments, real estate, or insurance contracts that are important to insurance companies. A description of several recent issues is provided below; however, readers should consult detailed minutes for additional information.

.99 EITF Issue No. 94-7, *Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock,* addresses financial instruments that may be settled with a specified number of shares of an entity's stock or with a cash amount calculated on the basis of the value of a specified number of shares of an entity's stock. Issues include (1) whether the instrument should be classified as an asset or an equity instrument and (2) how gains and losses are reported.

.100 EITF Issue No. 95-5, *Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights,* involves discussion of certain issues related to sales and mortgage loan servicing rights.

.101 EITF Issue No. 95-11, *Accounting for Derivative Instruments Containing Both a Written Option-Based and a Forward-Based Component,* involves discussion of accounting for certain derivative instruments.

.102 Appendix D to the *EITF Abstracts* contains EITF discussions of technical matters that have long-term relevance and do not relate specifically to a numbered EITF Issue. Readers should be alert to the following topics of recent discussion:

.103 Appendix D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value,* contains a FASB staff announcement concerning the implementation of FASB Statement No. 115 (AC I80). The FASB expects to issue a Special Report *A Guide to the Implementation of FASB Statement No. 115 Accounting for Certain Investment in Debt and Equity Securities* by the end of the year. Also, the SEC staff is continuing to strictly and literally apply the guidelines in FASB Statement No. 115 (AC I80) on sales and transfers of held-to-maturity securities.

.104 Appendix D-45 contains FASB staff views on *Implementation of FASB Statement No. 121 for Assets to Be Disposed Of.*

Special Report on FASB Statement No. 115

.105 The FASB staff is developing a guide to FASB Statement No. 115 (AC I80), which will provide implementation guidance in a question and answer format. The Special Report is expected to be issued by the end of the year.

Information Sources

.106 Further information matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.107 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.108 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.109 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.110 All telephone numbers listed are voice lines, unless otherwise designated by fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed for data lines.

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.111 This Audit Risk Alert supersedes *Insurance Industry Developments—1994.*

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.112 Practitioners should also be aware of the economic, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
National Association of Insurance Commissioners	*Order Department* 120 W. 12th St., Suite 1100, Kansas City, MO 64105-1925 (816) 471-7004	*Order by Fax* (816) 471-7004		
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250(f)		*U.S. Government Printing Office's The Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account. User assistance line: (202) 512-1530 (202) 512-1387(d) Telnet via internet: federal.bbs.gpo.gov 3001	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 4 (202) 942-7114 (tty)		*Information Line* (202) 942-8088 (202) 942-7114 (tty)

AAM Section 8050

Banks and Savings Institutions Industry Developments—1995/96

Industry and Economic Developments

.01 The U.S. economy's slow growth during 1995 was reflected in the banking and savings institutions industry by moderate loan growth, tighter liquidity, and declining interest-rate spreads, while capitalization remained strong. These factors, as well as continuing trends of cost control and consolidation within the industry, have various implications for audit risk.

.02 Institutions' efforts to grow loan portfolios or introduce new loan products during the year may involve assumption of greater risk. Changing credit or documentation standards to increase loan originations or accommodate new products may increase audit risk associated with estimates of loan losses.

.03 Growth in loan portfolios has also tightened liquidity at many institutions. Liquidity for funding portfolio activities typically comes from deposits, borrowings, or sales of assets such as securities for institutions to attract new deposits and investors have shifted funds away from existing deposits. Because wholesale borrowings often carry higher interest rates, deposits have been a primary funding source for portfolio growth, resulting in higher loan-to-deposit ratios. In 1994, rates on deposits did not increase to the same degree as market interest rates. As market interest rates went down in 1995, the importance of deposits as a funding source (and the value of related customer relationships as openings to offer other products) kept many institutions from lowering deposit rates to the same degree as decreases in market interest rates. Far from lowering deposit rates to market rates, many institutions had to choose between maintaining or raising deposit rates or using higher cost funds to support portfolio growth, thereby contributing to narrower interest-rate spreads. Auditors should be alert to the effect on audit risk of pressure to maintain or improve interest-rate spreads.

.04 Some institutions have sold securities or loans for liquidity to support portfolio growth. Auditors should be alert to the impact of such sales on management's intent for, classification of, and valuation of securities and loans for financial reporting purposes. Auditors should also be alert to the effect of sales with recourse on credit risk and recognition of gains and losses.

.05 Many institutions have organized personnel, technology, office space, and other resources into structures to support origination of various loan products. When origination volumes are consistently lower than targeted, it becomes more costly to sustain such structures. Auditors should be alert to the impact on audit risk of changes in or dismantling of origination structures.

.06 Consolidation and restructuring within the industry continued during 1995 as institutions anticipate interstate branching and attempt to control costs. Related reductions in staff or elimination or merger of duties increase the potential for weaknesses in knowledge of or adherence to internal controls. Auditors should be alert to such matters when considering an institution's internal control structure as part of a financial statement audit and when testing controls over financial reporting as part of an engagement to attest to related management assertions.

.07 Many institutions have completed restructuring or cost containment programs and are now focused on increasing revenues through new products and fee-based services. Auditors should be alert to the impact on audit risk of new products and services, as well as of related pressures to increase revenues or reduce or defer expenses.

.08 Strong capitalization has funded consolidation, increased dividends, and stock repurchases. Auditors should be alert to audit risk created by these events.

Legislative and Regulatory Developments

.09 Laws and implementing regulations affect the areas and ways in which institutions operate by creating standards with which those institutions must comply. Also, some laws and regulations directly address the responsibilities of auditors. Auditors should be generally familiar with certain laws and regulations because of their impact on auditors'—

- Acceptance of engagements in the industry.
- Development of the expected conduct and scope of an engagement.
- Responsibility for detection of errors, irregularities, and illegal acts.
- Evaluation of contingent liabilities and related disclosures.
- Consideration of an institution's ability to continue as a going concern.

.10 Also, AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), requires that auditors consider matters, such as government regulations, affecting the industry in which the entity operates. For that purpose, being familiar with the nature and purpose of regulatory examinations—including the differences and the relationship between examinations and financial statement audits—is helpful for auditors. An understanding of the regulatory environment in which banks and savings institutions operate is also necessary to complement the auditor's knowledge of existing regulatory requirements. Because the regulatory environment is continually changing, the auditor should monitor relevant regulatory changes and consider their implications in the audit process.

.11 Following are legislative and regulatory developments of particular significance in audits of the financial statements of banks and savings institutions. Other legislative and regulatory matters covering other policy areas, such as regulations for fair lending practices or the Community Reinvestment Act, are not within the scope of this document. Auditors should be alert to the effect of legislative and regulatory developments on contingent liabilities or planned mergers or acquisitions, or direct and material effects of such developments on the determination of amounts in the institution's financial statements. This Audit Risk Alert does not provide a comprehensive discussion of each issue. Readers should not substitute a reading of this alert for a complete reading of related laws, regulations, rulings, or other documents where appropriate (see the "Information Sources" section herein). This alert refers to related publications of the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Office of Thrift Supervision (OTS) (collectively, the agencies) and other entities as appropriate.

Legislative Matters

.12 Legislation proposed but not passed by Members of Congress during 1995 centered on reforming provisions of the Glass-Steagall Act (which effectively prohibits commercial banks from underwriting securities or otherwise engaging in investment banking activities), providing relief from certain regulations, and further regulating derivatives.

.13 At press time, Congress was also considering legislation related to shoring up the FDIC's Savings Association Insurance Fund (SAIF). In August 1995, the FDIC lowered deposit insurance premiums for many institutions insured by its Bank Insurance Fund (BIF). Given the resulting differential between BIF and SAIF premiums, Congress is considering bills that would merge federal bank and savings institution charters and the BIF and SAIF after raising the SAIF reserve ratio to 1.25 percent through a special assessment of SAIF members. Related legislation has been proposed to address potential recapture by savings institutions of percentage-of-taxable-income deductions of bad debts for tax purposes. Auditors should be alert to the effect of any final legislation on audit risk associated with recognition and measurement of premiums and taxes in an institution's financial statements. (See "Deposit Insurance Premiums" in the "Other Regulatory Matters" subsection herein.)

Regulatory Capital Matters

.14 Capital regulations are complex and their application requires an understanding of specific requirements. The potential impact of noncompliance—particularly if an institution is involved in complex transactions, investments, or parent-subsidiary relationships—also should be understood. Highlights of major changes in capital regulations follow. Readers should consult related regulations for full definitions of the terms used.

.15 *Capital Adequacy Guidelines.* The FDIC, OCC, and FRB have common capital adequacy guidelines (which differ in some respects from those of the OTS) involving minimum (1) leverage capital and (2) risk-based capital requirements. The leverage requirement establishes a minimum ratio of capital as a percentage of total assets. The FDIC, OCC, and FRB require institutions to maintain a minimum leverage ratio of Tier 1 capital to total average assets based on the institution's rating under the regulatory CAMEL rating system.[1] Capital rules require that institutions with CAMEL ratings of one that are not anticipating or experiencing significant growth and have well-diversified risk maintain a minimum leverage ratio of 3.0 percent. An additional 100 to 200 basis points are required for all but these most highly rated institutions. The risk-based requirement also establishes a minimum ratio of capital as a percentage of total assets, but gives weight to the relative risk of each asset. The FDIC, OCC, and FRB require institutions to maintain a minimum ratio of Tier 1 capital to risk-weighted assets of 4.0 percent. Banks must also maintain a minimum ratio of total capital to risk-weighted assets of 8.0 percent.

.16 The OTS requires savings institutions to maintain also a minimum core-capital ratio of 3.0 percent and a tangible capital requirement of 1.5 percent of assets. The determination of tangible capital requires the immediate deduction of all unamortized supervisory goodwill arising from the purchase of a troubled institution before April 12, 1989. Regulations required that institutions fully deduct unamortized supervisory goodwill from core-capital by January 1, 1995. For savings associations, the OTS-required minimum total risk-based capital ratio (that is, the total of core and supplemental capital) is 8.0 percent and the minimum requirement for core capital included in total thrift risk-based capital is 4.0 percent.

.17 *Prompt Corrective Action.* The FDIC Improvement Act of 1991 (FDICIA) added Section 38 to the Federal Deposit Insurance Act (FDI Act), which outlines a uniform framework for prompt corrective regulatory action. Section 38 focuses regulatory intervention primarily on an institution's capital levels compared with the Section 38 standards. Noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern (as discussed in SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* [AU section 341]). The application of the prompt corrective action provisions warrants similar attention by auditors when considering an institution's ability to remain a going concern.

.18 Under the provisions, each bank or savings institution falls into one of five regulatory capital categories based primarily on three capital measures: Tier 1 leverage, total risk-based, and Tier 1 risk-based capital. Regulations carrying out Section 38 define the measures in the same manner as for the respective agencies' capital adequacy guidelines and, for savings institutions, Tier 1 leverage capital is comparable to core capital.

.19 Regulations carrying out Section 38 also specify a minimum requirement for tangible equity, which is Tier 1 capital plus cumulative perpetual preferred stock, net of all intangibles except limited amounts of mortgage-servicing rights (MSRs), net of disallowed deferred tax assets. In calculating the tangible capital ratio, intangibles (except qualifying MSRs), net of disallowed deferred tax assets, are deducted from total assets included in the ratio denominator.

[1] The acronym CAMEL relates to capital adequacy, asset quality, management, earnings, and liquidity.

.20 Regulators may reclassify an institution into another capital category if they deem the institution's condition or one of its activities to be "unsafe or unsound." A change in an institution's capital category initiates certain mandatory—and possible additional discretionary—action by regulators. Under Section 38, an institution is considered—

1. *Well capitalized* if its capital level *significantly exceeds* the required minimum level for each relevant capital category.
2. *Adequately capitalized* if its capital level *meets* the minimum levels.
3. *Undercapitalized* if its capital level *fails to meet* the minimum levels.
4. *Significantly undercapitalized* if its capital level is *significantly below* the minimum levels.
5. *Critically undercapitalized* if it has a ratio of tangible equity to total assets of 2 percent or less, or otherwise fails to meet the critical capital level.

.21 The minimum levels follow:

Category	*Total Risk-based Ratio (%)*	*Tier 1 Risk-based Ratio (%)*	*Tier 1 Leverage Capital Ratio (%)*
Well capitalized	≥ 10 and	≥ 6 and	≥ 5
Adequately capitalized	≥ 8 and	≥ 4 and	≥ 4 *
Undercapitalized	< 8 or	< 4 or	< 4 *
Significantly undercapitalized	< 6 or	< 3 or	< 3

* 3.0 percent for institutions with a rating of one under the regulatory CAMEL or related rating system that are not anticipating or experiencing significant growth and have well-diversified risk (as defined).

.22 An institution will not be considered well capitalized if it is under a cease-and-desist order, formal agreement, capital directive, or prompt corrective action capital directive.

.23 Actions regulators may take under the prompt corrective action provisions range from the restriction or prohibition of certain activities to appointment of a receiver or conservator of the institution's net assets.

.24 Regulators will also require undercapitalized institutions to submit a plan for restoring the institution to an acceptable capital category. For example, each undercapitalized institution is required to submit a plan that specifies—

1. Steps the institution will take to become adequately capitalized
2. Targeted capital levels for each year of the plan
3. How the institution will comply with other restrictions or requirements put into effect
4. The types and levels of activities in which the institution will engage

.25 *Recourse Arrangements.* The agencies revised their risk-based capital guidelines to address capital treatment of low-level recourse arrangements (defined as transactions in which an institution contractually limits its recourse exposure to less than the full effective minimum risk-based capital requirement for the assets transferred). In low-level recourse arrangements, the required amount of risk-based capital is limited to the maximum amount of recourse for which the institution is contractually liable (FDIC Financial Institutions Letter [FIL] 27-95; *Federal Register* [March 28, 1995 and February 13, 1995]).

.26 *Interest-Rate Risk.* FDI Act Section 18 (added by FDICIA Section 305) requires the agencies to revise their risk-based capital guidelines as necessary to ensure adequate consideration of interest-rate risk.

.27 Effective January 1, 1994, the OTS added an interest-rate risk component to its risk-based capital requirements. Institutions with a greater than normal interest-rate risk exposure (as defined) must take a deduction from the total capital available to meet their risk-based capital requirement, equal to half the difference between the institution's actual measured exposure and a defined normal level of exposure (*Federal Register* [August 31, 1993]). In a March 20, 1995, letter to chief executive officers (CEO Letter), the OTS stated that, in calculating the risk-based capital requirement, no institution will be required to deduct capital for interest-rate risk or to report such a deduction in its call report until the OTS issues a Thrift Bulletin (TB) describing the appeals process for the deduction.

.28 The FDIC, OCC, and FRB issued a final rule that amends risk-based capital standards to explicitly identify concentrations of interest-rate risk as qualitative factors to be considered in assessing an institution's overall capital adequacy. The final rule includes no quantitative measure of such risks. The FDIC, OCC, and FRB also proposed a joint policy statement on methods by which interest-rate risk exposure will be assessed for supervisory purposes (OCC Bulletin 95-46; *Federal Register* [August 2, 1995]).

.29 OCC Advisory Letter 95-1 and OCC Bulletin 95-28 express the OCC's expectations regarding banks' interest-rate risk management practices. FDIC FIL-60-94 includes guidance to FDIC examiners on assessment and management of interest-rate risk. These documents may also provide useful information to auditors.

.30 *Concentration of Credit Risk and Nontraditional Activities.* In December 1994, the agencies issued final rules for regulatory consideration of concentrations of credit risk and risks of nontraditional activities (FDIC FIL-85-94; *Federal Register* [December 15, 1994]). The final rule amends existing risk-based capital standards explicitly to identify concentrations of credit risk and risks of nontraditional activities as qualitative factors to be considered by the agencies' examiners in assessing an institution's overall capital adequacy. The final rule includes no quantitative measure of such risks.

.31 The OCC requires regulatory examination reports to include certain information about concentrations of credit (as defined) (OCC Bulletins 95-7 and 95-26). Although the definition of concentrations of credit is not equivalent to that used for purposes of disclosure in conformity with Financial Accounting Standards Board (FASB) Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), examination reports are available to auditors, who may find the regulatory summary helpful as one source of information for addressing the completeness of related financial statement disclosures.

.32 *Market Risk.* In July 1995, the FDIC, OCC, and FRB issued a proposal to amend their risk-based capital guidelines to incorporate a measure of market risk (OCC Bulletin 95-42; *Federal Register* [July 25, 1995]). The FRB also issued a request for comments on a possible approach to setting capital requirements for market risk (*Federal Register* [July 25, 1995]).

.33 *RAP-GAAP Differences.* Auditors should also consider the effect on audit risk of differences between regulatory accounting practices (RAP) used to prepare regulatory financial reports and generally accepted accounting principles (GAAP) used to prepare general-purpose financial statements. For example, the FASB's Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No. 85-44, *Differences between Loan Loss Allowances for GAAP and RAP,* that an institution could record different loan loss allowances under RAP and GAAP because those amounts may differ due to the subjectivity involved in estimating the amount of loss or the use of arbitrary factors by regulators. However, the consensus suggests that auditors should be particularly skeptical of such RAP-GAAP differences in loan loss allowances and must justify such differences based on the circumstances.

.34 Also, because of regulatory rule changes during the year, certain balances and transactions accounted for in conformity with GAAP for regulatory reporting purposes will receive special treatment in regulatory capital calculations. Descriptions of these transactions follow.

- *Deferred Tax Assets.* Only a limited amount of certain deferred tax assets recognized under FASB Statement No. 109, *Accounting for Income Taxes* (AC I27), may be included in Tier 1 capital (FDIC FIL-16-95; *Federal Register* [February 13, 1995 and December 22, 1994]; OCC Bulletin 95-10; OTS TB 56).

- *Securities Gains and Losses.* Net unrealized holding losses on equity securities classified as available for sale in conformity with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), are included in the calculation of Tier 1 capital. However, all other unrealized holding gains and losses on available-for-sale securities are not included in calculation of Tier 1 capital (FDIC FIL-3-95; OCC Bulletin 94-68; OTS CEO Letter [November 28, 1994]; *Federal Register* [December 8, 1994]).

- *Loan Loss Allowances.* Regulations permit institutions to include in Tier 2 capital a limited amount of loan loss allowances established in conformity with FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC I08), whereas these amounts reduce assets (rather than increase capital) for GAAP purposes. The notice of the Federal Financial Institutions Examination Council's (FFIEC's) final action appeared in the *Federal Register* on February 10, 1995. Further, through OTS Regulatory Bulletin (RB) 32, the OTS revised its policies to require that the valuation and classification of troubled, collateral-dependent loans (as defined) in regulatory financial reports "should be based on the fair value of collateral, and not on the present value of expected future cash flows nor on the loan's observable market price."

- *Offsetting of Repurchase and Reverse Repurchase Agreements.* The OTS follows GAAP established in FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* (AC B10) (see the "Accounting Developments" section herein). The FDIC, OCC, and FRB generally prohibit netting for repurchase and reverse repurchase agreements, including those that fall within the scope of FASB Interpretation No. 41 (AC B10).

In August 1995, the agencies issued an interim final rule on regulatory accounting and capital treatment of mortgage servicing rights (FDIC FIL-56-95; *Federal Register* [August 1, 1995]). The interim rule permits both originated and purchased mortgage servicing rights to be included in (that is, not deducted from) Tier 1 capital subject to certain limitations.

Other Regulatory Matters

.35 *FDI Act Section 36—Reporting Requirements.*[2] Several regulatory releases in the past year relate to additional guidance on or amendments to the regulations carrying out FDI Act Section 36.

.36 The FDIC proposed additional guidance on annual reporting requirements that, in part, would make technical changes to required compliance attestation procedures. The FDIC also referred managements and auditors to the May 1994 addendum to the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) September 1992 report *Internal Control—Integrated Framework* (Product No. 990008) for reporting guidance on internal controls involving safeguarding of assets. Although the comment period has closed and no final rule has been issued, the FDIC said it would not object if a bank or savings institution chooses to follow the proposal when preparing required assertions and auditors' reports (FDIC FIL-19-95 and FIL-86-94; *Federal Register* [February 15, 1995]).

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[2] The audit and other reporting requirements created in FDI Act Section 36 (as added by FDICIA Section 112), and related implementing regulations contained in Title 12 of the Code of Federal Regulations (12 CFR) Part 363, were discussed in detail in the AICPA Audit Risk Alert *FDIC Improvement Act Implementation Issues* (Product No.022140) [AAM section 8190]. Those and related discussions in the AICPA's Audit Risk Alerts *Banks and Savings Institutions Industry Developments—1994* and *Banks and Savings Institutions Industry Developments—1993* have been incorporated into an appendix of the proposed AICPA Audit and Accounting Guide *Banks and Savings Institutions.* See the "Audit and Accounting Guide" section herein.

.37 Following are descriptions of recent actions that involve laws and regulations addressed in 12 CFR Part 363's required management compliance assertions and related attestation procedures.

- The FRB issued final changes to 12 CFR Part 215 (Regulation O) that, effective April 7, 1995, remove requirements that an institution's board of directors provide prior approval on loans made to executive officers that are secured by a first lien on the executive officer's residence (FDIC FIL-5-95; OTS TB 64-1; *Federal Register* [February 15, 1995]).
- The OCC issued OCC Bulletin 94-41, which interprets Title 12 of the United States Code (12 USC) 60(b) to allow OCC supervisory offices to grant prior approval for national banks' dividend requests subject to the law before the period in which dividends would be declared.

.38 FDI Act Section 39—Safety and Soundness Guidelines. The Riegle Community Development and Regulatory Improvement Act of 1994 (Public Law [P.L.] 103-325) included amendments to FDI Act Section 39 to allow regulators to carry out Section 39's provisions through the issuance of guidelines rather than more rigid regulations. The agencies issued final rules and guidelines carrying out Section 39 which, among other matters, include guidelines for internal controls and internal audit systems, as defined (*Federal Register* [July 10, 1995]).

.39 Specifically, the final rules state that the agencies believe their internal control requirements are consistent with the guidelines in COSO's report *Internal Control—Integrated Framework*. The agencies concluded, therefore, that using the COSO framework in developing and evaluating internal controls is one way an institution's management could meet the standards proposed by the agencies.

.40 The final rules also highlight that, although many institutions use data processing service organizations, the determination of whether an auditor needs to review those operations as they relate to internal controls should be made in accordance with general accepted auditing standards (GAAS).

.41 *Examiner-Auditor Relationship*. Auditors often are engaged to attest to the fairness of presentation of an institution's financial statements and to management assertions about an institution's financial reporting controls and compliance with laws and regulations. Regulators conduct periodic on-site examinations to address broader regulatory and supervisory issues. In September 1994, the Group of Thirty (an international financial policy organization) issued its report *Defining the Roles of Accountants, Bankers and Regulators in the United States*. In part, the report cites a need for closer cooperation, and elimination of unnecessary overlap, among managements, auditors, and examiners.

.42 The proposed AICPA Audit and Accounting Guide *Banks and Savings Institutions* explains that examiners and auditors share some objectives, and that coordination in consultation with the institution may be beneficial (see appendix). The Guide incorporates and supersedes AICPA Statement of Position (SOP) 90-5, *Inquiries of Representatives of Financial Institution Regulatory Agencies*, and related sections of the AICPA Audit and Accounting Guide *Audits of Savings Institutions*.

.43 The agencies' July 23, 1992 *Interagency Policy Statement on Coordination and Communication Between External Auditors and Examiners* (FDIC FIL-57-92) addresses information that institutions should provide to auditors of their financial statements (including requirements of FDI Act Section 36). The policy statement also provides guidance for participation by auditors at meetings between an institution's management and examiners.

.44 The policy statement encourages institutions to advise their auditors promptly of the dates and scope of supervisory examinations to simplify the auditor's planning and scheduling of work. The policy statement also encourages institutions to give their auditors a report of any actions initiated or undertaken by a federal banking agency since the beginning of the period covered by the audit, or of any similar action taken by an appropriate state bank supervisor. The policy statement encourages auditors to attend examination exit conferences upon completion of field work or other meetings between supervisory examiners and an institution's management or board of directors at which examination findings are discussed that are relevant to the scope of the audit. In addition, the auditor may request a meeting with any or all of the appropriate agencies involved in the supervision of the institution or its holding company during or after completion of examinations to ask about supervisory matters relevant to the institution whose financial statements they are auditing.

.45 *Frequency and Nature of Examinations.* In January 1995, the OCC amended its requirements for the frequency of on-site safety and soundness examinations effective September 23, 1994, as required by Section 306 of the Riegle Community Development and Regulatory Improvement Act of 1994 (OCC Bulletin 95-4). Under the revised requirements, every national bank must undergo a full-scope, on-site regulatory examination not less than once every twelve months; however, the OCC may extend some periods to eighteen months if certain criteria are met. In July 1994, the OCC issued guidance on *Community Bank Examination Procedures for Noncomplex Banks.* The guidance defined certain banks as noncomplex and set minimum scope requirements for on-site regulatory activity for such banks. Auditors should be alert to the effect changes in the frequency and nature of exams may have on their coordination with examiners.

.46 *Deposit Insurance Premiums.* Section 7(b) of the FDI Act, as amended by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the FDICIA, requires the FDIC to maintain the BIF and the SAIF at minimum reserve ratios of insurance funds to insured deposits of 1.25 percent. To achieve these ratios, the FDIC increased premiums to an average of 23.2 cents per $100 of insured deposits. Section 7(b) also allows the FDIC's Board of Directors to increase either fund's reserve ratio beyond 1.25 percent of estimated insured deposits if there is a significant risk of substantial future losses to the fund.

.47 On August 8, 1995, the Board voted to reduce BIF premiums to an average 4.4 cents per $100 of insured deposits once the BIF reached the 1.25 percent reserve ratio. On September 5, 1995, the FDIC confirmed that the BIF passed the 1.25 percent reserve ratio by May 31, 1995 (FDIC News Release PR-54-95). The FDIC announced it would refund BIF-member institutions the difference between payments under the new and old premium rates since June 1, 1995. The FDIC paid institutions the refund and related interest on September 15, 1995 (FDIC FIL-58-95). Auditors should be alert to the effect of this action on audit risk associated with recognition and measurement of premiums in an institution's financial statements.

.48 The SAIF reserve ratio is well below 1.25 percent, in part because some premiums received are used to pay interest on Financing Corporation (FICO) bonds. (The proceeds from FICO bonds funded past closings of failed institutions.) On August 8, 1995, the FDIC's Board of Directors voted to keep SAIF premiums at existing rates. (See "Legislative Matters" in the "Legislative and Regulatory Developments" section herein.) Auditors should be alert to the effect on audit risk of disclosures about the potential for a special SAIF assessment and accounting for such an assessment if enacted.

.49 *Derivatives Activities.* In June 1995, the OCC released a report on best practices used by the most active multinational banks that sell derivative financial instruments. In October 1994, the OCC issued guidance to national bank examiners for evaluating the adequacy of risk management practices that national banks use in derivatives activities. The document entitled *Risk Management of Financial Derivatives* was incorporated into the OCC's *Comptroller's Handbook.* FRB Supervisory Release (SR) 95-17 discusses risk management and internal controls for securities and derivatives used in nontrading activities. The FRB's "Trading Activities Manual" includes guidance for examiners on capital markets and trading activities. Auditors may find these documents helpful in understanding risks associated with derivatives.

.50 *Quasi-Reorganizations.* The OCC revised requirements for banks applying for permission to complete quasi-reorganizations, including accounting treatment of quasi-reorganizations in regulatory financial reports (OCC Bulletin 95-27).

.51 *Loan Losses.* The FDIC and FRB issued guidance to examiners on applying FASB Statement No. 114 (AC I08) in Transmittal No. 95-051 and SR 95-38, respectively.

.52 *Loan Losses at U.S. Branches and Agencies of Foreign Banks.* In January 1995, the FRB announced elimination of its requirement that uninsured United States branches and agencies of foreign banks establish and maintain loan loss allowances separate from those of the foreign banks. The FRB emphasized its continuing policy requiring uninsured United States branches and agencies of foreign banks to establish and maintain procedures for identifying loan losses. The OCC clarified that the FRB's decision does not alter the OCC's requirement that each branch or agency maintain loan loss allowances as required by the OCC's February 1992 Banking Circular 201 and July 1993 Agency Circular No. 1 (OCC Bulletin 95-15).

.53 *Shared National Credits.* The agencies have an interagency Shared National Credit Program for review and risk assessment of the largest and most complex credits shared by multiple financial institutions. OCC Bulletin 95-9's description and guidelines for the Shared National Credit Program may provide helpful information to auditors of the financial statements of institutions that share credit risk of loans or loan commitments that aggregate $20 million.

.54 *OTS Audit Requirements.* The OTS amended its annual financial-statement audit requirement for savings institutions, eliminating the mandatory annual financial-statement audit requirement for institutions having less than $500 million in assets and CAMEL ratings of one or two. Under the final rule, the OTS may require an independent audit of financial statements or performance of agreed-upon procedures for safety and soundness reasons, including requiring reports for institutions that have received CAMEL ratings of 3, 4, or 5 or savings and loan holding companies that control savings association subsidiaries with aggregate consolidated assets of $500 million or more (OTS RB 32-1; *Federal Register* [November 23, 1994]).

.55 *Stock Transfer Agent Reports.* In February 1995, the AICPA's Auditing Standards Board (ASB) requested that the Securities and Exchange Commission (SEC) staff adopt a "no action" position for reports on a transfer agent's internal control structure; specifically, that reports based on AICPA Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AT section 400), be considered in compliance with Rule 17Ad-13 of the Securities Exchange Act of 1934. (Such reports were previously prepared under SAS No. 30, *Reporting on Internal Accounting Control,* before SSAE No. 2 (AT section 400) superseded it.)

.56 In April 1995, an SEC staff letter to the AICPA stated that the SEC will take no action if reports on the internal control structure of transfer agents are prepared in accordance with SSAE No. 2 (AT section 400). Following is an illustrative transfer agent report developed by the ASB and to which the SEC staff would not object.

Independent Accountant's Report

Board of Directors
Example Bank:

We have examined management's assertion that "Example Bank maintained an effective internal control structure, including the appropriate segregation of responsibilities and duties, over the transfer agent and registrar functions, as of October 31, 19X5, and that no material inadequacies as defined by Rule 17Ad-13(a)(3) of the Securities Exchange Act of 1934 existed at such date." [3]

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included a study and evaluation of the internal control structure over the transfer agent and registrar functions, using the objectives set forth in Rule 17Ad-13(a)(3) of the Securities Exchange Act of 1934. Those objectives are to provide reasonable, but not absolute, assurance that securities and funds are safeguarded against loss from unauthorized use or disposition and that transfer agent activities are performed promptly and accurately. We believe that our examination provides a reasonable basis for our opinion.

[3] Management's assertion should be appropriately segregated by quotation marks using the language noted, which is also included in management's representation letter to the practitioner.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over the transfer agent and registrar functions to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that, as of October 31, 19X5, Example Bank maintained an effective internal control structure, including the appropriate segregation of responsibilities and duties, over the transfer agent and registrar functions, and that no material inadequacies existed as defined by Rule 17Ad-13(a)(3) of the Securities Exchange Act of 1934, is fairly stated, in all material respects, based on the criteria established by Rule 17Ad-13(a)(3) of the Securities Exchange Act of 1934.

This report is intended solely for the information and use of the board of directors and management of Example Bank and for the Securities and Exchange Commission and should not be used for any other purpose.

December 15, 19X5

.57 *HUD Annual Lender Recertification Requirements.* Bank and savings institution subsidiaries and affiliates that are mortgagees under certain mortgage insurance programs administered by the United States Department of Housing and Urban Development (HUD) should be aware of certain requirements for annual audits of financial statements. HUD Mortgagee Letter 95-6 provides additional information.

.58 *Lender Reports.* In 1992, Congress amended the Higher Education Act of 1965 (HEA) to require compliance engagements for lenders who participate in Federal Family Education Loan (FFEL) programs. Many banks and savings institutions are subject to the requirements because they participate as lenders in these FFEL programs, which include the Federal Stafford Loan Program (formerly the Guaranteed Student Loan Program), the Federal Supplemental Loans for Students Program, the Federal PLUS Program, and the Federal Consolidation Loan Program.

.59 In late 1992, the United States Department of Education (ED) issued implementing regulations, specifying that they would define procedures for conducting the engagements in a guide the ED's Office of the Inspector General (OIG) would develop. The regulations made the reporting requirement effective for fiscal years beginning after July 23, 1992. The OIG issued the Guide, *Compliance Audits (Attestation Engagements) of Federal Family Education Loan Program at Participating Lenders,* in March 1995.

.60 The Guide generally requires an examination of management assertions about compliance with certain requirements for preparation of the *Lender's Interest and Special Request and Reports* (ED Form 799), performed, in part, in accordance with SSAE No. 3, *Compliance Attestation* (AT section 500). The HEA also requires that the engagements be performed in accordance with the United States General Accounting Office's (GAO's) *Government Auditing Standards,* which include general standards for an external quality control review and for continuing education requirements.

.61 In a September 14, 1995, letter, the ED extended the due date for reports from lenders with portfolios equal to or less than $5 million (as defined) until June 30, 1996.

.62 Auditors may wish to discuss the reporting requirements with clients.

.63 *Lender/Guaranty Agency Servicer Reports.* Institutions participating as third-party servicers for *lender or guaranty agencies* in the ED's Title IV programs under the HEA are required by 12 CFR Subpart 682.416(e) to have independent audits of their administration of the participation in the FFEL programs (*Federal Register* [April 29, 1994]).

.64 Further, 34 CFR Subpart 668.23(c)(1)(ii) requires institutions participating as third-party servicers for *educational institutions* in the Title IV programs (for example, Federal Perkins Loan) to have independent audits (that meet the compliance audit standards for educational institutions) of the servicer's administration of the participation in the Title IV programs (*Federal Register* [November 29, 1994]).

.65 Implementing regulations state that procedures for conducting the audits are available in a guide developed by the ED's OIG. The OIG is drafting—but has not yet issued—such a guide. Accordingly, the OIG has delayed the due dates for required reports until after they issue a guide. The regulations specify effective dates for the audits covering the first full fiscal year (for lender and guaranty agency servicers) or award year (for education institution servicers) beginning on or after July 1, 1994. The regulations specify that the audits must be conducted in accordance with the GAO's *Government Auditing Standards*. The regulations exempt third-party servicers that contract with only one lender or guaranty agency (or educational institution) from the audit requirement if the lender or guaranty agency (or educational institution) has had an audit covering the servicer's administration.

.66 Auditors may wish to discuss the reporting requirements with clients.

.67 *"Exceptional Performance Standards" Reports*. Beginning July 1, 1995, the HEA allows institutions participating as lenders or lender servicers in FFEL programs voluntarily to seek "exceptional performance" status based on their performance collecting delinquent and defaulted FFEL program loans. "Exceptional performance" designation by the Secretary of Education makes a lender or lender servicer eligible to be reimbursed 100 percent for insurance claims submitted for twelve months from the date the ED notifies them of the designation. 34 CFR Subpart 682.415(a)(2) establishes qualifications for exceptional performance status, including a required report on a compliance audit of the lender's or lender servicer's loan portfolio that reports a compliance performance percentage of 97 percent or higher (as defined). The ED's OIG is preparing a guide that would specify procedures to be performed and reported on in accordance with SSAE No. 3 (AT section 500) and the GAO's *Government Auditing Standards*. The guide would also include procedures for sampling and calculating the performance compliance percentage.

.68 Auditors may wish to discuss the reporting requirements with clients.

SEC Actions

.69 During the year, the SEC staff has expressed its views on accounting for various transactions in public speeches and comments on registrants' filings (see the "Information Sources" section herein). Auditors should be alert to the audit risk associated with related matters, which include the following:

- Identifying and using the predominant risk characteristics of underlying loans to stratify mortgage servicing rights for purposes of applying the impairment provisions of FASB Statement No. 122, *Accounting for Mortgage Servicing Rights* (AC Mo4).
- Accounting for financial instruments as "hedges" of mortgage servicing rights
- Accounting for swaps that are leveraged, swaps designated to equity instruments, swaps not designated, swaps designed to front-load income, and swaps held for speculative purposes
- Improper classification of liabilities for credit losses on off-balance-sheet financial instruments
- Sale or transfer of a held-to-maturity security due to a change in circumstances other than a change in circumstances identified in paragraph 8 of FASB Statement No. 115 (AC I80.105) and, therefore, considered inconsistent with the security's original classification

GAO Reports

.70 The following GAO reports issued in the past year may give auditors helpful information about current industry issues:

1. *Depository Institutions: Divergent Loan Loss Methods Undermine Usefulness of Financial Reports* (October 1994: GAO/AIMD-95-8)

2. *Deposit Insurance Funds: Analysis of Insurance Premium Disparity Between Banks and Thrifts* (March 1995: GAO/AIMD-95-84)

Audit and Accounting Guide

.71 In early 1996, the AICPA will issue an AICPA Audit and Accounting Guide *Banks and Savings Institutions.* The Guide supersedes the AICPA Industry Audit Guide *Audits of Banks* and the AICPA Audit and Accounting Guide *Audits of Savings Institutions.* The Guide discusses those aspects of accounting and auditing unique to banks and savings institutions and was developed to help preparers and auditors of financial statements of banks and savings institutions. The Guide incorporates new accounting and financial reporting requirements issued by the FASB and the AICPA's Accounting Standards Executive Committee (AcSEC), and new auditing standards issued by the ASB, since issuance of the guides that would be superseded.

.72 The Guide establishes new requirements for disclosures about regulatory matters effective for financial statements issued for fiscal years ending after June 15, 1996, and for interim financial statements issued after initial application. The auditing provisions of the Guide will be required to be applied prospectively to audits of financial statements for fiscal years ending after June 15, 1996.

Audit Issues and Developments

Asset Quality and Valuation Issues

.73 Auditors of the financial statements of banks and savings institutions should give special attention to credit quality and other asset quality issues surrounding commercial and consumer loans, real estate portfolios, troubled debt restructurings, foreclosed assets and other real estate owned, off-balance-sheet financial instruments, and other assets. Auditors should obtain sufficient competent evidence to evaluate the adequacy of management's loan loss allowance and liabilities for other credit exposures. The subjectivity of determining such amounts, combined with the issues discussed in the "Industry and Economic Developments" section herein, reinforces the need for careful planning and execution of audit procedures in this area, as well as evaluation of results of those procedures.

.74 Lack of an effective system to evaluate credit exposure and other sources of impairment or failure of an institution to document adequately its criteria and methods for determining loan loss allowances may suggest a reportable condition or a material weakness in the institution's internal control structure over financial reporting. These deficiencies would generally (1) increase the judgment auditors and regulatory examiners must apply in evaluating the adequacy of management's related allowances and liabilities, and (2) increase the likelihood that differences in judgments will result. The guidance in SAS No. 57, *Auditing Accounting Estimates* (AU section 342), is useful when considering this area. The AICPA Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks* (Product No. 021050) is another source of information on auditing estimated credit losses. (See "Risk and Uncertainties" in the "Accounting Standards Executive Committee Activities" subsection herein.)

.75 Auditors should also be alert to valuation issues related to classification and impairment of securities. Paragraph 16 of FASB Statement No. 115 (AC I80.115) requires that, for individual securities classified as either available-for-sale or held-to-maturity (as defined), an institution should determine whether a decline in fair value below the amortized cost basis is other than temporary.

.76 Paragraph 69 of FASB Statement No. 115 (AC I80) says "if the sale of a held-to-maturity security occurs without justification, the materiality of that contradiction of the enterprise's previously asserted intent must be evaluated." The SEC staff is interpreting paragraph 69 of FASB Statement No. 115 (AC I80) to mean that if held-to-maturity securities are transferred or sold due to changes in circumstances other than those listed in paragraph 8 of FASB Statement No. 115 (AC I80.105), the SEC staff will challenge management's (1) assertions about the classification of other held-to-maturity securities and (2) future assertions regarding the classification of securities purchased subsequently for an extended period of time, no less than one year.

.77 Other factors that may affect audit risk include the entity's exposure to interest-rate, liquidity, prepayment, and other risks. For example, institutions heavily invested in fixed-rate assets (or variable-rate assets subject to caps on interest-rate increases) may face narrower spreads in a rising-rate environment. Auditors also should be alert to the effects interest-rate increases could have on borrowers' ability to repay loans and the effects interest-rate decreases could have on the realization of assets that are sensitive to prepayments (such as mortgage servicing rights and interest-only securities). Institutions with large volumes of money market or other short-term deposit liabilities are subject to greater liquidity risk because those liabilities must be refinanced.

Noncompliance With Capital Adequacy and Other Regulatory Requirements

.78 Events of noncompliance with regulatory requirements, such as failure to meet minimum capital requirements or participation in impermissible activities or investments, expose banks and savings institutions to regulatory action. Events of noncompliance may be brought to the auditor's attention during the application of normal auditing procedures, during the review of regulatory examination reports, or because of actions required by regulators.

.79 SAS No. 59 (AU section 341) states that "the auditor has a responsibility to evaluate whether there is substantial doubt 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 audited." Noncompliance with regulatory capital requirements is a condition, when considered with other factors, that could indicate substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. SAS No. 59 (AU section 341) identifies examples of other factors that the auditor may evaluate.

Investments in Derivatives

.80 Recent years have seen a growing use of innovative financial instruments, commonly referred to as derivatives, that often are very complex and can involve a substantial risk of loss. As interest rates, commodity prices, and many other market rates and indices from which certain financial instruments (derivatives) derive their value have been volatile over the past several months, several entities have incurred significant losses because of their use. Banks and savings institutions sometimes use derivatives as risk management tools or as speculative investment vehicles. The use of derivatives often increases audit risk. Although financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditor's approach to achieving related audit objectives may differ because the notional and contractual amounts of certain derivatives—such as futures, forwards, swaps, options, and other contracts with similar characteristics—are not generally recognized in the financial statements. Auditors should understand both the economics of derivatives used by an institution and the nature and business purpose of the institution's derivatives activities. In addition, auditors should evaluate accounting for any such instruments, especially those reported at amounts other than fair value. To the extent the derivatives qualify as financial instruments as defined in FASB Statements No. 105 (AC F25), No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), the disclosure requirements set forth in those statements must be met. When derivatives are accounted for as hedges of on-balance-sheet assets or liabilities or of anticipated transactions, auditors should carefully review the appropriateness of the use of hedge accounting, particularly considering whether the criteria set forth in applicable authoritative accounting literature are met.

.81 Audit risk considerations presented by the use of derivatives are discussed in *Audit Risk Alert—1995/96*. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations. (See "Disclosures About Derivatives" in the "Accounting Developments" section herein.)

.82 An advisory council to COSO has been preparing a guide on applying COSO's *Internal Control—Integrated Framework* to derivatives activities. COSO plans to issue a final guide in 1996.

Electronic Funds Transfer Association Engagements

.83 Some electronic funds transfer (EFT) associations or networks require their members who process transactions to complete a "compliance review." For example, institutions with automated teller machines that use one or more EFT associations or networks may be required to provide related auditor reports.

.84 Some EFT association requirements intend for auditors to (1) complete a questionnaire about an institution's compliance with the EFT association's operating rules and procedures related to internal controls over security and (2) sign a "certification" statement that the institution is in compliance with such operating rules and procedures.

.85 SSAE No. 3 (AT section 500) governs engagements of this nature. Auditors who are asked to perform such engagements should determine whether the actions that are required conflict with SSAE No. 3 (AT section 500). For example, "certification" statements may extend an auditor's responsibility significantly beyond the limits of professional standards. Sometimes, the statements prescribed by the EFT association refer to GAAS or other professional standards that do not apply to such services. Such statements also may refer to the auditor's review of compliance; however, SSAE No. 3 (AT section 500) prohibits review services related to compliance, permitting only examination (assuming certain conditions exist) or agreed-upon-procedures engagements. Furthermore, compliance questionnaires often ask for responses to questions about compliance without providing sufficiently objective criteria for determining when compliance does or does not exist.

Mortgage Banking Engagements

.86 In May 1995, the Mortgage Bankers Association of America (MBA) released its revised *Uniform Single Attestation Program for Mortgage Bankers* (USAP). The USAP supersedes MBA's existing program (published in 1983) with an opinion-level attestation engagement performed following SSAE No. 3 (AT section 500). Specifically, MBA redefined the engagement to address mortgage servicing companies' compliance with the USAP's specified minimum servicing standards. The USAP will be effective for fiscal years ending on or after December 15, 1995, and later, with earlier application encouraged.

.87 In a September 1995 letter to its members, the MBA said that commercial and multifamily loan servicers could report using the USAP, except that minimum standards V.4 and VI.1 could be omitted from management's assertion and the auditor's attestation reports. In the letter, the MBA described a project under way to consider amending or expanding the USAP to explicitly address reporting by commercial and multifamily loan servicers.

.88 The USAP addresses reporting on management assertions about an entity's compliance with specified criteria. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), provides guidance on factors auditors should consider when auditing the financial statements of entities that use service organizations (such as mortgage bankers that service mortgages for others). Information about the control structure policies and procedures at mortgage bankers or other loan servicing organizations may affect assertions in the user entity's financial statements. Also, some service auditors' reports prepared according to SAS No. 70 (AU section 324) include descriptions and results of tests of operating effectiveness of specified control policies and procedures. Accordingly, those SAS No. 70 (AU section 324) reports may enable an auditor of the financial statements of a user entity to assess control risk below the maximum of relevant financial statement assertions. Readers should consult SAS No. 70 (AU section 324) for additional information on how to use a service auditor's report when auditing the financial statements of a user organization.

.89 The Federal Home Loan Mortgage Corporation (Freddie Mac) sent a September 29, 1995 letter to chief financial officers of its seller/servicers announcing that, effective immediately, Freddie Mac no longer requires an independent accountant's agreed-upon-procedures attestation report on compliance with requirements of Freddie

Mac's programs. The report previously was required by Freddie Mac's 1993 *Compliance Reporting Guide*. Readers should be alert to a Freddie Mac bulletin that will be issued explaining the change and clarifying Freddie Mac's other independent audit requirements.

SAS No. 70 Auditing Procedure Study

.90 A task force of the ASB has drafted an auditing procedure study that provides guidance to auditors on implementing SAS No. 70 (AU section 324). The study provides guidance to a service auditor engaged to issue a report on the control structure policies and procedures of a service organization. It also provides guidance to user auditors engaged to audit the financial statements of an entity that uses a service organization. An example of a service organization is a bank trust department that invests and holds assets for employee benefit plans. The task force expects to issue the study in early 1996.

Agreed-Upon Procedures Engagements

.91 In September 1995, the AICPA issued SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622), which will supersede SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*. The AICPA also issued SSAE No. 4, *Agreed-Upon Procedures Engagements* (AT section 600), which would, among other things, amend reports on agreed-upon procedures performed in accordance with SSAE No. 3 (AT section 500). SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) are effective for reports dated after April 30, 1996, with earlier application encouraged.

.92 Among other significant provisions, SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600)—

- Prohibit negative assurance about whether management's assertion is fairly stated from being included in reports on agreed-upon procedures.
- Clarify that SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AU section 322), does not apply to agreed-upon procedures engagements.
- State that the concept of materiality does not apply to agreed-upon procedures engagements unless the definition of materiality is agreed to by the specified users.

SSAE No. 4 (AT section 600) also requires a written management assertion as a condition of engagement performance.

.93 The appendix to the exposure draft of the AICPA Audit and Accounting Guide *Banks and Savings Institutions* entitled "Suggested Guidelines for CPAs Participating in Bank Directors' Examinations" will be omitted from the final guide. The AICPA Banking and Savings Institutions Committee is studying the need for changes in related guidance due to changes in legal requirements and professional standards. Auditors should consult SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) for engagements that fall within their scopes. For agreed-upon procedures engagements related to management assertions about the entity's compliance or the entity's internal control structure over financial reporting, the auditor should consult SSAE No. 3 (AT section 500) (as amended) and SSAE No. 2 (AT section 400), respectively.

.94 Examples of other engagements affected by SAS No. 75 (AU section 622) or SSAE No. 4 (AT section 600) include those to report on agreed-upon procedures relating to management assertions about:

- Collateral for Federal Home Loan Bank advances
- Compliance with EFT association requirements
- Compliance with FFEL program requirements (see the "Other Regulatory Matters" section herein)

- Compliance with safety and soundness laws and regulations designated in 12 CFR Part 363 (see the "Other Regulatory Matters" section herein)
- Compliance with bond-selling-group agreements
- Officers' expenses
- Trust activities

Auditors should be alert to the effects of SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) on these and similar engagements.

Elimination of Uncertainty Reporting

.95 In July 1995, the ASB issued an exposure draft of a proposed Statement on Auditing Standards, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that the auditor add an uncertainties explanatory paragraph to the auditor's report, if certain criteria are met.

.96 The proposed amendment would also expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AU section 508.37), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The proposed amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

.97 The proposal does not affect the provisions of SAS No. 59 (AU section 341), which requires that the auditor add an explanatory paragraph to the auditor's report when there is substantial doubt about the entity's ability to continue as a going concern. The ASB hopes to finalize this SAS in late 1995 and to issue an SAS that would be effective for reports issued on or after June 30, 1996.

.98 Comments on the proposed SAS were due October 20, 1995.

Accounting Developments

Mortgage Servicing Rights

.99 FASB Statement No. 122 (AC Mo4) amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (AC Mo4), to require that a mortgage banking enterprise recognize as separate assets rights to service mortgage loans for others, however those servicing rights are acquired. A mortgage banking enterprise that acquires mortgage servicing rights through either the purchase or origination of mortgage loans and sells or securitizes those loans with servicing rights retained is required by the Statement (AC Mo4) to allocate the total cost of the mortgage loans to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on their relative fair values if it is practicable to estimate those fair values. If it is not practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights), the Statement (AC Mo4) requires that the entire cost of purchasing or originating the loans should be allocated to the mortgage loans (without the mortgage servicing rights) and no cost should be allocated to the mortgage servicing rights.

.100 FASB Statement No. 122 (AC Mo4) requires that a mortgage banking enterprise assess its capitalized mortgage servicing rights for impairment based on the fair value of those rights. The Statement (AC Mo4) requires that a mortgage banking enterprise should stratify its mortgage servicing rights that are capitalized after the adoption of the Statement (AC Mo4) based on one or more of the predominant risk characteristics of the underlying loans. The Statement (AC Mo4) requires that impairment should be recognized through a valuation allowance for each impaired stratum.

.101 FASB Statement No. 122 (AC Mo4) applies prospectively in fiscal years beginning after December 15, 1995, to transactions in which a mortgage banking enterprise sells or securitizes mortgage loans with servicing rights retained and to impairment evaluations of all amounts capitalized as mortgage servicing rights, including those purchased before adoption, with earlier application encouraged. The Statement (AC Mo4) prohibits retroactive capitalization of mortgage servicing rights retained in transactions in which a mortgage banking enterprise originates mortgage loans and sells or securitizes those loans before the adoption.

.102 In July 1995, the FASB staff announced that the Board agreed to clarify the transition provisions of FASB Statement No. 122 (AC Mo4), noting in FASB's Action Alert No. 95-21 that:

> . . . earlier application is encouraged as of the beginning of a fiscal year for which annual financial statements or annual financial information has not been issued or as of the beginning of an interim period within that fiscal year for which interim financial statements or interim financial information has not been issued. For example, Public Company X issued financial information for the first quarter. In the second quarter, management of Public Company X has two choices for early adoption: (1) adopt as of the beginning of the fiscal year because annual financial statements or annual financial information has not been issued for that fiscal year or (2) adopt as of the beginning of the second quarter because interim financial statements or interim financial information has not been issued for that quarter.

Impairment of Long-Lived Assets

.103 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). FASB Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the institution estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties.)

.104 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.105 Paragraph 16 of FASB Statement No. 121 (AC I08.135) requires that assets to be disposed of that are within the scope of FASB Statement No. 121 (AC I08) should "not be depreciated (amortized) while they are held for disposal."

.106 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle. (See "Foreclosed Assets" in the "Accounting Developments" section herein.)

.107 Auditors of the financial statements of banks and savings institutions should consider management's policies and procedures for determining whether all impaired assets have been properly identified. Auditors should evaluate management's estimates of future cash flows from asset use and impairment losses following the guidance of SAS No. 57 (AU section 342).

Disclosures About Derivatives

.108 In October 1994, the FASB issued Statement No. 119 (AC F25), which requires disclosures about derivatives financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 (AC F25) and No. 107 (AC F25).

.109 The Statement (AC F25) requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 (AC F25.115P) encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

.110 FASB Statement No. 119 (AC F25) was effective for financial statements issued for fiscal years ending after December 15, 1994, except for institutions with less than $150 million in total assets. For those institutions, the Statement (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1995.

.111 The FASB Special Report, *Illustrations of Financial Instrument Disclosures*, contains illustrations of the application of FASB Statements No. 105 (AC F25), No. 107 (AC F25), and No. 119 (AC F25), including specific illustrations of application by a domestic and an international financial institution.

Income Recognition on Impaired Loans

.112 In October 1994, the FASB issued Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (AC I08), which amends FASB Statement No. 114 (AC I08) to allow creditors to use existing methods for recognizing interest income on impaired loans. To accomplish that, it eliminates the provisions in FASB Statement No. 114 (AC I08) that describe how creditors should report income on impaired loans.

.113 FASB Statement No. 118 (AC I08) does not change the provisions in FASB Statement No. 114 (AC I08) that require creditors to measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral-dependent.

.114 FASB Statement No. 118 (AC I08) also amends the disclosure requirements in FASB Statement No. 114 (AC I08) to require disclosure of information about the recorded investment in certain impaired loans and about how creditors recognize interest income related to those loans.

.115 FASB Statement No. 118 (AC I08) is effective concurrent with the effective date of FASB Statement No. 114 (AC I08), that is, for financial statements for fiscal years beginning after December 15, 1994.

Impairment of a Loan

.116 In May 1993, FASB Statement No. 114 (AC I08) was issued to address the accounting by creditors for impairment of certain loans. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Statement (AC I08) is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller balance homogeneous loans that are collectively valued for impairment (for example, credit-card, residential mortgage, and consumer installment loans), loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115 (AC I80). It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms, including groups of smaller balance homogeneous loans that may otherwise have been excluded from the scope of the Statement (AC I80).

.117 FASB Statement No. 114 (AC I08) requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent. The impairment is recognized by creating or adjusting a valuation allowance for the impaired loan with a corresponding charge to bad debt expense.

.118 The Statement (AC I08) amends FASB Statement No. 5, *Accounting for Contingencies* (AC C59), to clarify that a creditor should evaluate the collectibility of both the contractual interest and contractual principal of all receivables in assessing the need for a loss accrual. The Statement (AC I08) also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (AC D22), to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

.119 The Statement (AC I08) applies to financial statements for fiscal years beginning after December 15, 1994.

Offsetting

.120 Accounting Principles Board (APB) Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7 (AC B10.101-103), says that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), defines *right of setoff* and specifies what conditions must be met to permit offsetting. FASB Interpretation No. 41 (AC B10) modifies FASB Interpretation No. 39 (AC B10) to permit offsetting in the statement of financial position of payables and receivables that represent repurchase agreements and reverse repurchase agreements and that meet all of the conditions specified therein. FASB Interpretation No. 41 (AC B10) was effective for financial statements issued for periods ending after December 15, 1994.

Discussions of the FASB's EITF

.121 The EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to banks and savings institutions. A description of issues discussed during the year follows; readers should consult detailed minutes for additional information.

- EITF Issue No. 95-11, *Accounting for Derivative Instruments Containing Both a Written Option-Based Component and a Forward-Based Component*, addresses accounting for certain derivative instruments.
- EITF Issue No. 95-5, *Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights*, addresses certain issues related to sales of mortgage loan servicing rights.

- EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination,* addresses what types of direct, integration, or exit costs to accrue as liabilities in a purchase business combination and when to recognize those costs.

- EITF Issue No. 95-2, *Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party,* addresses what constitutes a significant economic penalty to a consolidated entity under EITF Issue No. 91-1, *Hedging Intercompany Foreign Currency Risks.*

- EITF Issue No. 94-9, *Determining a Normal Servicing Fee Rate for the Sale of an SBA Loan,* discusses how, when applying EITF Issue No. 88-11, *Allocation of Recorded Investment When a Loan or Part of a Loan is Sold,* an enterprise should determine a normal servicing fee rate for United States Small Business Administration (SBA) loans without a major secondary market maker. A secondary issue is how to account for a change in the normal servicing fee rate.

- EITF Issue No. 94-7, *Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock,* addresses financial instruments that may be settled with a specified number of shares of an entity's stock or with a cash amount calculated on the basis of the value of a specified number of shares of an entity's stock. Issues include (1) whether the instrument should be classified as an asset or an equity instrument and (2) how gains and losses are reported.

- EITF Issue No. 94-5, *Determination of What Constitutes All Risks and Rewards and No Significant Unresolved Contingencies in a Sale of Mortgage Loan Servicing Rights under Issue No. 89-5,* involves accounting for transfers of mortgage-servicing rights.

.122 Appendix D to the *EITF Abstracts* contains EITF discussions of technical matters that have long-term relevance and do not relate specifically to a numbered EITF Issue. Readers should be alert to the following topics of recent discussion:

- Appendix D-46, *Accounting for Limited Partnership Investments,* contains an announcement by the SEC staff concerning the application of the equity method to investments in limited partnerships.

- Appendix D-45 contains FASB staff views on *Implementation of FASB Statement No. 121 for Assets to Be Disposed Of.*

- Appendix D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value,* contains a FASB staff announcement concerning implementation of FASB Statement No. 115 (AC I80).

- Appendix D-43 contains FASB staff views on *Assurance That a Right of Setoff Is Enforceable in a Bankruptcy under FASB Interpretation No. 39.*

.123 Readers should consult the minutes for the following issues to understand the effect of issuance of FASB Statement No. 122 (AC Mo4) on related consensuses.

- EITF Issue No. 88-11, *Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold*

- EITF Issue No. 86-39, *Gains from the Sale of Mortgage Loans with Servicing Rights Retained*

- EITF Issue No. 86-38, *Implications of Mortgage Prepayments on Amortization of Servicing Rights*

.124 Readers should consult the minutes for the following issues to understand the effect of issuance of FASB Statement No. 121 (AC I08) on related consensuses.

- EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*

- EITF Issue No. 90-16, *Accounting for Discontinued Operations Subsequently Retained*

- EITF Issue No. 90-6, *Accounting for Certain Events Not Addressed in Issue No. 87-11 Relating to an Acquired Operating Unit to Be Sold*
- EITF Issue No. 87-11, *Allocation of Purchase Price to Assets to Be Sold*
- EITF Issue No. 84-28, *Impairment of Long-Lived Assets*

.125 The issuance of FASB Statement No. 119 (AC F25) nullified the disclosure requirements in EITF Issue No. 91-4, *Hedging Foreign Currency Risks with Complex Options and Similar Transactions.*

Risks and Uncertainties

.126 In December 1994, the AcSEC issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires institutions to include in their financial statements disclosures about (1) the nature of operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires institutions to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.127 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Besides valuation allowances for commercial and real estate loans, examples of similar estimates often included in bank and savings institutions financial statements include:

- Impairment of long-lived assets, for example, assets related to marginal branches
- Estimates involving assumed prepayments, for example, discounts or premiums on financial assets (such as securities or loans), mortgage servicing rights and excess servicing receivables, and mortgage-related derivatives
- Lives of goodwill and identifiable intangible assets (for example, depositor or borrower relationships)

Examples of bank or savings institution concentrations that may be subject to disclosure if they meet the criteria of paragraph 21 of SOP 94-6 include:

- Sale of a substantial portion of or all receivables or loan products to a single customer
- Loss of approved status as a seller to or servicer for a third party
- Cancellation of a third-party guarantee program
- Concentration of revenue from mortgage banking activities

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending subsequent to December 15, 1995, and for financial statements for interim periods in fiscal years after the year for which SOP 94-6 is first applied. Early application is encouraged but not required.

.128 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

Foreclosed Assets

.129 Certain provisions of SOP 92-3, *Accounting for Foreclosed Assets,* are inconsistent with provisions of FASB Statement No. 121 (AC I08). AcSEC is considering actions that it should take on SOP 92-3; however, FASB Statement No. 121 (AC I08) takes precedence for transactions within its scope.

[The next page is 8159-3.]

SEC Staff Accounting Bulletin

.130 SEC Staff Accounting Bulletin No. 94, *Recognition of a Gain or Loss on Early Extinguishment of Debt,* expresses SEC staff views about the period in which a gain or loss is recognized on the early extinguishment of debt.

Information Sources

.131 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.132 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.133 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.134 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.135 All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed for data lines.

* * * *

.136 This Audit Risk Alert supersedes *Banks and Savings Institutions Industry Developments—1994.*

* * * *

.137 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext 444)
Federal Home Loan Mortgage Corporation (Freddie Mac)	*Customer Service* 8200 Jones Branch Drive McLean, VA 22102-3107 (800) FREDDIE			
Federal Deposit Insurance Corporation	*Corporate Communications* 550 17th Street, NW Washington, DC 20429-0001 (202) 898-6996	*Facsimile Bulletin Board System* (804) 642-0003	*Electronic Bulletin Board System* Instructions are available through the FDIC's Facsimile Bulletin Board System. (804) 642-2737(d)	*Action Update* (202) 898-7210
Federal Reserve System	*Publications Services* 20th and C Streets, NW Washington, DC 20551-0001 (202) 452-3245	*U.S. Department of Commerce STAT-USA/FAX* Some information is available to guest users. Other information requires a subscription fee. (202) 482-0005	*U.S. Department of Commerce's Economic Bulletin Board* Some information is available to guest users. Other information requires a subscription fee HelpLine: (202) 482-1986 (202) 482-3870 (d-300/1200/2400 bps) (202) 482-2584 (d-9600 bps) (202) 482-2167 (d-14.4 kbps) Telnet access via Internet ebb.stat-usa.gov	*Federal Reserve Board Highlights* (202) 452-3206 *Bank Holding Company Applications and Orders* (202) 452-3207

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
Mortgage Bankers Association of America	*Publications Department* 1125 15th Street, NW Washington, DC 20005-2766 (800) 793-MBAA, ext. 3	*MBA Fax on Demand* This service is available only to MBA members. For more information, call (800) 793-MBAA.		
U.S. Department of the Treasury—Office of the Comptroller of the Currency	*Publications Control* P.O. Box 70004 Chicago, IL 60673-0004 (202) 874-4884	*OCC Information Line* (202) 479-0141	*U.S. Treasury's Electronic Library (TEL)* (703) 321-3339(d) Via internet: ftp.fedworld.gov (192.239.92.205) Telnet via Internet: fedworld.gov (192.239.93.3) FTP via Internet: ftp.fedworld.gov (192.239.92.205) World Wide Web home page: http://www.fedworld.gov	
U.S. Department of the Treasury—Office of Thrift Supervision	*OTS Dissemination Branch* 1700 G Street, NW Washington, DC 20552-0001 (202) 906-6427	The OTS is developing a fax service that they may launch in late 1995.		
U.S. Department of Education	*Federal Student Aid Information Center* (800) 433-3243			
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office's Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250(f)		*U.S. Government Printing Office's The Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account. User assistance line (202) 512-1530 (202) 512-1387(d) Telnet via internet: federal.bbs.gpo.gov 3001	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 3 (202) 942-7114 (tty)	World Wide Web home page: http://=www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)

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Appendix

Examiner-Auditor Relationship

The following excerpt from the proposed AICPA Audit and Accounting Guide *Banks and Savings Institutions* provides guidance on coordination between examiners and auditors. The Guide incorporates and supersedes AICPA Statement of Position (SOP) 90-5, *Inquiries of Representatives of Financial Institution Regulatory Agencies,* and related sections of the AICPA Audit and Accounting Guide *Audits of Savings Institutions.*

> Independent accountants may be engaged to attest to the fairness of presentation of the institution's financial statements and to management's assertions about the institution's financial reporting controls and compliance with laws and regulations. Banking regulators conduct periodic on-site examinations to address broader regulatory and supervisory issues. There are some objectives shared by examiners and independent accountants, and coordination in consultation with the institution may be beneficial.
>
> The primary objective of communicating with examiners is to ensure that independent accountants consider competent evidential matter produced by examiners before expressing an opinion on audited financial statements. In areas such as the adequacy of credit loss allowances and violations of laws or regulations, for example, information known to or judgments made by examiners should be made known to management and the independent accountant before financial statements are issued or an audit opinion is rendered. Such communication will minimize the possibility that a regulatory agency will subsequently require restatement—based on the examiner's additional knowledge or different judgment—of call reports and affect the general purpose financial statements, on which the independent accountant has already expressed an opinion, dated during or subsequent to the period in which a regulatory examination was being conducted.
>
> [Federal Deposit Insurance Act] Section 36(h) requires that each institution provide its independent accountant with copies of the institution's most recent call report and examination report (see [Title 12 of the Code of Federal Regulations] Subpart 363.403). The institution must also provide the independent accountant with any of the following documents related to the period covered by the engagement:
>
> *a.* Any memorandum of understanding (MOU) or other written agreement between the institution and any federal or state banking agency
>
> *b.* The report of any action initiated or taken by any federal or state banking agency, including any assessment of civil money penalties
>
> The independent accountant should review communications from examiners and, when appropriate, make inquiries of examiners. Specifically, the independent accountant should—
>
> *a.* Request that management provide access to all reports of examination and related correspondence.
>
> *b.* Review the reports of examination and related correspondence between examiners and the institution during the period under audit and through the date of the independent accountant's opinion.
>
> *c.* With prior approval of the institution, communicate with the examiners if their examination is still in process, the institution's appeal of an examination finding is outstanding, or their examination report is still pending.

d. With prior approval of the institution, consider attending, as an observer, the exit conference between the examiner and the institution's board of directors, its executive officers, or both.

The independent accountant's attendance at other meetings between examiners and representatives of the institution requires prior approval by the regulatory agency.

Independent accountants may request a meeting with the appropriate regulatory representatives to inquire about supervisory matters relevant to the client institution. Management of the institution would generally be present at such a meeting, and matters discussed would generally be limited to findings already presented to management. Federal regulatory policy also permits meetings between examiners and independent accountants in the absence of the institution's management.[1] In addition, the [Office of Thrift Supervision (OTS)] has established a policy that generally makes OTS examination working papers available for review.[2]

Management refusal to furnish access to reports or correspondence, or to permit the independent accountant to communicate with the examiner, would ordinarily be a limitation on the scope of a financial statement audit sufficient to preclude an opinion. Refusal by an examiner to communicate with the independent accountant may create the same scope limitation, depending on the independent accountant's assessment of the circumstances (see paragraphs 40-44 of [Statement on Auditing Standards (SAS)] No. 58, *Reports on Audited Financial Statements* [AICPA, *Professional Standards,* vol. 1, AU sec. 508], for additional guidance).

Examiners might request permission to attend the meeting between the independent accountant and representatives of the institution (for example, the audit committee of the board of directors) to review the independent accountant's report on the institution's financial statements. If such a request is made and management concurs, the independent accountant should be responsive to the request.

Examiners and others may, from time to time, request auditors of financial statements of banks and savings institutions to provide access to working papers. Auditors who have been requested to provide such access should refer to [Interpretation No. 1 of SAS No. 41, *Working Papers,* titled "Providing Access to or Photocopies of Working Papers to a Regulator" (AU section 9339.01—.15)]. The Interpretation provides auditors with guidance on—

- Advising management that the regulator has requested access to (and possibly photocopies of) the working papers and that the auditor intends to comply with the request.
- Making appropriate arrangements with the regulator for the review.
- Maintaining control over the original working papers.
- Considering submitting to the regulator a letter clarifying that an audit in accordance with GAAS is not intended to, and does not, satisfy a regulator's oversight responsibilities. An example of such a letter is illustrated in paragraph 6 of the Interpretation (AU section 9339.06).

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[1] Related instructions to examiners were published in a July 23, 1992, *Interagency Policy Statement on Coordination and Communication Between External Auditors and Examiners.*

[2] See OTS letter to chief executive officers dated September 11, 1992.

In addition, the Interpretation addresses situations in which an auditor has been requested by a regulator to provide access to the working papers before the audit has been completed and the report released. Also, the Interpretation notes that when a regulator engages an independent party, such as another independent public accountant, to perform the working paper review on behalf of the regulatory agency, there are some precautions auditors should observe.

Information in examination reports, inspection reports, supervisory discussions—including summaries or quotations—is considered confidential. Such information may not be disclosed to any party without the written permission of the appropriate agency, and unauthorized disclosure of such information could subject the independent accountant to civil and criminal enforcement actions.

AAM Section 8060

Employee Benefit Plans Industry Developments—1996

Industry and Economic Developments

.01 Employee benefit plan issues continue to receive emphasis by Washington policymakers and regulators. Current federal activity focuses on several key areas related to employee benefit plans. Legislation has been introduced in Congress to improve the quality of employee benefit plan audits and to simplify pension plans, and the U.S. Department of Labor (DOL) kicked off a national savings education campaign to encourage Americans to save for retirement. In addition, the DOL initiated an investigation of 401(k) plans for a possible illegal diversion of participant contributions for personal or business use.

.02 Plan sponsors increasingly continue to offer 401(k) and other defined contribution plan options in lieu of traditional defined benefit plans and to offer more investment options for participants. Further, many plan sponsors are outsourcing plan administrative recordkeeping and other functions to third-party administrators or other service providers.

.03 Also, the recent flurry of activity in company mergers and acquisitions, coupled with the many terminations of defined benefit pension plans, has resulted in an increase in employee benefit plan mergers and terminations.

Regulatory and Legislative Developments

Regulatory Developments

.04 *PWBA Assessment of the Quality of Employee Benefit Plan Audits.* During 1995, the DOL's Pension and Welfare Benefits Administration (PWBA) completed a comprehensive, nationwide study to assess the quality of employee benefit plan audits. The study's primary objective was to assess whether the level and quality of audit work being performed by auditors with respect to audits of employee benefit plans covered under the Employee Retirement Income Security Act of 1974 (ERISA) had improved since 1989, the date of an earlier study performed by the DOL's Office of Inspector General (OIG). PWBA representatives performed on-site workpaper reviews on a statistically selected random sample of 276 plan audits to determine the extent of compliance with professional auditing standards and ERISA's reporting and disclosure requirements.

.05 The PWBA found that many audits conducted by auditors pertaining to the 1992 filing year continued to fail to comply with professional standards. Certain factors identified by the PWBA are believed to have contributed to this failure. These factors included—

- Inadequate technical training and knowledge on the part of auditors conducting employee benefit plan audits.
- Lack of awareness by auditors of the uniqueness of employee benefit plan audits.
- A failure of audit firms to establish quality review and internal process controls.
- A perception by plan administrators, auditors, or both that employee benefit plan audits are ancillary and provide no useful purpose except to fulfill a governmental regulatory requirement.

- Auditors whose overall practices did not include many audits.
- The failure of auditors to perform necessary audit work.
- The failure of auditors to understand the limited scope audit exemption.

.06 Additionally, the PWBA found a significant number of audit reports that failed to comply with one or more of ERISA's or DOL's reporting and disclosure requirements. The most common reporting and disclosure deficiencies were as follows:

- The auditor's report failed to extend to one or more of the required supplemental schedules.
- The required supplemental schedules failed to include all the necessary information pursuant to ERISA and DOL regulations.
- The plan administrator inappropriately invoked the limited scope audit exemption when the financial institution holding the plan's assets did not qualify for such exemption because it was not a bank or similar institution or an insurance company.
- The statement of net assets was not presented in comparative form as required by DOL regulations.
- The footnotes to the plan's financial statements failed to include certain information required by DOL regulations (for example, a footnote reconciling financial statement amounts to amounts reported in Form 5500 Series Annual Report).
- The audit was of the trust rather than of the plan.

.07 *Ongoing PWBA Review of Plan Financial Statement Audits.* The PWBA has established an ongoing quality review program to assess the quality of audit work performed by auditors in audits of plan financial statements required by ERISA. Auditors deemed by the PWBA to have performed significantly substandard audit work are referred to either state licensing boards or the AICPA Professional Ethics Division for further investigation. As of December 31, 1995, 59 referrals had been made to state licensing boards and 270 referrals had been made to the AICPA Professional Ethics Division; of the latter the Professional Ethics Division has resolved 204 cases. Of the resolved cases, 64 had been referred to the AICPA Trial Board or had been settled without a Trial Board hearing, 109 resulted in letters of recommended corrective action, 9 had been found to contain no deficiencies, and 22 had been closed for other reasons. Common deficiencies noted in the referrals included the following:

- Inadequate or no audit program or planning
- Inadequate or no documentation of the auditor's understanding of the internal control structure
- Inadequate or no documentation supporting the audit work performed
- Deficiencies in the auditor's report
- Deficiencies in the footnote disclosures

.08 *Form 5500 Reporting of Accumulated Postretirement Benefit Obligations by Multiemployer Health and Welfare Benefit Plans.* Certain multiemployer health and welfare benefit plan groups have requested that the DOL not enforce the provisions of AICPA Statement of Position (SOP) 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans,* for multiemployer plans in connection with Form 5500 filings with the DOL. (See the related discussion of SOP 92-6 in the "Accounting Developments" section). As of the date of this Alert, the DOL has not made a formal determination on this matter; however, the AICPA has strongly recommended against the DOL issuing such a waiver. Notwithstanding any DOL action on this matter, if a plan does not adopt the provisions of SOP 92-6, including presenting a statement of the plan's benefit obligations and a statement of changes in the plan's benefit obligations, which are required to fairly present the plan's financial statements in conformity with generally accepted accounting principles (GAAP), the auditor should consider the effect of this departure from GAAP on the audit report. AICPA Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements* (AU section 508), describes the circumstances that may require a qualified or adverse opinion when the financial statements contain a departure from GAAP (AU section 508.35—.60). A qualified opinion is expressed when the auditor believes, on the basis of the audit, that the financial statements contain a departure from GAAP, the effect of which is material, and the auditor has decided not to express an adverse opinion. An auditor should express an adverse opinion when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP.

.09 *401(k) Plan Contribution Remittance.* The DOL issued a proposed regulation that would significantly reduce the maximum period for which employers could hold participant contributions to defined contribution plans, including 401(k) plans. (See *Federal Register,* December 20, 1995.) Current rules require employers to transmit money withheld from employees to their plans as soon as reasonably possible, but in no event longer than ninety days. However, some employers have interpreted the current rule to mean that contributions could be held for ninety days even when those contributions could have been transmitted to the plan in a shorter period.

.10 The proposed regulation would eliminate the ninety-day maximum period and replace it with the same requirements that employers have for depositing withheld income and employment taxes, including Social Security contributions. Under the proposed regulation, all but the smallest employers that sponsor contributory employee benefit plans would be required to deposit employee contributions within a few days of withholding the money from employee wages. Smaller employers would be required to make the deposits by the fifteenth day of the following calendar month. Failing to remit, or untimely remittance of participant contributions, constitutes a prohibited transaction (either a use of plan assets for the benefit of the employer or a prohibited extension of credit) and, in certain circumstances, may constitute embezzlement of plan assets. Additionally, such information should be properly presented on the required Form 5500 supplemental schedule of nonexempt transactions with parties in interest. When plan administrators have failed to disclose this information, plan auditors should consider the effect on the auditors' opinion on the required supplemental schedule accompanying the plan's financial statements.

.11 *Pension Payback Program.* In March 1996, the DOL announced a Pension Payback program designed to make sure that the money withheld from wages is actually deposited to employees' 401(k) plans. The program, which began March 7, 1996, and ends September 7, 1996, gives employers a six-month "grace period" to contribute, with lost earnings, all funds they deducted from employees' paychecks but failed to deposit in 401(k) plans within required time periods. Employers must also notify the DOL and plan participants. If employers voluntarily come forward, they can avoid criminal and civil penalties.

.12 The program is not available to employers that are now under investigation by DOL. Nor can employers take part if the total amount of withheld participant contributions not forwarded to 401(k) plans is more than the participant contributions withheld from employee wages for calendar 1995.

.13 For specific information concerning program eligibility requirements and the notification process for participation, employers may call (202) 219-4377 or write the Pension and Welfare Benefits Administration, U.S. Department of Labor, P.O. Box 77235, Washington, DC 20013-7235.

.14 *PWBA Reporting Compliance Program.* The PWBA continues its aggressive reporting compliance program to ensure that plan administrators comply with ERISA's reporting and disclosure requirements. Through 1995, the PWBA has rejected over 4,200 filings and imposed over $64 million in civil penalties under ERISA section 502(c)(2), which provides for penalties of up to $1,000 per day against plan administrators that fail to file acceptable annual reports on a timely basis. In addition, the PWBA continues to actively identify and target both late filers and nonfilers. Over 590 late filers and nonfilers have been identified and assessed over $49 million in late filing and nonfiling penalties.

.15 *Delinquent Filer Voluntary Compliance Program.* In April 1995, the PWBA initiated an ongoing Delinquent Filer Voluntary Compliance (DFVC) program designed to encourage filer compliance by allowing plan administrators that failed to file or filed their Form 5500 reports late to apply for relief from full delinquency penalties. This program was designed to be less burdensome on small plans and to balance the PWBA's limited resources between enforcement and compliance objectives. Participation in the DFVC program constitutes a waiver by plan administrators to receive notice of assessment of civil penalties under ERISA section 502(c)(2) and to contest the DOL's assessment of the penalty amount. Participation in the DFVC program does not preclude assessment of nonfiling or late-filing penalties by the Internal Revenue Service (IRS). The IRS has recommended that plan administrators participating in the DFVC program attach reasonable cause statements to their original Form 5500 filings.

.16 In addition, plan administrators of certain employee benefit plans for highly compensated individuals, known as *top hat* plans, and apprenticeship and training plans that missed their filing deadlines may submit statements and elect an alternative method of compliance in lieu of making annual report filings. Filers participating in the DFVC program will be assessed $2,500 per statement. To date, the DOL has received 2,490 annual report filings and 118 statements by top hat plans and apprenticeship and training plans totaling $7.3 million in reduced penalty assessments. Questions concerning the DFVC program should be directed to the PWBA's Division of Reporting Compliance at (202) 219-8770.

.17 *PWBA Outreach and Customer Service Efforts.* The PWBA encourages auditors and plan filers to call its Division of Accounting Services at (202) 219-8794 with ERISA-related accounting and auditing questions and questions regarding preparation of Form 5500. Questions concerning filing requirements should be directed to the Division of Reporting Compliance at (202) 219-8770.

.18 In addition to handling technical telephone inquiries, the PWBA is involved in numerous outreach efforts designed to provide to practitioners information needed in understanding ERISA's reporting and disclosure requirements. Questions on those outreach efforts should be directed to the Office of the Chief Accountant at (202) 219-8818.

.19 Finally, the PWBA has published the following booklets to assist practitioners in understanding ERISA's reporting and disclosure requirements:

- Trouble-Shooter's Guide to Filing the ERISA Annual Reports
- Reporting and Disclosure Guide for Employee Benefit Plans
- MEWAs Under ERISA—A Guide to Federal and State Regulation
- Guide to Summary Plan Description Requirements
- Fidelity Bonding Under ERISA
- Exemption Procedures Under Federal Pension Law

These publications may be ordered by writing to Publications Desk, PWBA-DPA, Room N-5656, U.S. Department of Labor, 200 Constitution Avenue, NW, Washington, DC 20210.

.20 *DOL Interpretive Bulletin Relating to Participant Investment Education.* In January 1996, the DOL issued regulations titled "Interpretive Bulletin Relating to Participant Investment Education" (Interpretive Bulletin), which provide guidance on the distinction between nonfiduciary education and fiduciary investment advice in the context of participant-directed employee benefit plans, primarily 401(k) plans. In defining *fiduciary* under ERISA, section 3(21) of ERISA indicates broadly that a fiduciary includes anyone who "renders investment advice for a fee or other compensation, direct or indirect, with respect to any money or other property of [a] plan, or has authority or responsibility to do so." The Interpretive Bulletin provides examples of certain categories of information and material that constitute nonfiduciary investment education rather than fiduciary investment advice. The Interpretive Bulletin specifies four broad categories of information and services that, alone or in combination, will be treated as nonfiduciary employee education. These categories include plan information, general financial and investment information, asset allocation models, and interactive investment materials. CPAs providing education to participant directed plans should become familiar with the Interpretive Bulletin to determine whether their activities in connection with providing participant investment education may subject them to fiduciary status.

Legislative Developments

.21 *Pension Audit Improvement Act of 1995.* The Pension Audit Improvement Act of 1995 (S. 1490) was introduced in the Senate on December 20, 1995, by Senator Simon (D-IL) and cosponsored by Senators Jeffords (R-VT), Leahy (D-VT),. and Boxer (D-CA). The proposed legislation is designed to improve audits to better protect participants and beneficiaries. Among other things, S. 1490 proposes to—

- Repeal the limited scope audit exemption for plan years beginning on or after January 1 of the calendar year following the date of enactment.
- Redefine who meets the requirements of an independent qualified public accountant (IQPA) under ERISA. The bill would mandate external quality control reviews and continuing professional education (CPE) requirements for auditors who conduct ERISA audits. Auditors must have undergone qualified external quality control reviews of their accounting and auditing practices during the three-year period immediately preceding each engagement. In addition, auditors must have completed at least eighty hours of CPE or training that contributes to their professional proficiency within the two-year period immediately preceding each engagement. At least twenty hours must have been completed during the one-year period immediately preceding each engagement, and at least sixteen of the eighty hours must relate to employee benefit plan matters.
- Require the plan administrator to report certain events (for example, irregularities) directly to the DOL within five business days after the plan administrator first has reason to believe (or after the plan administrator has been notified by the auditors) that an event may have occurred with respect to the plan. If a plan administrator fails to report such an event to the DOL, the auditor would be required to report such information directly to the DOL.
- Require the plan administrator to notify the DOL about the auditor's termination of the engagement within five business days after termination. If the plan administrator fails to provide such notification to the DOL or if the auditor disagrees with the reasons given in the notification, the bill would require the auditor to notify the DOL of the termination, giving the reasons.
- Subject auditors to civil penalties of up to $100,000 for failing to comply with the above reporting provisions.

Auditors should be aware that this proposed legislation, if enacted, could substantially change the way benefit plan audits are conducted and could affect their audit practices. Auditors should be alert for new developments in this area.

.22 *Pension Reform.* Recently, attention has been focused on underfunded retirement plans and how the Pension Benefit Guaranty Corporation's (PBGC's) growing accumulated deficit will affect its ability to meet its obligation to guarantee employees' benefits under most private-sector defined benefit pension plans. In December 1994, the Retirement Protection Act of 1994 (the Act) was enacted as part of the General Agreement on Tariffs and Trade (GATT) legislation. The Act is intended to increase the security of the pension system and improve the PBGC's ability to meet its obligations to plan participants. It modifies existing rules to encourage employers to more fully fund their defined benefit pension plans by imposing new minimum funding rules for plans with more than one hundred participants and by raising the full-funding limit. The Act amends various qualification requirements, including limiting the ability of sponsors of underfunded plans to select interest and mortality assumptions for purposes of calculating their minimum contributions, and modifies the interest and mortality assumptions used for calculating lump-sum distributions from defined benefit plans. Other key provisions of the Act include—

- Elimination of the cap on variable-rate PBGC premiums, which could increase premiums for underfunded plans.
- The addition of new participant notice and PBGC reporting requirements.
- Establishment of a new PBGC program for missing participants in standard terminations.
- Elimination of quarterly contributions for well-funded plans.
- Elimination of the excise tax for some nondeductible contributions.
- Extension until the year 2000 of a company's ability to transfer excess pension assets to a 401(h) account to pay current retiree health benefits.

The Act's provisions generally are effective for 1995 plan years.

.23 Such changes could, among other things, affect a plan's tax qualification status. Auditors should make inquiries of, and obtain representations from, management concerning compliance with the laws and regulations and the prevention of violations that may cause disqualification. The auditing procedures ordinarily applied in assessing a plan's tax status as part of a financial statement audit are discussed in paragraph 12.03 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans.*

Audit and Accounting Developments

Audit Issues

.24 *Plan Merger Effective Dates.* The recent flurry of activity in company mergers and acquisitions, coupled with the many terminations of defined benefit pension plans, has resulted in an increase in employee benefit plan mergers. Because the effective date of a merger, according to the plan documents, often is prior to the actual transfer date of the related plan assets, confusion exists about how to determine the correct merger date for Form 5500 and financial statement purposes. Procedures the auditors may wish to apply to determine the proper merger date include discussion with management and service providers regarding the intended date of merger; review of plan documents, amendments, minutes of plan meetings, correspondence with service providers, and other pertinent plan information; and testing the transfer of assets from former custodian to current custodian. Auditors need to use judgment in each merger situation based on the procedures described above to determine the proper merger date for Form 5500 and financial statement purposes.

.25 *OCBOA Financial Statement Disclosures.* Some plan administrators prepare plan financial statements on a modified cash basis or another comprehensive basis of accounting (OCBOA) rather than in conformity with GAAP. Often, such financial statements do not include information about accumulated plan benefits. Paragraphs 9 and 10 of SAS No. 62, *Special Reports* (AU section 623.09 and .10), require that auditors apply essentially the same criteria to OCBOA financial statements as they do to financial statements prepared in conformity with GAAP. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in paragraph 4 of SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AU section 411.04). Thus, as noted in paragraph 13.22 of *Audits of Employee Benefit Plans,* plan financial statements prepared on an OCBOA should disclose information regarding accumulated plan benefits or accumulated benefit obligations, as applicable. Certain other disclosures also may be appropriate. If such disclosures are not made, the auditor should comment in his or her report on the lack of such disclosures and should express a qualified or an adverse opinion on the financial statements.

.26 *Limited Scope Audit Exemption.* ERISA section 103(a)(3)(C) allows auditors to limit the scope of their testing of investment information prepared and certified by a qualified trustee or custodian, such as a bank, trust company, or similar institution or an insurance company. However, this limited scope audit exemption does not apply to information prepared and certified by broker-dealers and investment companies or to noninvestment information, such as benefit payments, employer-employee contributions, loans, and receivables.

.27 Auditors should also be aware that the limited scope audit exemption does not apply to assets held by a broker-dealer or an investment company unless the investment company owns a subsidiary bank that can certify the investment information. The exemption also does not apply to investment information other than that certified by a qualified trustee or custodian or to other noninvestment information. The scope limitation and the corresponding limitation of the auditor's work extends only to investments and related investment activity certified by the qualified trustee or custodian. Plan investments not held by a qualified trustee or custodian, and all noninvestment related information (for example, contributions receivable, benefits paid, other expenses), should be subjected to the same audit procedures as those for a full scope audit. The auditor's responsibilities in limited scope engagements are discussed in detail in paragraphs 7.47 and 7.48 of *Audits of Employee Benefit Plans.*

.28 *Claims Incurred but not Reported.* Paragraph 39 of SOP 92-6 requires that self-funded health and welfare benefit plans measure the cost of claims incurred but not reported (IBNR) at the present value, as applicable, of the estimated ultimate cost to the plan of settling the claims (paragraph 4.37 of *Audits of Employee Benefit Plans*). However, financial statement preparers and auditors often are unclear about what the estimated ultimate cost should include. In some cases, plans may inappropriately be using a "lag" approach (recording known amounts that relate to the period covered by the financial statements that are reported subsequent to year end but prior to the issuance of the financial statements) to estimate the ultimate cost of IBNR claims and do not consider any future obligations of the plan relating to conditions that existed as of the end of the period but that had not been reported prior to the issuance of the financial statements.

.29 SOP 92-6 states that the estimated ultimate cost of IBNR claims should reflect the plan's obligation to pay claims to or for participants, regardless of status of employment, beyond the financial statement date pursuant to the plan provisions or regulatory requirements. For example, an individual contracts a terminal disease or has a catastrophic accident in December. The claim is reported to the plan subsequent to the plan's calendar year end. Treatment is ongoing and is expected to continue throughout the next year. The plan does not require any return to work and fully covers all services. The actuarial present value of the obligation for all future payments to be made as of the plan year end (December) should be included as a benefit obligation in IBNR.

.30 Auditors should be aware that the calculation of IBNR amounts is often quite complex and may require the use of actuarial estimates. In such cases, the auditor should discuss with the plan administrator the need for the plan to engage an actuary and should consider the guidance in SAS No. 73, *Using the Work of a Specialist* (AU section 336).

.31 *Trend Toward Outsourcing.* With the trend toward daily valuation of 401(k) plans, more benefit plans are using service providers to execute transactions and maintain accountability on behalf of the plan administrator. Oftentimes the plan does not maintain independent accounting records of transactions executed by the service provider. For example, many plan sponsors no longer maintain participant enrollment forms detailing the contribution percentage and the allocation by fund option. In these situations, the auditor may not be able to obtain a sufficient understanding of the internal control structure relevant to transactions executed by the service organization to plan the audit and to determine the nature, timing, and extent of testing to be performed without considering those elements of the internal control structure maintained by the service organization. This understanding can be efficiently achieved by obtaining and reading a report prepared in accordance with SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), for the service organization. If the SAS No. 70 (AU section 324) report is unavailable, the auditor should consider other appropriate procedures to obtain sufficient evidence to achieve the audit objectives. For example, if participant enrollment forms are unavailable from the plan sponsor, the auditor may wish to confirm the information directly with the participants. Alternatively, the auditor could consider requesting the enrollment forms from the service provider or visiting the service provider to perform the necessary testing. (See chapter 6 "Internal Control Structure". of *Audits of Employee Benefit Plans.*)

.32 *Investment in Derivatives.* Employee benefit plans sometimes use derivatives as risk management tools or as speculative investment vehicles. The use of derivatives often increases audit risk. Although financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditor's approach to achieving related audit objectives may differ because the notional and contractual amounts of certain derivatives—such as futures, forwards, swaps, options, and other contracts with similar characteristics—generally are not recognized in the financial statements. Auditors should understand both the economics of derivatives used by employee benefit plans and the nature and business purpose of the derivatives activities. To the extent the derivatives meet the definition of financial instruments as defined in Financial Accounting Standards Board (FASB) Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25); No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25); and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), the disclosure requirements set forth in those Statements (AC F25) must be met.

.33 Audit risk considerations presented by the use of derivatives are discussed in *Audit Risk Alert—1995/96* [AAM section 8010]. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (product no. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations.

Audit Developments

.34 *SAS No. 70 Auditing Procedure Study.* In April 1996, the AICPA Auditing Standards Board (ASB) issued an Auditing Procedure Study, *Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations,* that provides guidance on implementing SAS No. 70 (AU section 324) to service auditors engaged to issue a report on the internal control structure policies and procedures of a service organization and to user auditors engaged to audit the financial statements of an entity that uses a service organization. Examples of a service organization include a bank trust department that invests and holds assets for a plan or a third-party service that processes claims or performs recordkeeping services for a plan.

.35 *SAS on Using the Work of a Specialist.* Plan auditors frequently use the work of actuaries and appraisers to corroborate assertions in plan financial statements (for example, the actuarial present value of benefit obligation amounts and asset values). SAS No. 73 (AU section 336) provides guidance for auditors who use the work of such specialists in audits performed in accordance with generally accepted auditing standards (GAAS).

Accounting Issues

.36 *401(h) Plans.* A number of employers have amended defined benefit pension plans that they sponsor to provide for the payment of certain health benefits for retirees, their spouses, and dependents in addition to the normal retirement benefits. The Internal Revenue Code (IRC) permits defined benefit pension plan sponsors to fund (subject to certain restrictions and limitations) all or a portion of their postretirement medical obligations through a 401(h) account in their defined benefit pension plans. Contributions to a 401(h) account may be used only to pay health benefits. Auditors should be aware that the plan assets set aside in a 401(h) account are not assets available to pay pension benefits and should not be characterized as such in the plan's financial statements. The AICPA Employee Benefit Plans Committee currently has an SOP project under way to provide guidance on the accounting for and disclosure of 401(h) features of both defined benefit pension plans and health and welfare benefit plans. The committee expects to issue an exposure draft in mid-1996. This project would not affect plan accounting and reporting for 1995 plan year-end reporting; however, auditors should be alert for further developments on this project.

Accounting Developments

.37 *Health and Welfare Benefit Plans.* In August 1992, the AICPA Employee Benefit Plans Committee issued SOP 92-6, which clarified several accounting and reporting requirements set forth in chapter 4 of *Audits of Employee Benefit Plans* and updated chapter 4 to incorporate Statements issued by the FASB.

.38 SOP 92-6 is now effective for most employee benefit plans. It was effective for single-employer plans with more than five hundred participants for plan years beginning after December 15, 1992; for single-employer plans with no more than five hundred participants for plan years beginning after December 15, 1994; and for multiemployer plans for plan years beginning after December 15, 1995. When a plan adopts the SOP, the plan must adopt it in its entirety.

.39 Accounting changes adopted to conform to the provisions of the SOP should be made retroactively. When there has been a change in accounting principles that has a material effect on the comparability of the plan's financial statements, SAS No. 58 (AU section 508) states that auditors should refer to the change in an explanatory paragraph of their report. Because ERISA requires comparative statements of net assets available for plan benefits, it will be necessary to restate the prior year's statement of net assets in the year of adoption in an ERISA audit to comply with the provisions of the SOP. In addition, because accumulated benefit obligations are not reported on Form 5500, plans should include a note to their financial statements reconciling the amounts reported in the financial statements to amounts reported on Form 5500, as described in paragraphs 12.16 and A.51 of *Audits of Employee Benefit Plans.*

.40 *Valuation of Insurance and Investment Contracts.* In September 1994, the AICPA Employee Benefit Plans Committee issued SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans,* which provides guidance on how those plans should report investment contracts issued by insurance companies, banks, thrift institutions, and others. In addition, the SOP provides guidance for determining the fair value of investment contracts held by all types of plans. The SOP is effective for financial statements for plan years beginning after December 15, 1994, except that the application of the SOP to investment contracts entered into before December 31, 1993, is delayed to plan years beginning after December 15, 1995.

.41 Certain investment contracts that are held by health and welfare plans and defined contribution pension plans may be reported at contract value. In the current economic environment, some of those contracts may have been issued by what are now troubled insurers. In those cases, the auditor should be aware that continuing to carry the assets at contract value may not be appropriate, because the plan may not recover the entire contractual amount. When addressing contracts issued by troubled insurers, auditors should consider the guidance in FASB Statement No. 5, *Accounting for Contingencies* (AC C59).

.42 *Risks and Uncertainties.* In December 1994, the AICPA Accounting Standards Executive Committee (AcSEC) issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires entities to include in their financial statements disclosures about (1) the nature of operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires entities to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations. The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending subsequent to December 15, 1995.

.43 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure. Examples of SOP 94-6 disclosures affecting employee benefit plans are as follows:

- *Nature of Operations*—The SOP requires a description of the major products or services the reporting entity sells or provides and its principal market. *Audits of Employee Benefit Plans* currently requires that plans disclose a description of the plan agreement. However, it allows plans that publish or make available a plan description to exclude certain disclosures. SOP 94-6 requires full disclosure of the nature of operations regardless of whether a plan description is published or made available.

- *Use of Estimates*—According to the SOP, financial statements should include an explanation that financial statements prepared in conformity with GAAP require the use of management's estimates. Benefit plan financial statements generally include various elements that are subject to estimates (for example, actuarial present value of accumulated benefits, fair value of certain investments such as real estate or nonreadily marketable securities) and thus a disclosure regarding the use of estimates would be required.

- *Certain Significant Estimates*—The SOP requires disclosures of certain significant estimates when certain criteria are met. The SOP includes examples of items that may be based on estimates that are particularly sensitive to change in the near term and would need to be disclosed. Included in the examples are amounts related to long-term obligations, such as amounts reported for pensions and postemployment benefits. Thus, certain defined benefit pension and health and welfare plan financial statements may need to present this disclosure.

.44 *Impairment of Long-Lived Assets.* In March 1995, the FASB issued FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08), which establishes accounting standards for the impairment of long-lived assets. The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is not permitted by the Statement (AC I08).

.45 Auditors of the financial statements of employee benefit plans should consider management's policies and procedures for determining whether all impaired long-lived assets, for example, real estate owned by the plan for plan operations for which the value has been impaired, have been properly identified. Auditors should evaluate management's estimates of future cash flows from asset use and impairment losses following the guidance of SAS No. 57, *Auditing Accounting Estimates* (AU section 342).

Frequently Asked Questions

.46 The following questions and answers are adapted from an article written by David M. Walker, Arthur Andersen LLP, appearing in the June 1996 *Journal of Accountancy*. They include frequently asked questions received during the past year by AICPA Employee Benefit Plans Committee members and the AICPA staff. Many of the questions relate to issues identified by the DOL as problem areas during its recently completed review of selected 1992 employee benefit plan audit engagements.

a. *Which entity—the plan or the trust—has to be audited under ERISA?*

   While some trust activity must be audited in any plan audit, the audit report must be on the plan, not on the trust. For example, if several plans are funded through a single master trust, each plan that meets ERISA's audit requirements (generally funded plans with one 100 or more participants as of the beginning of the plan year) must be audited and a report issued. A sole audit report on the master trust with separate columns for each plan's financial information will not satisfy ERISA's audit requirements.

b. *Can a plan report detailed master trust information in its financial statements in lieu of submitting a separate master trust filing with the DOL?* .

   No. DOL regulations require that a separate master trust filing be submitted to the DOL.

c. *Do plan auditors have to issue a report on a master trust's financial statements?*

   No. The master trust's financial statements do not have to be audited. However, the auditors generally have to audit certain master trust activity in order to express an opinion on any related plan's financial statements.

d. Can the plan meet the GAAP disclosure requirements related to master trust information by attaching a copy of the master trust's filing?

No. The required summary master trust disclosures, as described in paragraphs 2.28 and 3.27 of *Audits of Employee Benefit Plans*, must be in the notes of the applicable plans' financial statements.

e. Does the plan have to report fund information in a participant-directed plan that is funded via a master trust?

Yes. GAAP requires disclosure of certain fund information by participant-directed and nonparticipant-directed accounts.

f. Which institutions may certify investment information under ERISA's limited scope audit exception (ERISA section 103)?

Banks, insurance companies, trust companies, and certain other financial institutions that are subject to regular and periodic examination by a state or federal agency may do this. As a result, mutual fund companies, broker-dealers, and selected other entities (such as associations) generally are not eligible for this statutory scope exemption unless they have set up a separate trust company or other eligible institution that has custody any related ERISA plan assets.

g. Does ERISA's limited scope audit exception apply to benefit payments and plan administrative expenses if the trustee certifies such information?

No. The exception applies only to investment-related information that is certified both as to completeness and accuracy by an eligible institution.

h. Should plan auditors extend the scope of their testing to include functions performed by certain third-party service organizations (such as third party welfare plan claims administrators and savings plan administrators) when conducting an ERISA limited scope audit?

Yes. However, the limited scope audit exception does not apply to certain areas that need to be examined in connection with any GAAS audit, including ERISA limited scope audits (for example, benefit payments, and administrative expenses). The nature and scope of testing will depend on a variety of factors (such as the kinds of functions being performed by the third-party service organization; what type of report was generated in compliance with SAS No. 70 [AU section 324]; and the results).

i. Will the Securities and Exchange Commission accept an ERISA limited scope audit report (for example, a disclaimer of opinion) in connection with a Form 11-K filing?

No.

j. Will the DOL reject a Form 5500 filing if the auditor's opinion on the plan's financial statements is qualified for any reason other than the limited scope audit exception?

Generally yes. However, the DOL has informally stated that it will not reject a Form 5500 filing if the auditor's opinion is qualified solely for failure to present comparative benefit obligation information in connection with the adoption of SOP 92-6. Current-year benefit obligation information must be presented, however.

k. If the plan auditor issues a qualified opinion on one or more supplemental schedules (for example, because of failure to provide historical cost information) and an unqualified opinion on the plan's financial statements, does the plan report that a qualified opinion has been issued in response to question 26b on Form 5500?

No. This question addresses the opinion on the plan's financial statements and not on the supplemental schedules.

l. What method does the DOL require be used for determining historical cost on the supplemental schedules?

The DOL generally will accept any clearly defined and consistently applied method of determining historical cost that is based on the initial acquisition cost of the related asset (for example, first in, first out or average cost). For the reportable transactions schedule, historical cost must be the original historical cost as of the date of acquisition of the asset.

m. *Do the disclosure requirements in FASB Statement No. 107 (AC F25) apply to employee benefit plan assets?*

Yes. Most employee benefit plan assets are carried at fair value, and no additional disclosures are necessary for those assets under FASB Statement No. 107 (AC F25). However, disclosure of fair value is required for financial instruments not carried at fair value. The most frequent example is investment contracts held by defined-contribution pension or welfare benefit plans that are carried at contract value as required by SOP 94-4, *Reporting on Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans.* The disclosure amounts relating to such contracts typically are calculated by employing a discounted cash flow approach based on prevailing interest rates for similar instruments.

n. *If a plan has performed a voluntary tax compliance review and has discovered certain operational violations, what authoritative guidance should be followed for reporting and disclosure in the plan's financial statements?*

Such matters should be handled in accordance with FASB Statement No. 5 (AC C59).

o. *What are an auditor's responsibilities in connection with prohibited transactions?*

Under GAAS, auditors must design an audit to detect any prohibited transactions that would have a direct and material effect on the plan's financial statements. The auditor also has the responsibility to be watchful for any prohibited transactions. If the auditor becomes aware of a potential prohibited transaction, he or she must ascertain whether the transaction is prohibited. If it is, it must be disclosed on the applicable supplemental schedule of nonexempt transactions, irrespective of quantitative materiality. In such cases, the auditor should consider consulting the plan's legal counsel.

p. *What should a plan auditor do if he or she discovers that required information has been omitted from one or more required ERISA supplemental schedules?*

If any required information (for example, historical cost), items (for example, participant loans), or transactions (such as prohibited transactions) are not disclosed in the applicable supplemental schedules, the auditors should modify his or her report on the applicable supplemental schedule(s). Paragraphs 13.14 through 13.18 of *Audits of Employee Benefit Plans* provides guidance in this area.

q. *What responsibilities does an auditor have in connection with a plan's tax status?*

Under GAAS, auditors would ordinarily review any applicable Internal Revenue Service tax determination letter or opinion letters of qualified tax counsel relating to the plan and the associated trust. If these are not available, the auditor should review those aspects of the plan document relevant to the determination of the plan's tax-exempt status. In addition, the auditor should make informed inquiries of the plan administrator or other appropriate plan representatives regarding the plan's operations and changes in plan design that could jeopardize its tax-exempt status. Because of the complexity of this area and the related risks, the auditor should ensure that those responsible for performing the tax status review are qualified to do so.

r. *Are participant loans considered plan investments?*

Yes. Therefore, they should be shown as investments on the plan's financial statements and on the supplemental schedule of assets held for investment. They can be shown as a single line item on the schedule of assets held for investment if the conditions noted in the instructions to Form 5500 are met. Generally, participant loans would be shown as a separate participant-directed investment column in any applicable plan's financial statements if they represent more than 5 percent of the plan's net assets.

s. *Are audit workpapers subject to examination by the DOL?*

The DOL says that ERISA gives it legal access to audit workpapers since they support the audited financial statements that are attached to the Form 5500 annual report filing. As a result, the DOL conducts on-site reviews of audit workpapers as part of its ongoing enforcement efforts.

t. *What action does the DOL take when it determines that auditors have performed substandard audit work?*

The DOL may reject the client plan's Form 5500 filing (of which the audited financial statements are a part), potentially subjecting the plan administrator to a civil penalty of $300 per day (up to $50,000) calculated from the day after the Form 5500 filing was due. The DOL also refers significantly deficient work to the AICPA Professional Ethics Division and state licencing authorities.

u. What should the auditor do when he or she becomes aware that a plan has not made the required filings?

The auditor has no express responsibilities under GAAS. However, he or she may wish to advise the plan administrator of the filing requirements and the availability of the DOL's delinquent filer voluntary compliance program, which gives plan administrators an opportunity to file overdue annual reports and pay reduced civil penalties.

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.47 This Audit Risk Alert supersedes *Employee Benefit Plans Industry Developments—1995.*

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.48 Auditors should also be aware of the economic, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010].

[*The next page is 8179.*]

AAM Section 8070

State and Local Governmental Developments—1996

Industry and Economic Developments

.01 In general, state and local governments have benefitted from the slow growth of the United States economy, with many cutting taxes during 1995 and still ending the year with surpluses. However, others continue to struggle with the pressures of balancing their budgets, forcing state and local officials to reevaluate the services they provide, and, in some cases, to put off big-ticket items, such as the construction of schools or libraries.

.02 Tax cutting activities that occurred during 1995 have likely peaked since federal budget cuts that affect state and local government budgets are a virtual certainty in 1996 and beyond. Many state and local governments continue to cast a wary eye on likely federal budget and tax changes that could have a future negative impact. A National Conference of State Legislatures report titled *State Tax Actions 1995,* observes that although 1995 "was the best year states have experienced since the mid 1980s, a revolution in the federal budget is taking place and federal aid to the states is likely to fall significantly in fiscal 1996 and the following years." In addition to budget cuts, state and local officials are also concerned about proposed federal tax changes that could have a revenue impact at the state and local level. For instance, capital gains tax cuts would change the federal definition of adjusted gross income, to which a majority of state and local governments tie their own income tax. Until these issues are resolved, state and local officials are likely to take a cautious approach, building up surplus funds and crafting budgets with conservative spending and revenue assumptions.

.03 The demand for change in the way government does business has been on the increase. Like many other organizations in the private sector, governmental entities have recently been faced with a myriad of pressures related to budgets, restructuring, and reengineering. The "doing more with less" philosophy that many organizations are grappling with has resulted in deep structural changes for many state and local governments. Auditors should consider the effects of these changes on their consideration of internal controls.

.04 In the aftermath of the investment losses incurred by Orange County, California, and other municipalities around the country, attention continues to be focused on the use of derivatives and structured financial instruments by governmental entities (for further discussion on the audit implications of derivatives use, see the section entitled "Audit Issues and Developments").

Industry Conference

.05 The AICPA will hold its thirteenth annual National Governmental Accounting and Auditing Update Conference on August 5–6, 1996, in Washington, D.C., and again on September 12–13, 1996, in Phoenix, Arizona. This conference is designed for practitioners; officials working in federal, state, or local governmental finance and accounting; and recipients of federal financial assistance. Participants will receive updates on current issues, practical advice, and timely guidance on recent developments from experts. For more information about the conference, please call the AICPA Meetings and Travel Department at (201) 938-3232.

Regulatory, Legislative, and Other Developments

Final Revisions Issued to Office of Management and Budget Cost Circular A-87

.06 In May 1995, the U.S. Office of Management and Budget (OMB) issued revised OMB Circular A-87, *Cost Principles Applicable to State and Local Governments*, which is generally effective for awards made on or after September 1, 1995. However, for costs charged indirectly or covered by state-wide or local central services or public assistance cost allocation plans, the revision applies to the plans or indirect cost proposals submitted or prepared for a government's fiscal year that begins on or after September 1, 1995. The Circular establishes principles and standards for determining allowable costs incurred by state and local governments under federal grants and agreements.

.07 The revisions conform many of OMB Circular A-87 requirements to those found in OMB Circular A-21, *Cost Principles for Educational Institutions* and OMB Circular A-122, *Cost Principles for Non-Profit Organizations*. As part of the revisions, OMB completely reorganized Circular A-87. Beyond this reorganization, the most significant changes pertained to the allowability of selected items of cost. Specifically, the revisions—

- Allow interest on equipment and building improvements under certain conditions.
- Clarify the allowability of depreciation and use charges.
- Clarify the allowability of costs for salaries and wages.
- Allow costs for pension costs and retiree health benefits based on generally accepted accounting principles (GAAP) if they are funded.
- Disallow self-assessed sales taxes that have a disproportionate impact on federal programs.
- Clarify lobbying and litigation cost prohibitions.

These changes may affect amounts reported as receivables from the federal government and related revenue. Auditors should consider the effect of these changes on reported amounts in the financial statements.

Revisions Issued to OMB Cost Circular A-21

.08 Auditors involved with audits of federal financial assistance for governmental colleges and universities should be aware that the OMB issued revisions to OMB Circular A-21 in May 1996 (*Federal Register*, May 8, 1996). The revisions are effective for fiscal years beginning after May 8, 1996. Specifically, the proposed revisions—

- Establish additional criteria for allowing interest incurred on debt-financed purchases.
- Require indirect cost rates established at the time of an initial award to be used throughout the term of a sponsored agreement.
- Establish cognizance assignments for cost negotiation to the U.S. Department of Health and Human Services and the U.S. Office of Naval Research.
- Eliminate the allowability of dependent tuition benefits.
- Disallow the results of special cost analysis studies to be used to allocate utility costs to federally sponsored research effective July 1, 1998.
- Replace the term *indirect* costs with *facilities and administrative* costs throughout the entire Circular.

.09 The OMB also extended Cost Accounting Standards Board (CASB) standards and the applicability of the CASB Accounting Policies Disclosure Statement to all sponsored agreements subject to OMB Circular

A-21. The Disclosure Statement submission is required for universities receiving more that 25 million in federally-sponsored agreements and requires a display of cost accounting practices by those universities. In addition, the threshold for defining equipment has been raised to $5,000 from $500. Auditors should note that the OMB issued a notice (in the July 14, 1995 *Federal Register*) that allows the $5,000 capitalization threshold to be implemented immediately.

Revisions to the Single Audit Act and OMB Single Audit Circulars

.10 It appears that 1996 may be the year for the overhauling of single audit policy. In February 1996, legislation was introduced in the U.S. Senate to amend the Single Audit Act of 1984 (S.1579). A comparable bill has also been introduced in the U.S. House of Representatives (H.R.3184). The proposed revisions would include not-for-profit organizations in the scope of the act, raise the dollar threshold for single audit coverage to $300,000 from $25,000, implement a risk-based approach to selecting major programs, and reduce the audit report due date to nine months. It is uncertain at this time how quickly the proposed legislation will move through Congress.

.11 At the same time, the OMB is moving forward on a project to combine the audit requirements under OMB Circulars A-128, *Audits of State and Local Governments*, and A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. As the first step in this project, the OMB issued proposed revisions to OMB Circular A-133 in March 1995. A revised Circular A-133 was finalized on April 22, 1996, and will be effective for audits of fiscal years ending on or after June 30, 1997. It is expected that as soon as the Single Audit Act is amended (see the preceding paragraph), the OMB will publish a notice in the *Federal Register* of its intent to rescind OMB Circular A-128 and further revise OMB Circular A-133 to be applicable to state and local governments, colleges and universities, and not-for-profit organizations. Since it appears likely that the provisions of Circular A-133 will become applicable to state and local governmental entities, a summary of the proposed revisions follows:

- The threshold for an audit under Circular A-133 would be raised to $300,000 from $25,000.
- Auditors would determine "major programs," as defined in Circular A-133, on the basis of a risk assessment, considering prior audit experience, oversight performed by federal agencies and others, and the inherent risk of the program, rather than solely on the basis of federal expenditures, as currently required.
- The required level of testing of the internal control structure over major programs would be clarified as being based on auditors' planning for a low assessed level of control risk.
- The minimum requirements for the Schedule of Federal Awards would be provided.
- Guidance would be included concerning (1) reporting audit findings concerning federal awards in a single schedule of findings and questioned costs which includes a summary of the auditor's results; (2) thresholds for determining which audit findings should be included in the audit report; (3) descriptions of what information auditors should include in an audit finding; and (4) required follow-up on audit findings, including providing a corrective action plan for current audit findings and a summary schedule of prior audit findings.
- The definition of *nonprofit organization* would be revised to include nonprofit hospitals.
- Guidance would be included concerning the assignment of cognizant agencies.
- Restrictions would be imposed on auditor selection whereby auditors who also prepare the indirect cost proposal or cost allocation plan are prohibited from being selected as the auditor if the indirect costs recovered in the prior year are greater than $1 million in total.
- The due date would be shortened for submitting reports required by the Circular from thirteen to nine months after the end of the recipient's fiscal year. (The provision for a cognizant or oversight

agency to grant an extension would be retained.) Also, the report submission process would be streamlined.

A copy of the Circular may be obtained from the April 30, 1996, *Federal Register* (61 FR 19134); OMB fax information line (202)395-9063, document number 1133; OMB home page on the Internet which is currently located at http://www.whitehouse.gov/WH/EOP/omb; or by writing or calling the Office of Administration, Publications Office, Room 2200, New Executive Office Building, Washington, DC 20505, telephone (202) 395-7332.

Revisions to the OMB Compliance Supplements

.12 The OMB intends to issue one Compliance Supplement that will combine its *Compliance Supplement for Single Audits of State and Local Governments* and its *Compliance Supplement for Institutions of Higher Learning and Other Non-Profit Institutions* in late 1996. This publication, which will cover state and local governments, colleges, universities, and not-for-profit organizations, will set forth the compliance requirements that are to be considered in single audits. Further, the OMB plans to update the specific program requirements to incorporate new laws and regulations and to make changes to the General Requirements, which will now be called Common Requirements. The Compliance Supplement is also being expanded to include a separate comprehensive section pertaining only to single audits of public housing authorities (see the discussion in the following section).

.13 The Compliance Supplement will also be expanded to include a section illustrating internal controls that could be used by recipients to assure compliance with laws and regulations covered by the Common Requirements. The illustrative internal controls could also assist auditors in assessing whether internal control structure policies and procedures are in place to provide reasonable assurance that the entity is managing federal financial assistance programs in compliance with laws and regulations.

.14 Additionally, the Compliance Supplement is being revised to provide generic suggested audit procedures for the Common and Specific Compliance Requirements, as opposed to procedures for each program compliance requirement (for example, one set of audit procedures for eligibility, regardless of the program).

Issuance of Interim Compliance Supplement for Housing Agencies and Authorities

.15 In early 1995, the U.S. Department of Housing and Urban Development (HUD) issued interim guidance to public housing agencies and indian housing authorities (HAs) for use by auditors performing single audits of HAs in accordance with OMB Circular A-128. The interim guidance is intended to be used until the OMB issues a revised Compliance Supplement (see the discussion in the preceding section). The guidance contains compliance requirements, internal control structure policies and procedures that management should implement to assure compliance with these requirements, and compliance audit procedures. Copies of the interim guidance were mailed to all HAs. Auditors should be aware that this guidance was effective upon issuance and should be used on audits of HAs. Requests for single copies of the guidance should be faxed to Nancy Menhennick at HUD at (202) 401-3963.

Interim Compliance Supplement Revisions for Certain Department of Education Programs

.16 Recent legislation (Improving America's Schools Act, Goals 2000: Educate America Act, and School-to-Work Opportunities Act) has significantly changed the requirements of a number of Department of Education programs included in the Compliance Supplement. These changes are generally effective for the 1995–96 school year. Because of these changes, the U.S. Department of Education in September 1995 issued interim revisions to the Compliance Supplement for four programs that deleted certain compliance requirements and audit procedures that were no longer important for audits covering operations conducted during the 1994–95 school year. That revision is only effective for audits of that period. The affected programs are 84.003 Bilingual Education, 84.010 Educationally Deprived Children—LEAs (Chapter 1), 84.011 Migrant Education, and 84.151 Federal, State, and Local Partnerships for Educational Improvement (Chapter 2). The interim revisions for the 1994–95 year were sent to all school districts and many firms. Requests for additional copies can be faxed to the Department of Education at (202) 205-8238. They are also available on the U.S. General Accounting Office (GAO) electronic bulletin board. (In the section "References for Additional Guidance" see the subsection entitled, "General Accounting Office" for further information on accessing this bulletin board.)

.17 The Department of Education also plans to issue major revisions to the Compliance Supplement sections for these and other programs in the spring of 1996 for audits of operations conducted for the 1995–96 school year, the first year the new laws are effective. These revisions will be sent to all school districts and many firms upon completion. Auditors should be alert for developments in this area.

Municipal Bond Activity

.18 The market for municipal securities is characterized by great diversity and high volume. Issuers include state governments, cities, towns, counties, and special subdivisions, such as special-purpose districts and public authorities. In recent years, the forms of securities used to meet the financing needs of municipal issuers have become increasingly diverse and complex. For example, certificates of participation and a variety of derivative products have joined traditional general obligation and revenue bonds as popular forms of municipal financing. Although the quality of primary offering disclosure in the municipal securities markets has generally improved over the last two decades, there continue to be concerns about the adequacy of municipal offering disclosures. In response to these concerns, both the Securities and Exchange Commission (SEC) and certain members of Congress have increased their interest in municipal bonds.

.19 *Congressional Focus.* Although Congress exempted offerings of municipal securities from the registration requirements and civil liability provisions of the Securities Act of 1933, and a mandated system of periodic reporting under the Securities Exchange Act of 1934, it did not exempt transactions in municipal securities from the coverage of the antifraud provisions of those acts.

.20 In response to the Orange County bankruptcy and similar problems encountered in other state and local governments, certain members of Congress have recently become interested in the area of municipal bond disclosures. In January 1996, legislation was introduced by Senator Hank Brown that would require municipalities that issue $1 billion or more in revenue bonds to conform to the registration and continuous reporting requirements of the Securities Act of 1933 and the Exchange Act of 1934 (S.1549 titled, "Municipal Securities Investor Act of 1996"). With the continuing Congressional focus on budget matters, it is uncertain whether municipal bond legislation will come to a vote during 1996. Auditors should be alert for developments in this area.

.21 *SEC Actions.* Due to increasing concerns over the adequacy of municipal bond disclosures, the SEC has also taken recent actions. A final rule entitled, *Municipal Securities Disclosure*, became effective on July 3, 1995 (Section 17, Code of Federal Regulations (CFR), Part 240, Release No. 34-34961). The final rule amends Rule 15c2-12 under the Securities Exchange Act of 1934 and attempts to deter fraud and manipulation in the municipal securities market by prohibiting the underwriting and subsequent recommendation of securities for which adequate information is not available. The final rule prohibits underwriters from purchasing or selling new issues of municipal securities unless the issuer (a state or local government) and obligated persons provide certain annual information and material event notices to various information repositories. Obligated persons are the persons (including issuers) who are generally committed by contract or other arrangement to support payment of all or part of the obligation, other than providers of bond insurance, letters of credit, or liquidity facilities. Certain issuances of municipal securities, including those with an aggregate principal amount of less than $1 million, are completely exempted from the final rule.

.22 Written agreements or contracts for the benefit of holders of municipal securities will specify which parties must provide annual financial information and event notices. These agreements will also specify the kind of financial information and operating data to be provided, the required accounting principles that will be used to prepare annual financial statements and whether they will be audited, and the date that the financial information will be provided. The required financial information and operating data must be filed annually, with nationally recognized municipal securities information repositories (NRMSIRs) and a state information depository (SID), if one has been created in the issuer's state. Further, all issuers subject to the continuing disclosure requirements will also be required to notify the Municipal Securities Rulemaking Board or all NRMSIRs (and a SID) of the occurrence of certain events relating to covered issues of their bonds, if such events are material. The eleven events, which are detailed in the final rule, include actions such as rating changes, defaults, defeasance, and changes in credit enhancement.

.23 Auditors should also be aware that the SEC issued Interpretive Release No. 33-7049 (Section 17, CFR, Parts 211, 231, and 241) *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*. This interpretive release is cited in the above-described final rule as a source of guidance on the disclosure obligations of issuers of municipal securities and is intended to assist municipal securities issuers, brokers, and dealers in meeting their obligations under the antifraud provisions of the securities laws.

.24 As a result of the additional attention on municipal bonds, there is certain to be an increased focus on official statements and, hence, potentially higher exposure for auditors. The Audit and Accounting Guide *Audits of State and Local Governmental Units* (the Guide), chapter 19, discusses the requirements of AICPA Statement on Auditing Standards (SAS) No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550), and contains guidance for auditors associated with financial statements included in official statements. Also, the recent SEC actions will lead to contractual requirements for issuers that may govern, among other things, required financial information and audit requirements. Therefore, auditors should be alert for potential compliance problems in this area.

.25 *IRS Audits.* The Internal Revenue Service (IRS) is increasing its enforcement activities regarding tax-exempt municipal bonds. Currently, the IRS is auditing about 150 targeted municipal bond issues for possible tax law violations. Most of these audits involve questions relating to arbitrage, which is earned in the municipal bond market by investing tax-exempt bond proceeds in higher yielding obligations and is generally prohibited. These targeted audits have arisen from various factors, including tips from market participants and press reports about allegedly abusive bond transactions. The IRS is also setting up a random audit program to determine the overall level of compliance in municipal bond offerings. These IRS audits are expected to begin during fiscal year 1997 and will, in some cases, include a review of how bond proceeds are used. If the IRS determines that municipal bond issuers did not comply with laws and regulations, the IRS will likely work with the issuers to reach a settlement. However, if such a settlement cannot be reached, the IRS has the authority to tax bondholders on their interest earnings.

.26 The calculation of arbitrage rebate, as well as other aspects of arbitrage law, are complex and continue to be an area of concern for all entities that issue tax-exempt debt. Since a violation in the calculation of arbitrage rebate could result in a liability, auditors should become familiar with the arbitrage rebate regulations issued by the IRS and the regulations for calculating rebate earnings in connection with the accounting for bond proceeds, refunding issues, and proceeds that are commingled with other funds for investment purposes. Regulations regarding the calculation of arbitrage rebate, as well as other aspects of arbitrage law, can be found under Section 148 of the Internal Revenue Code (IRC). Due to the complexity of this area, increased audit scrutiny may be warranted on arbitrage rebate liability computations.

.27 With respect to compliance matters, paragraph 11.34 of the Guide states that auditors should consider obtaining evidence that governmental entities have complied with provisions of indentures and agreements relating to indebtedness, particularly on the use of proceeds, including any restrictions on the use of those proceeds before expenditure for their intended purpose.

IRS Activities

.28 *Section 403(B) Tax-Sheltered Annuities.* Certain governmental entities offer Section 403(B) tax-sheltered annuities to their employees. The IRS has developed an examination program for employers that offer these annuities. To date, examinations have uncovered many deficiencies in employers' plans. These deficiencies have included exceeding the various contribution limits which apply, noncompliance with distribution requirements, inadequate salary reduction agreements, and failure to offer universal availability of salary reduction programs (due to impermissible eligibility restrictions, mandatory contributions, and participant exclusions). Sizable assessments against these employers have been common as a remedy to prevent the programs from being declared taxable. Auditors should be alert to potential liabilities and compliance problems in this area.

.29 The IRS is now offering a Tax-Sheltered Annuity Voluntary Correction (TVC) program to employers who voluntarily identify and correct deficiencies that may exist in their tax-sheltered annuity programs. The TVC program is scheduled to be available through October 31, 1996. Use of the TVC program may result in significantly reduced settlements with the IRS, compared to assessments based on deficiencies discovered during audits performed by the IRS.

.30 *Classification of Employees Versus Independent Contractors.* Many governments, in their efforts to reengineer and streamline operations, are using independent contractors more frequently. Auditors should be aware that the IRS has identified employee–independent contractor classification as an area with significant compliance problems. In 1988, the IRS began a nationwide Employment Tax Examination Program (ETEP) to increase compliance by requiring organizations, including state and local governmental entities, to treat misclassified independent contractors as employees subject to withholding taxes. Employers classifying workers as employees must withhold federal income and Social Security taxes (including Medicare) from employees' pay and match the Social Security and Medicare taxes. Employers are also subject to federal unemployment tax and various state employment taxes. Further, the reclassification of a worker from an independent contractor to employee for federal purposes is likely to cause a similar reclassification for state tax purposes. Since such misclassifications by employers result in compliance problems and potential tax liabilities, auditors should be alert to problems in this area.

Airport Revenue Diversion

.31 Auditors of public airports should be aware that the Federal Aviation Administration (FAA) has issued a notice of proposed policy titled, *Policy and Procedures Concerning the Use of Airport Revenue* (*Federal Register*, February 26, 1996). The proposed policy relates to federal grants received by public airports under the Airport Improvement Program (AIP). Among other things, AIP requires that revenue generated by a public airport is to be expended for the capital or operating costs of the airport. The proposed policy is being issued to alleviate confusion by airports as to how to define *airport revenue* and also in response to reports that certain airports have appeared to be diverting revenue when they were not lawfully permitted. The proposed policy defines airport revenue and *revenue diversion* and discusses the permitted and prohibited uses of airport revenue, and the procedures for monitoring compliance with the revenue use requirement.

.32 The proposal indicates that the FAA will be amending the Compliance Supplement to address the use of airport revenue. However, auditors should be aware that the proposal also states that while the policy statement is not yet effective, public airports should assume that the FAA would act consistently with the views expressed in the document in any enforcement action for revenue diversion.

Audit Issues and Developments

AICPA Guidance on 1994 Revision to *Government Auditing Standards*

.33 A revised edition of the Audit and Accounting Guide *Audits of State and Local Governmental Units* (the Guide) was issued with conforming changes as of May 1, 1995, to incorporate changes resulting from the 1994 revision to *Government Auditing Standards* (the 1994 Revision) issued by the GAO. The 1994 Revision changed the reporting requirements for financial audits performed in accordance with those standards, as well as certain other general and fieldwork standards. Conforming changes were also made to the Guide to update it for other auditing and accounting standards that were issued subsequent to the release of the prior edition. Auditors should ensure that they are using the May 1, 1995, edition of the Guide, particularly since the audit reports in that Guide have been updated to conform to the 1994 Revision.

Determining Whether an Entity Is a Government

.34 The implementation of GASB Statement No. 14, *The Financial Reporting Entity,* has caused governmental entities to consider the inclusion of various not-for-profit entities in their financial reports and to consider whether those entities are governments. As a result, there has been increasing confusion over which set of GAAP apply to certain entities such as health care entities, museums, not-for-profit housing services, foundations, and public radio and television stations. SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AU section 411), recognizes the GASB as the primary standards-setting body for state and local governmental entities and the FASB as the primary standards-setting body for all nongovernment entities.

.35 Auditors performing audits of such entities should carefully consider whether the entity has been appropriately determined to be a governmental or nongovernmental entity. This determination is essential in determining whether the entity should follow the hierarchy of accounting standards applicable to state and local governmental entities or the hierarchy applicable to nongovernmental entities. If an entity is classified as a government, it should follow the hierarchy of accounting standards applicable to state and local governmental entities. The following definition of state and local governmental entities should be considered by auditors in determining whether an entity is applying the appropriate GAAP. This definition was agreed to by both the GASB and FASB during their review of proposed revisions to the AICPA's Audit and Accounting Guides for not-for-profit organizations and health care organizations.

> Public corporations' and bodies corporate and politic are governmental organizations. Other organizations are governmental organizations if they have one or more of the following characteristics:
>
> - Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments;
> - The potential for unilateral dissolution by a government with the net assets reverting to a government; or
> - The power to enact *and* enforce a tax levy.
>
> Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

.36 Another area of confusion concerns whether certain governmental entities should or could apply FASB Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made* (AC C67), and FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations* (AC No5). The GASB has addressed this question in the recently issued GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities* (see the separate discussion of this Statement in the section entitled "Accounting Issues and Developments"). This Statement precludes proprietary activities from changing their accounting and financial reporting to apply FASB Statement Nos. 116 (AC C67) and 117 (AC No5).

Derivatives

.37 Derivatives are financial instruments whose values are derived from underlying market rates or indices. Some governmental entities have incurred significant losses as a result of their use. If legally authorized (or sometimes unless legally prohibited), governmental entities may use derivatives and similar financial instruments for debt, investment, and other purposes. With regard to their debt, governmental entities may enter into interest-rate swaps, or they may issue debt with features such as inverse floating-rates and interest-rate caps, floors, or collars. These transactions may be used to take advantage of changes in interest rates, to change the character of the debt (for example, to convert it from variable-rate debt to fixed-rate debt to mitigate the market risk of volatile interest rates), to lower interest costs, or to make the debt more attractive to investors. With regard to investments, governmental entities may purchase futures contracts and options on financial exchanges and forward contracts, options, and swaps (for example, interest-rate swaps, or foreign-currency swaps) on the over-the-counter markets; may invest in various mortgage-backed securities, such as collateralized mortgage obligations, principal-only strips, and interest-only strips; and may write (sell) forward contracts or options. All of these financial instruments may be used to modify exposure to certain risks, to enhance yields on investments, or to effect changes in investment portfolios without significantly affecting liquidity. Furthermore, governmental entities may invest in these financial instruments indirectly (for example, through an investment pool or a mutual fund).

.38 Debt and investment activity for governmental entities is generally governed by legal or contractual provisions and, in many cases, governments are precluded from entering into most derivative transactions. These legal provisions include those arising from constitutions, charters, ordinances, resolutions, governing body orders, and intergovernmental grant or contract regulations. Auditors should be aware that in response to highly publicized problems encountered at various governments, some states have recently passed legislation regarding investment policies and/or the kinds of investments that are allowable. SAS No. 54, *Illegal Acts by Clients* (AU section 317), requires an auditor to consider laws and regulations that, if noncompliance occurs, could have a direct and material effect on the financial statement amounts. *Government Auditing Standards* also requires auditors to test and report on compliance with laws and regulations. Since many governments are legally precluded from using derivatives, auditors should be alert for possible violations of laws and regulations in this area. The Audit and Accounting Guide *Audits of State and Local Governmental Units*, paragraph 7.25, states that auditors should consider performing procedures, as appropriate, relative to whether there is compliance with the following:

- Legal or official authority for all depositories and investments
- Laws, regulations, and investment policies governing the deposit, investment, and collateralization of public funds

.39 The use of derivatives nearly always increases audit risk. Although the financial statement assertions about derivatives are generally similar to those about other transactions, an auditor's approach to achieving related audit objectives may differ because certain derivatives—such as futures contracts, forward contracts, swaps, options, and other contracts with similar characteristics—are not generally recognized in the financial statements. Many other unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1995/96* [AAM section 8010].

.40 Accounting for derivatives is complex. In December 1994, the GASB staff issued Technical Bulletin (TB) No. 94-1, *Disclosures about Derivatives and Similar Debt and Investment Transactions*, to address financial statement disclosure about derivatives and similar transactions. This TB is effective for financial statements for periods ending after December 15, 1994. In March 1996, the GASB issued an exposure draft titled, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools* (see a separate discussion of the exposure draft in the section entitled "Accounting Issues and Developments"). Auditors should be alert for the issuance of a final GASB standard in this area.

Going Concern

.41 Although it is generally believed that governmental entities will continue as going concerns because of their ability to raise revenues to meet obligations, the Orange County bankruptcy filing and other small special-entity bankruptcy filings have demonstrated that this is not always the case. Taxpayer initiatives and limitations due to the lack of taxpayer resources have placed limits on many governments' taxing power. In addition, many special-purpose governments do not have the power to raise fees or taxes without the support of some other governmental body.

.42 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), requires that, as part of every audit, auditors evaluate whether the results of audit procedures performed identify conditions and events that, when considered in the aggregate, indicate that there could be substantial doubt 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 audited. In making this evaluation, auditors should consider factors such as the likelihood of default on debt (for example, revenues less than originally forecasted for the repayment of revenue bonds), the use of deficit financing bonds, a large unfunded pension obligation combined with diminishing revenues, a declining tax base (for example, declining population, school enrollment, per capita personal income, the number and value of building permits or business licenses, or retail sales), increasing reliance on external funding, and the ability of one fund to continue to support the activities or operations of another fund incurring large deficits (for example, the general fund's ability to continue to support a transit system, or the lottery's ability to continue to provide support to the general governmental operations).

.43 If, after considering the identified conditions and events in the aggregate, an auditor believes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, auditors should consider management's plans for addressing the adverse effects of the conditions and events. Auditors should obtain information about the plans and consider whether it is likely that the adverse effects will be mitigated for a reasonable period of time and that such plans can be effectively implemented. When evaluating management's plans, auditors should identify those elements that are particularly significant to overcoming the adverse effects of the conditions and events and should plan and perform auditing procedures to obtain evidential matter about them.

.44 Auditors should also note that in August 1995, the Audit Issues Task Force (AITF) of the AICPA's Auditing Standards Board (ASB) issued an auditing Interpretation of SAS No. 59 entitled, *Eliminating a Going Concern Explanatory Paragraph From a Reissued Report* (AU section 9341.01–.02). Additional information on this Interpretation (AU section 9341.01–.02) is included in *Audit Risk Alert—1995/96* [AAM section 8010].

Recent Auditing Pronouncements Issued

.45 *SAS No. 75.* In September 1995, the ASB issued SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622), which provides guidance to an accountant concerning performance and reporting in all engagements to apply agreed-upon procedures to specified elements, accounts, or items of a financial statement, except for in certain circumstances, as discussed in the SAS (AU section 622). The Statement (AU section 622) is effective for reports on engagements to apply agreed-upon procedures dated after April 30, 1996, with earlier application encouraged.

.46 *SAS No. 76.* In September 1995, the ASB issued SAS No. 76, *Amendments to SAS No. 72,* Letters for Underwriters and Certain Other Requesting Parties (AU section 634). The SAS (AU section 634) provides reporting guidance and an example of a letter, actually a form of agreed-upon procedures report, that the accountant can provide in response to a request to provide a comfort letter in circumstances in which the party requesting the letter is not willing to provide the accountant with the representations required in paragraphs 6 and 7 of SAS No. 72 (AU section 634.06 and .07). The Statement (AU section 634) is effective for letters issued pursuant to paragraph 9 of SAS No. 72 (AU section 634.09) after April 30, 1996.

.47 *SAS No. 77.* In November 1995, the ASB issued SAS No. 77, *Amendments to SAS No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, *and No. 62,* Special Reports (AU sections 311, 341, and 623), which, among other things, clarifies that a written audit program should be prepared in every audit and precludes the use of conditional language in the auditor's explanatory paragraph to indicate that there is substantial doubt about the entity's ability to continue as a going concern. Of particular interest to auditors of state and local governments, SAS No. 77 (AU sections 311, 341, and 623) precludes general distribution of audited financial statements prepared in accordance with the requirements of financial reporting provisions of a government regulatory agency pursuant to SAS No. 62 (AU section 623). SAS No. 77 (AU sections 311, 341, and 623) is effective for engagements beginning after December 15, 1995. Additional information is included in the *Audit Risk Alert—1995/96* [AAM section 8010].

.48 *SAS No. 78.* In December 1995, the ASB issued SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AU section 319), which revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* (the COSO Report), published by the Committee of Sponsoring Organizations of the Treadway Commission, formed to address the Report of the National Commission on Fraudulent Reporting. This Statement (AU section 319) is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

.49 *SAS No. 79.* In December 1995, the ASB issued SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements (AU section 508), which eliminates the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report. SAS No. 79 (AU section 508) also clarifies and reorganizes the guidance in SAS No. 58 (AU section 508) concerning emphasis paragraphs, matters involving uncertainties, and disclaimers of opinion. This SAS (AU section 508) does not affect SAS No. 59 (AU section 341) nor preclude auditors from adding a paragraph to their report to emphasize a matter disclosed in the financial statements. This SAS (AU section 508) is effective for reports issued or reissued on or after February 29, 1996, with earlier application permitted. Auditors should be alert for the issuance of a revised edition of the Audit and Accounting Guide *Audits of State and Local Governmental Units,* which will be issued with conforming changes as of May 1, 1996. Among other conforming changes, the revision will update certain of the illustrative reports to reflect the issuance of SAS No. 79 (AU section 508).

Recent Attestation Standards Issued

.50 *SSAE No. 4.* In September 1995, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 4, *Agreed-Upon Procedures Engagements* (AT section 600). SSAE No. 4 (AT section 600) sets forth attestation standards and provides guidance on the performance and reporting in all agreed-upon procedures engagements, except for in certain circumstances, and is effective for reports on agreed-upon procedures engagements dated after April 30, 1996. SSAE No. 4 (AT section 600) generally should be used when applying agreed-upon procedures to nonfinancial statement subject matter. In addition, SSAE No. 4 (AT section 600) requires a written assertion from management as a condition of engagement performance.

.51 *SSAE No. 5.* In November 1995, the ASB issued SSAE No. 5, *Amendment to Statement on Standards for Attestation Engagements No. 1,* Attestation Standards (AT section 100). This amendment (AT section 100) provides guidance on the quantity, type, and content of working papers for attestation engagements and is effective for engagements beginning after December 15, 1995.

.52 *SSAE No. 6.* In December 1996, the ASB issued SSAE No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AT section 400). This amendment (AT section 400) conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 (AU section 319) (see discussion in the preceding section) and *Internal Control—Integrated Framework.* The amendment (AT section 400) is effective for an examination of management's assertion when the assertion is as of or for the period ending December 15, 1996, or thereafter. Early application of the provisions of this Statement (AT section 400) is permitted.

Two New Quality Control Standards Issued

.53 In May 1996, the ASB issued Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (QC section 20) and No. 3, *Monitoring a CPA Firm's Accounting and Auditing Practice* (QC section 30). SQCS No. 2 (QC section 20) supersedes SQCS No. 1, *System of Quality Control for a CPA Firm and its Interpretations* (QC sections 10 and 10-1). The provisions of these Statements (QC sections 20 and 30) are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 1997.

.54 SQCS No. 2 (QC section 20) redefines a firm's accounting and auditing practice to include all audit, attest, and accounting and review services for which professional standards have been established by the ASB or the Accounting and Review Services Committee under Rules 201, *General Standards* (ET section 201), and 202, *Compliance With Standards* (ET section 202), of the AICPA *Code of Professional Conduct.* The definition of a firm's accounting and auditing practice has been revised to include engagements performed under SSAEs issued by the ASB. These standards had not been issued when SQCS No. 1 (QC section 10) was promulgated. Also, the new standard replaces the nine specific elements discussed in SQCS No. 1 (QC section 10) with the following five broad elements—independence, integrity, and objectivity; personnel management; acceptance and continuance of clients and engagements; engagement performance; and monitoring. SQCS No. 3 (QC section 30) provides guidance on how a firm can implement the new monitoring element of a quality control system in its accounting and auditing practice.

Client Representations

.55 On occasion, auditors of governmental entities may encounter difficulties obtaining a representation letter if, for example, the responsible administrative officer is an elected official whose term differs from the government's reporting year. Auditors should be aware that an interpretation of SAS No. 19, *Client Representations* (AU section 333), was issued in October 1995 that addresses this problem. The Interpretation, entitled *Management Representations When Current Management Was Not Present During the Period Under Audit* (AU section 9333.05–.06), discusses auditors' responsibilities for obtaining written representations in an audit engagement when current management was not present during the period under audit. When confronted with this situation, the Interpretation (AU section 9333.05–.06) states that auditors should obtain written representations from current management on all periods covered in their report. The Interpretation (AU section 9333.05–.06) appeared in the October 1995 *Journal of Accountancy* and was effective upon publication. Additional information on this and other recently issued Interpretations is included in the *Audit Risk Alert—1995/96* [AAM section 8010].

Revisions to Ethics Interpretation 101-10

.56 As a result of the issuance of GASB Statement No. 14, questions have arisen about the independence requirements of primary government auditors and component unit auditors. In response to these questions, the AICPA Professional Ethics Executive Committee has issued a revision to Ethics Interpretation 101-10, *The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements* (ET section 101.12), under Rule 101, *Independence* (ET section 101.01), of the AICPA *Code of Professional Conduct.* This Interpretation (ET section 101.12) can be found in the January 1996 *Journal of Accountancy.*

.57 Auditors should be aware that at the same time that the AICPA Professional Ethics Executive Committee issued this revised Interpretation (ET section 101.12), it deleted Ethics Ruling No. 83, *Member on Board of Component Unit and Auditor of Oversight Entity,* and Ethics Ruling No. 84, *Member on Board of Material Component Unit and Auditor of Another Material Component Unit.*

Indemnification of a Client

.58 Recently, the AICPA Professional Ethics Executive Committee issued Ethics Ruling No. 102, *Member's Indemnification of a Client* (ET section 191.204–.205), in the January 1996 *Journal of Accountancy*. This Ruling (ET section 191.204–.205) states that auditors should not enter into agreements that would require them to indemnify their client for damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or indirectly, to client acts, or their independence will be impaired. The use of such clauses by state and local governments in Requests for Proposal (RFP) and audit contracts have been on the increase. Therefore, auditors should carefully review RFP and audit contracts for such clauses before entering into them.

Environmental Liabilities

.59 State and local governmental entities are subject to a number of financial risks as a result of environmental hazards or issues. Risks may arise, for example, from a governmental entity's operations, from properties owned or operated by a governmental entity (such as schools built with asbestos or landfills identified as Superfund sites), or from facilities acquired by a governmental entity based on tax liens (such as an old filling station with leaking underground storage tanks). The GASB Implementation Guide, *Guide to The Implementation of GASB Statement 10 on Accounting and Reporting for Risk Financing and Related Insurance Issues*, Question 75, addresses whether environmental liabilities are included in the scope of GASB Statement No. 10. It states the following:

> The scope of GASB Statement 10 neither specifically includes nor excludes environmental liabilities, which are liabilities that have arisen from events such as toxic waste spills and contamination of water supplies by waste sites. These types of liabilities could be considered to be under the scope of Statement 10 as "torts," "destruction of assets," or "business interruption." In any case, in the absence of specific guidance from the GASB (or from other sources deemed applicable using the GAAP hierarchy) on environmental liabilities, *claims* related to environmental liabilities should be measured and recognized in accordance with Statement 10. The provisions of GASB Statement No. 18, *Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs*, should be applied to entities covered by the scope of the Statement.

Auditors should inquire of management and, as appropriate, legal counsel about the status of any actions or litigation related to environmental issues.

Audit Quality

.60 The AICPA and the President's Council on Integrity and Efficiency (PCIE) are involved in a cooperative effort in which Federal Inspectors General (IG) of government agencies refer to the AICPA Professional Ethics Division audits of entities receiving federal financial assistance that the agencies consider to be of a substandard nature. Information gathered during these investigations about the most common deficiencies can be useful to auditors when undertaking, planning, and conducting audit engagements of entities receiving federal financial assistance. Some of the more common deficiencies include the following:

- Inadequate or no client representation letter
- Deficient auditor's reports (Reports on the internal control structure or compliance with applicable laws and regulations were missing, or did not include all of the required information.)
- Noncompliance with *Government Auditing Standards* or federal agency audit guide (This includes failure to adequately test internal controls or compliance with applicable laws and regulations, inadequate documentation of substantive testing of significant compliance/provisions of laws and regulations, and failure to report all findings.)

- Inadequate working papers (This includes failure to include adequate documentation to support the auditor's opinion.)

The risks and ramifications to auditors of issuing deficient audit reports or performing inadequate audits are significant and include suspension from performing further audits of recipients of federal funds.

Reporting When Portions of a Reporting Entity Do Not Have a Yellow Book Audit

.61 Since the implementation of GASB Statement No. 14, it is becoming more frequent for primary governments that are required to have an audit conducted in accordance with *Government Auditing Standards* (also known as the Yellow Book) to include component units as part of the reporting entity that are not required to have such an audit. As a result, there has been increasing confusion in practice over whether the auditor's report on a government's general-purpose financial statements and the *Government Auditing Standards* reports on internal control and compliance need to be modified when this situation is encountered.

.62 With regard to the report on the general-purpose financial statements of the reporting entity, if a material component unit or fund is not required to have an audit in accordance with *Government Auditing Standards* and the report on the general-purpose financial statements is required to state that the audit was conducted in accordance with *Government Auditing Standards,* auditors should modify the scope paragraph as follows:

> We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. The financial statements of [*name of fund or component unit*] were not audited in accordance with *Government Auditing Standards*. . . .

With regard to the reports on internal control and compliance required by *Government Auditing Standards,* auditors should modify the scope paragraphs of these reports as follows:

> We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. The financial statements of [*name of fund or component unit*] were not audited in accordance with *Government Auditing Standards* and accordingly this report does not extend to that [*fund or component unit*]. . . .

Compliance Attestation

.63 Auditors may be engaged to express an opinion or perform agreed-upon procedures regarding a governmental entity's compliance with specified requirements of state or local laws, regulations, contracts, and grants. For example, an auditor may be engaged to express an opinion about whether a local county's schools comply with specific state requirements regarding curriculum content or pupil transportation. In such situations, auditors should perform an attestation engagement in accordance with SSAE No. 3, *Compliance Attestation* (AT section 500). SSAE No. 3 (AT section 500) provides guidance for engagements related to management's written assertion about an entity's compliance with the requirement of specified laws, regulations, rules, or contracts not involving governmental financial assistance. Under SSAE No. 3 (AT section 500), management is required to present a written assertion about the organization's compliance with the specified requirements. Auditors should note that SSAE No. 3 (AT section 500) does not apply to engagements for which the objective is to report in accordance with SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AU section 801), unless the terms of the engagement specify an attestation report under SSAE No. 3 (AT section 500).

Accounting Issues and Developments

.64 The GASB has issued several new financial accounting or reporting standards applicable to state and local governments. Some of these standards are effective for the first time in 1996. Other standards will not be effective until after 1996; however, the GASB encourages early application. Auditors should determine which standards a state or local government is either required to adopt in the current year or has elected to adopt early.

GASB Statements Effective During 1996

.65 *Certain Grants and Other Financial Assistance.* In June 1994, the GASB issued GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance,* which is effective for periods beginning after June 15, 1995. GASB Statement No. 24 establishes accounting and financial reporting standards for pass-through grants, food stamps, and on-behalf payments for fringe benefits and salaries.

.66 Pass-through grants are those grants that a recipient government receives to transfer to or spend on behalf of a secondary recipient. GASB Statement No. 24 generally requires recipient governments to recognize all cash pass-through grants as revenue and expenditures or expenses in a governmental, proprietary, or trust fund. It also requires state governments to report the food stamp benefits they distribute as revenue and expenditures in the general fund or a special revenue fund. Food stamp balances at year-end should be reported in the balance sheet as an asset (but not as a cash equivalent), offset by deferred revenue. On-behalf payments for fringe benefits and salaries are direct payments made by one entity to a third-party recipient for the employees of another, legally separate entity. GASB Statement No. 24 requires employer governments to recognize revenue and expenditures or expenses for these on-behalf payments and provides guidance on how to measure and report the revenue and expenditures or expenses. It also requires governmental entities that make on-behalf payments for fringe benefits and salaries to classify those payments in the same manner that they classify similar cash grants to other entities.

.67 *The Use of Not-for-Profit Accounting Principles.* In August 1995, the GASB issued GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities.* This project was added to the GASB's technical agenda because of questions concerning whether certain governmental entities could apply not-for-profit accounting and financial reporting principles, especially FASB Statement Nos. 116 (AC C67) and 117 (AC No5) (see the separate discussion of determining whether an entity is a government in the section entitled "Audit Issues and Developments").

.68 GASB Statement No. 29 provides that governmental entities that have been applying not-for-profit accounting and financial reporting principles by following AICPA Statement of Position (SOP) 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations,* or Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations,* should apply the governmental model or the AICPA not-for-profit model. The AICPA not-for-profit model consists of the accounting and financial reporting principles contained in SOP 78-10 or *Audits of Voluntary Health and Welfare Organizations*—except for the provisions relating to the joint costs of informational materials and activities that include a fund-raising appeal—as modified by all applicable FASB pronouncements issued through November 30, 1989, and as modified by most applicable GASB pronouncements.

.69 The Statement also provides that proprietary activities that apply the provisions of paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting,* should apply only those FASB Statements and Interpretations issued after November 30, 1989, that are developed for business enterprises. They should not apply FASB Statements and Interpretations whose provisions are limited to not-for-profit organizations or address issues concerning primarily such organizations (such as FASB Statement Nos. 116 [AC C67] and 117 [AC No5]).

.70 The provisions of the Statement are generally effective for financial statements for periods beginning after December 15, 1994; the modifications of the AICPA Not-for-Profit model for certain GASB pronouncements is effective for entities that previously have not applied those pronouncements for periods beginning after December 15, 1995, with earlier application encouraged.

GASB Statements Effective After 1996, With Early Application Encouraged

.71 *Pension Accounting.* In November 1994, the GASB issued three pension-related Statements: GASB Statement Nos. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans;* 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans;* and 27, *Accounting for Pensions by State and Local Governmental Employers.* GASB Statement Nos. 25 and 27 supersede most of the existing standards for reporting pension information in governmental financial reports. GASB Statement No. 25 addresses the information that should be reported for a pension plan, whether the plan (or the public employee retirement system that administers the plan) issues a separate report or is included as a pension trust fund in the financial report of the plan sponsor or participating employer. GASB Statement No. 27 includes reporting requirements for an employer's expenditures/expense for contributions to a pension plan. GASB Statement No. 26 is an interim Statement pending completion of GASB's project on other postemployment benefits and includes reporting requirements for defined benefit plans that administer postemployment health-care plans. GASB Statement Nos. 25 and 26 are effective for periods beginning after June 15, 1996. GASB Statement No. 27 is effective for periods beginning after June 15, 1997. Early implementation is encouraged for all three Statements.

.72 The implementation of GASB Statement No. 25 will require actuarial involvement and GASB Statement No. 27 will require a retroactive assessment of the net pension obligation. Although these pension pronouncements are not effective during 1996, auditors may want to consider encouraging their clients to conduct a review of these pronouncements to ensure a smooth transition. As of the date of this Audit Risk Alert, the GASB is working on the development of an Implementation Guide that is expected to be issued during 1997.

.73 *Securities Lending Transactions.* In May 1995, the GASB issued GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions,* which is effective for financial statements for periods beginning after December 15, 1995, with early application encouraged. GASB Statement No. 28 establishes accounting and financial reporting standards for securities lending transactions. In these transactions, governmental entities lend their securities to broker-dealers and other entities for collateral—which may be cash, securities, or letters of credit—and simultaneously agree to return the collateral for the same securities in the future.

.74 GASB Statement No. 28 requires governmental entities to report their loaned securities as assets. If cash is received as collateral on the loan, it would also be reported as an asset, along with any investments made with the cash. Securities received as collateral would be reported as assets if the governmental entity is able to pledge or sell them without a borrower default. Liabilities resulting from these transactions should also be reported in the balance sheet. Securities lending transactions collateralized by letters of credit or by securities that the governmental entity does not have the ability to pledge or sell unless the borrower defaults should not be reported as assets and liabilities.

.75 GASB Statement No. 28 also requires that the costs of securities lending transactions, such as borrower rebates (interest costs) and agent fees, be reported as expenditures or expenses. These costs should not be netted with interest revenue or income from the investment of cash collateral, any other related investments, or loan premiums or fees.

.76 In addition, GASB Statement No. 28 requires disclosure of the source of legal or contractual authorization for the use of securities lending transactions, any significant violations of those provisions during the period, whether the maturities of the investments made with cash collateral generally match the maturities of the securities loans, and summary information about the credit risk associated with the transactions at the balance sheet date. Disclosure of general information about the transactions is also required, such as the types of securities lent, the types of collateral received, whether the government has the ability to pledge or sell collateral securities without a borrower default, the amount by which the value of the collateral provided is required to exceed the value of the underlying securities, any restrictions on the amount of the loans that can be made, and any loss indemnification provided to the entity by its securities lending agents. Disclosure is also required of the carrying amount and market or fair values of underlying securities at the balance sheet date. GASB Statement No. 28 also provides guidance for classifying securities lending collateral and the underlying securities in the categories of custodial credit risk required by GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements.*

.77 *Risk Financing Omnibus.* In February 1996, the GASB issued GASB Statement No. 30, *Risk Financing Omnibus,* an amendment of GASB Statement No. 10, that is effective for financial statements for periods beginning after June 15, 1996, with early application encouraged.

.78 For public entity risk pools, GASB Statement No. 30 modifies the method for calculating a premium deficiency, and it requires recognition of a premium deficiency liability and expense for the amount by which the premium deficiency exceeds unamortized acquisition costs. It also requires disclosure in the notes to the financial statements about the type of reinsurance or excess insurance coverage for certain claims costs, and requires presentation of gross, ceded, and net premiums and claims costs in the ten-year revenue and claims development information. Furthermore, GASB Statement No. 30 provides that claims development information should be reported consistently on an accident-year basis, a report-year basis, or a policy-year basis. It also allows presentation of additional percentage information.

.79 For entities other than pools, GASB Statement No. 30 includes specific, incremental claim adjustment expenditures/expenses and estimated recoveries (such as salvage and subrogation) in the determination of the liability for unpaid claims. Also, it requires disclosure of whether other claim adjustment expenditures/expenses are included in the liability for unpaid claims.

GASB Interpretations Effective After 1996, With Early Application Encouraged

.80 *Disclosures of Conduit Debt Obligations.* In August 1995, the GASB issued GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations,* which is effective for financial statements for periods beginning after December 15, 1995, with early application encouraged. This Interpretation provides disclosure requirements for conduit debt obligations. Conduit debt obligations are certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing capital financing for a specific third party that is not part of the issuer's financial reporting entity. Although conduit debt obligations bear the name of the governmental issuer, the issuer has no obligation for such debt beyond the resources provided by a lease or loan with the third party on whose behalf they are issued.

.81 The required disclosures include a general description of the conduit debt transactions, the aggregate amount of all conduit debt obligations outstanding at the balance sheet date, and a clear indication that the issuer has no obligation for the debt beyond the resources provided by related leases or loans.

.82 *Reverse Repurchase Agreements.* In January 1996, the GASB issued GASB Interpretation No. 3, *Financial Reporting for Reverse Repurchase Agreements,* which is effective for financial statements for periods beginning after December 15, 1995, with early application encouraged. The purpose of the Interpretation is to reconcile the differences between certain reporting requirements of GASB Statement No. 3 for reverse repurchase agreements and GASB Statement No. 28 for securities lending transactions. It provides guidance for reporting reverse repurchase agreements balances and transactions among participating funds in investment pools and for disclosing whether the maturities of the investments made with the proceeds of the agreements generally match the maturities of the agreements.

.83 *Capitalization Contributions.* In February 1996, the GASB issued GASB Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools,* an Interpretation of GASB Statement No. 10 and 14, that applies to capitalization contributions made to and received by public entity risk pools, both with and without the transfer or pooling of risk. The Interpretation is effective for financial statements for periods beginning after June 15, 1996, with early application encouraged.

.84 GASB Interpretation No. 4 requires entities to report capitalization contributions made to public entity risk pools with transfer of risk as deposits if a return of those contributions is probable. Otherwise, entities should report the contributions as prepaid insurance (an asset) to be allocated as expenditures/expenses over future periods (not to exceed ten years under certain circumstances) or, alternatively, in governmental funds, as expenditures in the period made. In neither case should entities report those capitalization contributions (or any participation in those pools) as equity interests in joint ventures. Furthermore, entities should continue to report capitalization contributions to public entity risk pools without transfer or pooling of risk as deposits or reductions of claims liabilities. The Interpretation also provides guidance for public entity risk pools that make capitalization contributions to other pools (such as excess pooling arrangements) in which they participate.

.85 This Interpretation requires public entity risk pools with transfer or pooling of risk to report capitalization contributions received as liabilities if a return of those contributions is probable. Otherwise, those pools should report the contributions as unearned premiums to be allocated as premium revenue over future periods (not to exceed ten years under certain circumstances). Public entity risk pools without transfer or pooling of risk should net capitalization contributions with other amounts and report assets or liabilities, as appropriate.

Recent GASB Exposure Drafts Issued

.86 *Accounting and Financial Reporting for Investments.* In March 1996, the GASB issued an exposure draft of a proposed Statement, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools,* that would establish accounting and financial reporting standards for all investments held by governmental external investment pools (see a separate discussion in the following section regarding the existing investment accounting rules that governmental entities should be following until the GASB issues a final Statement). For most other governmental entities, it would establish fair value standards for investments in (*a*) interest-earning investment contracts, (*b*) external investment pools and open-end mutual funds, (*c*) debt securities, and (*d*) equity securities, option contracts, stock warrants, and stock rights that have readily determinable fair values. For defined benefit pension plans and IRC Section 457 deferred compensation plans, it would provide guidance for applying fair value to certain investment transactions. The GASB is expected to issue a final Statement in late 1996.

.87 *Affiliated Organizations.* In December 1994, the GASB issued an exposure draft of a proposed Statement, *The Financial Reporting Entity—Affiliated Organizations,* that would establish standards to determine whether an organization should be classified as an affiliated organization and, if so, would establish criteria to determine whether that affiliated organization is a component unit of a primary government's financial reporting entity. The proposed Statement also would establish financial reporting guidance for those organizations that are governmental entities. It would apply to financial reporting by primary governments and other stand-alone governments, and to the separately issued financial statements of governmental component units as defined in GASB Statement No. 14. The GASB is expected to issue a final Statement in early 1997.

Other Accounting and Disclosure Issues

.88 *Current Governmental Accounting for Investments.* Questions continue to be raised as to when an investment should be written down for a governmental entity. Further, there is also confusion as to whether an investment that has been written down for "other than temporary" declines may be written back up to market now that certain investment values have rebounded. Although the GASB recently issued an exposure draft of a proposed Statement on accounting and financial reporting for investments, there are currently no specific GASB pronouncements that address the measurement and recognition of the value of investments for state and local governmental entities (see the separate discussion of the recent GASB exposure draft in the preceding section). However, proprietary activities that apply paragraph 7 of GASB Statement No. 20 should apply the provisions of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80). Furthermore, FASB Statement No. 12, *Accounting for Certain Marketable Securities*, which requires lower of cost or market accounting, is not applicable to either proprietary funds or governmental funds. The GASB reiterated this position in paragraph 25a in the "Basis for Conclusions" to GASB Statement No. 20.

.89 Except for proprietary activities that apply FASB Statement No. 115 (AC I80), governmental and proprietary funds generally report equity securities at cost and debt securities at cost or amortized cost. According to the Audit and Accounting Guide *Audits of State and Local Governmental Units*, paragraph 7.15, which is category (b) guidance in the hierarchy of GAAP, "investments reported in governmental funds are generally valued at cost." Furthermore, in governmental funds, fund balance generally should be reserved for the carrying value of noncurrent investments—not just for a decline in value. According to the Guide, paragraph 12.07, reservations of fund balance may be used to indicate that a portion of the fund balance is "not appropriable for expenditure because the underlying net asset is not an available financial resource for current appropriation or expenditure...." This is consistent with National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 118.

.90 If a government's intent is not to hold to maturity and, thus, investments are considered to be available resources not requiring a reserve, then the following guidance should be applied: In accordance with FASB Statement No. 5, *Accounting for Contingencies* (AC C59), and Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 3A, paragraph 9 (AC B05.017A), if a decline in the value of investments is other than temporary and it is probable that the government will incur a loss (for example, by having to liquidate the securities to meet its needs for operating resources), then the investments should generally be written down. (See the following paragraphs for possible exceptions.) This determination should be made for individual securities—not for a portfolio of investments in aggregate.

.91 If all of the following are true, then the securities should be reported at cost.

a. Such investments are in a government fund (or expendable trust fund).

b. The government has the intent and ability to hold the securities to maturity.

c. It is probable that the securities will be held to maturity and no loss will be realized.

d. Fund balance is reserved for the carrying value of the investments.

Furthermore, if all of the following are true, then the securities should be reported at cost.

a. Such investments are in a proprietary fund (or expendable trust fund).

b. The government has the intent and ability to hold the securities to maturity.

c. It is probable that the securities will be held to maturity and no loss will be realized.

d. The investments are classified as noncurrent assets.

In any particular situation, of course, professional judgment is required. When all of the conditions are met, disclosure of the decline in market value is appropriate to keep the financial statements from being misleading. This may include disclosures in addition to the market value disclosure required by GASB Statement No. 3, paragraph 68. For example, GASB TB No. 94-1 requires disclosure of information such as the risks related to certain investments.

.92 In the event that the value of written-down investments subsequently rises, no gain should be recorded until sale or maturity. In the interim, only a disclosure on the gain contingency may be made, in accordance with FASB Statement No. 5, paragraph 17 (AC C59.118). Furthermore, the difference between the new cost basis and the maturity value of fixed income securities should be amortized to investment income over the remaining life of the investment.

References for Additional Guidance

AICPA

.93 *Publications.* The following are some AICPA publications that may be of interest to auditors of state and local governmental units.

- Audit and Accounting Guide *Audits of State and Local Governmental Units*—See a separate discussion of this Guide in the section entitled "Audit Issues and Developments."
- *Checklists and Illustrative Financial Statements for State and Local Governmental Units* (No. 008697)
- *Internal Control—Integrated Framework* (No. 990009)—This report was commissioned by the Committee of Sponsoring Organizations of the Treadway Commission to establish a common definition of internal control that serves the needs of different parties for not only assessing their control systems, but also determining how to improve them; also available as a software package on WordPerfect (No. 990003) to help users identify and report on potential control deficiencies.

.94 *AICPA Continuing Professional Education (CPE) Courses.* The AICPA Governmental/Nonprofit Accounting and Auditing Certificate of Educational Achievement Program consists of the following series of CPE courses:

- Governmental Accounting and Financial Reporting: Issues and Implications (GAA1)
- Financial Audits of Governmental Entities (GAA2)
- Nonprofit Accounting: Issues and Implications (NAA1)
- Nonprofit Auditing: Issues and Implications (NAA2)
- Issues and Implications of *Government Auditing Standards* (GNP3)
- Performing the Single Audit (GNP4)

On successful completion of the program, the participant is awarded a certificate.

.95 In addition, the AICPA offers group study and self-study courses. Group study courses include the following:

- Accounting for Governmental Units Under GASB
- Audit Requirements of OMB Circular A-133
- Audits of Multifamily and Single Family Mortgagees and Loan Correspondents Participating in HUD Programs
- Audits of HUD-Assisted Projects
- Advanced Auditing of HUD-Assisted Projects
- Advanced Accounting for Governmental Units Under GASB
- Compliance Auditing

- Cost Principles for Nonprofit Organizations under OMB Circular A-133
- Governmental Auditing and Accounting Update
- How to Perform an Audit of a Local Government
- Performing a Single Audit for State and Local Governments
- Yellow Book: *Government Auditing Standards*

Self-study courses include the following:

- Introduction to Governmental Accounting
- Performing a Single Audit for State and Local Governments
- Audits of State and Local Governmental Units
- Understanding Federal Audit Policies and Procedures
- Working With the Revised Yellow Book on *Government Auditing Standards*
- Accounting for Nonprofits: Contributions and Financial Statements
- Audit Requirements of OMB Circular A-133
- HUD Audits: A Comprehensive Guide
- Accounting and Auditing for Certain Nonprofit Organizations
- Governmental Accounting and Auditing Update
- Introduction to Accounting Requirements for Government Contracts
- Compliance Auditing
- Audits of Farmers Home Administration Programs
- Advanced Accounting for Governmental Units Under GASB
- Communicating Material Noncompliance and Material Internal Control Weaknesses
- Selected Readings in Governmental and Nonprofit Accounting and Auditing

.96 The following video courses are also available:

- Effective Yellow Book Auditing
- 1995 Government Auditing and Accounting
- 1995 Nonprofit Auditing and Accounting

For more information about AICPA CPE courses, call the AICPA information hotline at (800) 862-4272.

.97 *Accountants Forum.* The Accountants Forum is the AICPA's national, online computer network. It is available on the CompuServe Information Service. Through the forum, AICPA members are able to communicate with the AICPA, state CPA societies, other professional organizations, and each other; have access to many publications, products, and services of the AICPA, the state societies, and others; can research a myriad of business information databases on the CompuServe system; and have full Internet access. Members can also send private e-mail messages to any worldwide Internet address. To set up a CompuServe account, call (800) 524-3388 and ask for the "AICPA package" or "rep. 748."

.98 *Fax Hotline.* The AICPA has a 24-Hour Fax Hotline that enables members to obtain pertinent information from a fax machine twenty-four hours a day, seven days a week. Current AICPA comment letters, conference brochures and registration forms, CPE information, AICPA Accounting Standards Executive Committee actions, and legislative news are some of the kinds of documents that can be retrieved on the Fax Hotline. To access the hotline, simply dial (201) 938-3787 from a fax machine, follow the voice cues, and when prompted, provide the number(s) of the document(s) desired. A list of all items available through this service may be obtained via the Fax Hotline by entering document number 1.

Governmental Accounting Standards Board

.99 The GASB offers the following publications and services:

- *Codification of Governmental Accounting and Financial Reporting Standards*, as of June 30, 1995 (GCD95)—An edition as of June 30, 1996, is expected to be issued in late summer 1996.
- *GASB Original Pronouncements*, as of June 30, 1995 (GOP95)—An edition as of June 30, 1996, is expected to be issued in late summer 1996.
- GASB Implementation Guides—These question-and-answer special reports are an occasional service containing implementation guidance for GASB standards. To date, the GASB has issued Implementation Guides for GASB Statement Nos. 3, 9, 10, and 14.
- GASB *Action Report*—This is a monthly newsletter.
- Governmental Accounting Research System (GARS)—This information-based software package allows research on GASB literature.

GASB publications and services can be obtained by calling the GASB Order Department at (203) 847-0700, extension 555.

Single Audit Information Service

.100 The *Single Audit Information Service* is a loose-leaf reference service offered by the Thompson Publishing Group. It explains how to implement the single audit and provides an update of current events in the governmental audit community. The *Single Audit Information Service* can be ordered by calling the Thompson Publishing Group at (800) 677-3789.

Federal Agencies—Administrative Regulations

.101 Most federal agencies issue general administrative regulations that apply to their programs. These regulations provide general rules on how to apply for grants and contracts, how grants are made, the general conditions that apply to and the administrative responsibilities of grantees and contractors, and the compliance procedures used by the various agencies. The regulations are included in the *Code of Federal Regulations*.

.102 In 1988, a final rule, *Uniform Administrative Requirements for Grants and Cooperative Agreements with State and Local Governments*, was published, establishing a *common* rule to create consistency and uniformity among federal agencies in the administration of grants to and cooperative agreements with state, local, and federally recognized Indian tribal governments. The common rule has been codified in each federal agency's portion of the *Code of Federal Regulations*.

.103 It should also be noted that federal agencies have also codified and revised OMB Circular A-128 in each agency's portion of the *Code of Federal Regulations*. Although the OMB *Compliance Supplement for Single Audits of State and Local Governments* sets forth the compliance requirements for programs contributing a great majority of funding to state and local governments, federal agencies also develop specific compliance requirements for use in auditing programs not included in the OMB document. These can be obtained directly from the regional office of the appropriate federal agency.

.104 Auditors should also be aware that many agencies have program-specific and other audit requirements that are not covered by OMB Circular A-128. Such requirements may relate to certain programs (such as student financial assistance or HUD-insured mortgage programs), as well as to contract audit requirements.

General Accounting Office

.105 GAO publications include the following:

- *Government Auditing Standards, 1994 Revision*—These standards relate to audits of government organizations, programs, activities, and functions and of government assistance received by contractors, nonprofit organizations, and other nongovernment organizations. The standards incorporate the AICPA Statements on Auditing Standards but prescribe additional standards needed to meet the more varied interests of users of reports on governmental audits. These standards are available from the Government Printing Office, Superintendent of Documents, Washington, DC 20401; telephone (202) 783-3238; telefax (202) 512-2250; Stock No. 020-000-00-265-4.
- *Interpretation of Continuing Education and Training Requirements*—This provides guidance to audit organizations and individual auditors on implementing the CPE requirements of *Government Auditing Standards* (April 1991, 020-000-00250-6). This Interpretation is available from the Government Printing Office, Superintendent of Documents, Washington, DC 20401.
- *Assessing Compliance with Applicable Laws and Regulations*—This booklet, issued by the GAO Office of Policy (OP), is intended to help auditors implement requirements for detecting noncompliance (December 1989, GAO/OP-4.1.2).
- *Assessing the Reliability of Computer-Processed Data*—This guidebook is intended mainly for auditors and evaluators, not for experts in data processing. It provides some guidelines on what auditors must do to satisfy the requirements of *Government Auditing Standards* (September 1990, GAO/OP-8.1.3).
- *Assessing Internal Controls in Performance Audits*—This guidebook relates specifically to performance audits (September 1990, GAO/OP-4.1.4).
- *Guide to Federal Agencies' Procurement of Audit Services from Independent Public Accountants (IPA)*—This booklet provides a basic understanding of how IPA contracts should be awarded to officials unfamiliar with federal procurement. It discusses the special requirements of the Chief Financial Officers (CFO) Act (April 1991, GAO/AFMD-12.19.3).
- *How to Get Action on Audit Recommendations*—This guide is intended to help auditors get more action and better results from their audit work on governmental programs and operations (July 1991, GAO/OP-9.2.1).

Unless otherwise noted above, requests for copies of these publications should be sent to the GAO, P.O. Box 6015, Gaithersburg, MD 20884-6015. The telephone number is (202) 512-6000. GAO's OP has established a bulletin board (BBS) to provide access to the latest electronic data that is maintained by the GAO OP. The BBS contains the electronic edition of *Government Auditing Standards*, the status of GAO's open recommendations, and GAO's audit policy guidance. Dial (202) 512-4286 to access this BBS. Set Internet users can connect to this BBS via Fedworld's BBS (fedworld.gov) gateway #135 and the U.S. Department of Justice's IGnet (ignet.usdoj.gov).

Office of Management and Budget—Circulars

.106 In consultation with grant-making agencies, the GAO, and representatives of grant recipients, the OMB developed a series of financial circulars that establish uniform policies and rules to be observed by all executive-branch agencies of the federal government. Circulars and other documents relevant to audits of state and local governmental units are listed below. For copies of circulars and bulletins, write or call the Executive Office of the President, Publications Office, Room 2200, New Executive Office Building, Washington, DC 20503; telephone (202) 395-7332.

OMB Circulars Relevant to Audits of State and Local Governments

Circular Number	*Applicability*	*Issue Date*
A-21 (Revised)	Cost principles for educational institutions	April 1996
A-87 (Revised)	Cost principles for state and local governments	May 1995
A-102 (Revised)	Grants and cooperative agreements with state and local governments	October 1994
A-122 (Revised)	Cost Principles for Non-Profit Organizations	October 1995
A-128	Audits of state and local governments (see also related question-and-answer document under "Office of Management and Budget—Other Guidance")	April 1985
A-133 (Revised)	Audits of institutions Circular of higher education and other non-profit institutions (see also PCIE Statement No. 6 under "PCIE Standards Subcommittee Guidance")	April 1996

Office of Management and Budget—Other Guidance

.107 *The Catalog of Federal Domestic Assistance* is a government-wide compendium of federal programs, projects, services, and activities that provide assistance or benefits to the American public. The General Services Administration (GSA) is responsible for the dissemination of federal domestic assistance information through the catalog and maintains the information database from which program information is obtained. The OMB serves as an intermediary between other federal agencies and the GSA, thus providing oversight relative to the collection of federal domestic assistance program data.

.108 Program information provided by the catalog includes authorizing legislation and audit requirements. The GSA distributes copies to certain specified national, state, and local government offices. Catalog staff may be contacted at (202) 708-5126. Private individuals may purchase the catalog from the Government Printing Office by calling (202) 783-3238.

.109 Program information is also available on machine-readable magnetic tape. The tape may be purchased by writing the Federal Domestic Assistance Catalog Staff, General Services Administration, Ground Floor, Reporters Building, 300 Seventh Street, SW, Washington, DC 20407, or calling (202) 708-5126.

.110 Other publications include the following:

- *Compliance Supplement for Single Audits of State and Local Governments*—This sets forth the major federal compliance requirements that should be considered in a single audit of state and local governments that receive federal assistance. It supplements OMB Circular A-128. The latest revision was issued in

September 1990, although a new revision is expected during 1996 (see a separate discussion of the compliance supplement in the section entitled "Regulatory, Legislative, and Other Developments").

- *Questions and Answers on the Single Audit Provisions of OMB Circular A-128,* Audits of State and Local Governments—This document provides guidance on the single audit process through a series of questions and answers. The document is available from the Executive Office of the President, Publications Office, at (202) 395-7332, and is also included as an appendix to the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units.*
- *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions*—This document supplements OMB Circular A-133 and sets forth the major compliance requirements that should be considered in an organization-wide audit of universities and other nonprofit institutions that receive federal assistance (see a separate discussion of the compliance supplement in the section entitled "Regulatory, Legislative, and Other Developments"). Information regarding the two compliance supplements may be obtained by contacting the OMB Financial Standards and Reporting Branch at (202) 395-3993.

PCIE Audit Committee Guidance

.111 The PCIE Audit Committee publishes supplemental, nonauthoritative guidance for federal officials addressing issues arising from the implementation of the Single Audit Act; OMB Circular A-128, which implements the Act; and OMB Circular A-133, which extends the single audit concept to institutions of higher education and other nonprofit institutions.

.112 The PCIE Audit Committee (or its predecessors) has issued the following position statements:

- PCIE Statement No. 1 provides guidance on determining when a series of audits of individual federal departments, agencies, and establishments may be considered an audit for purposes of the Single Audit Act.
- PCIE Statement No. 2 provides guidance to cognizant agencies on determining whether an audit report that does not meet the 50-percent rule on internal control coverage prescribed in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* should be accepted.
- PCIE Statement No. 3 provides guidance on using a cyclical approach to internal control reviews of nonmajor programs.
- PCIE Statement No. 4 establishes uniform procedures for referrals of substandard audits to state boards of accountancy and the AICPA.
- PCIE Statement No. 5 provides guidance for certain not-for-profit entities other than institutions of higher education or hospitals not covered by OMB Circular A-110, *Uniform Administrative Requirements for Grants and Other Agreements With Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations.* This statement is obsolete since it covers issues regarding audits of not-for-profit organizations prior to the issuance of OMB Circular A-133.
- PCIE Statement No. 6 provides clarifications and additional practical working guidance to Inspectors General and others participating in audits of not-for-profit organizations performed under OMB Circular A-133. It contains questions and answers on OMB Circular A-133 and was developed from questions frequently asked.

Position Statement Nos. 1 through 5 are available from the U.S. Department of Education, Office of the Inspector General, Technical and Nonfederal Audit Staff, 600 Independence Avenue, SW, Washington, DC 20202-1510; telefax (202) 205-8238. Position Statement No. 6 (stock number 041-001-00374-6) is available from the Government Printing Office, Superintendent of Documents, Mail Stop: SSOP, Washington, DC 20402-9328; telephone (202) 783-3238. All of the PCIE Position Statements are also available on the GAO electronic bulletin board. See the section titled "GAO" for further information on accessing this bulletin board. The PCIE has also issued the following:

- *Uniform Desk Review Guide of A-128 Single Audits* (last published in 1991) (PCIE-06-056)
- *Uniform Quality Control Review Guides for A-128 Single Audits* (last published in 1991) (PCIE-06-057)
- *Revised Program Audit Guide Listing* (stock number 065-000-00585-9)
- *Study on Improving the Single Audit Process* (stock number 065-000-0615-4)

Copies of the *Uniform Desk Review Guide* and the *Uniform Quality Control Guide* are available from the U.S. Department of Commerce, National Technical Information Service, Springfield, VA 22161. The *Revised Program Audit Guide Listing* and the *Study on Improving the Single Audit* are available from the Government Printing Office at the above address.

Government Finance Officers Association

.113 The address and telephone number of the Government Finance Officers Association (GFOA) are 180 N. Michigan Avenue, Suite 800, Chicago, IL 60601-7476; (312) 977-9700. GFOA publications include the following:

- *Governmental Accounting, Auditing, and Financial Reporting (GAAFR)*—The 1994 GAAFR provides detailed professional guidance on the practical application of GAAP to state and local governments. Discussions cover both the implementation of authoritative standards and current practice. Chapters are accompanied by detailed journal entries that tie to a complete illustrative comprehensive annual financial report. Special chapters are devoted to auditing, state governments, and special entities. An extensive glossary and model chart of accounts are also provided, along with both a general index and an index of journal entries. (The *GAAFR Study Guide* is also available.)
- *A Preparer's Guide to Note Disclosures*—This guide compiles all current authoritative guidance on note disclosures for state and local government financial statements.
- *An Elected Official's Guide to Auditing*—This guide provides elected officials, management, and other nonaudit professionals with practical information concerning the audit process for state and local governments.
- *Audit Management Handbook*—This handbook on audit management is intended for state and local governments and CPA firms that are involved in obtaining or performing financial audits. It provides information on all aspects of the audit management process, including establishing the scope of the audit, audit procurement (including a model request for proposal), monitoring the audit, and the resolution of audit findings.
- Financial Reporting Series—This set of books contains information and creative examples of how governments present specific financial reporting information. It includes the following:
  - *Illustrations of Notes to the Financial Statements of State and Local Governments* (Replaced by A Preparer's Guide to Note Disclosures)
  - *Illustrations of Introductory Sections of Comprehensive Annual Financial Reports of State and Local Governments*
  - *Illustrations of Statistical Sections of Comprehensive Annual Financial Reports of State and Local Governments*
  - *Illustrations of Supplementary Financial Data in Comprehensive Annual Financial Reports of State and Local Governments*
  - *Illustrations of Interim Financial Statements of State and Local Governments*
  - *How to Understand Local Government Financial Statements: A User's Guide*

— *Illustrations of Combined, Combining, and Individual Fund and Account Group Financial Statements of State and Local Governments*

— *Suggested Solutions to Governmental Accounting and Financial Reporting Practice Problems in Applying Authoritative Standards*

— *Illustrations of Popular Reports of State and Local Governments*

— *A Public Manager's Guide to Government Accounting and Financial Reporting*

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.114 This Audit Risk Alert supersedes *State and Local Governmental Developments—1995.*

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.115 Auditors should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1995/96* [AAM section 8010].

[The next page is 8195.]

AAM Section 8080
Agribusiness Industry Developments—1995/96

Industry and Economic Developments

.01 The agricultural industry accounts for a significant portion of U.S. economic activity. During 1995, the industry is expected to produce output of $258 billion while employing 3.82 million workers. Agricultural activities include producing, processing, distributing, or merchandising a wide range of commodities such as wheat, vegetables, fruits, and nuts as well as breeding and feeding cattle, hogs, and sheep; operating dairies and poultry facilities; breeding horses; raising mink and chinchilla; and so forth. Although the industry includes all forms of business organizations, smaller farmers and ranchers generally view the sole proprietorship as the preferred form. And while most agricultural entities are small sole proprietorships, there is a continuing trend toward larger farms, incorporation, and specialization.

.02 Based on the assumption of favorable weather conditions, 1995 was expected to be a year of overabundance for many U.S. farmers. The U.S. Department of Agriculture initially estimated that 1994-1995 corn crop would exceed 10 billion bushels—up 58 percent from flood-ravaged 1993-1994. Soybean and wheat crops were also expected to exceed 1994 levels with production topping 2.5 billion bushels and 2.3 billion bushels, respectively. These expected record harvests, along with excess supplies of inexpensive feed for livestock, were to create downward pressures on prices and, therefore, farm revenues. However, after spring downpours and a summer heat wave, the midyear assessment is that this has been a poor growing season for some corn and soybean farmers. Therefore, a meager fall harvest is expected. While weather conditions initially pushed corn and soybean prices up, mass selling by commodity traders and mutual fund managers put extreme pressure on prices. By early August, prices had fallen from previous levels by almost 10 percent.

.03 Encouraged in part by declining feed prices, many livestock producers overbred their herds. As a result, industry analysts believe that unless there are substantial increases in prices, even the most efficient producers will have a hard time making a profit. Mitigating this situation, to an extent, is the expectation of strong exports due to a rise in global demand for agricultural products, along with the new foreign markets opened by the ratification of the General Agreement on Tariffs and Trade and the North American Free Trade Agreement. Exports to the Pacific Rim are expected to increase. China, whose consumption of U.S. farm products tripled in 1994, is likely to import in excess of $1 billion—with heavy buying of cotton and vegetable oil. Meat exports are also expected to rise along with an 11 percent increase in poultry shipments. In spite of these export gains, overall farm income for 1995 is expected to remain flat at an estimated $55 billion.

.04 The implementation of technological advances (for example, improved varieties of seeds and animal feed and improved techniques for applying fertilizer and pesticide), which have contributed to increased productivity for many U.S. farmers, is expected to continue in 1995. Great strides have also been made in adapting information technology to farming. (Refer to the "Audit Issues and Developments" section of this Audit Risk Alert for a discussion of the audit implications of computerized accounting systems.) Technological advances adopted by the industry include crop harvesting that incorporates satellite navigation systems and electronic tags worn by cows that ration feed and record levels of milk output. Advances such as these bring new precision to agricultural activities that have historically been dependent on educated guesses and good fortune.

.05 Technologically driven efficiencies will generate higher production levels from fewer farms. In 1992, the number of U.S. farms fell below 2 million for the first time since 1850. This decline is expected to continue in 1995 as farmers take advantage of emerging technologies. Agricultural entities failing to implement such advances are likely to be overwhelmed by competitive pressures and may well face extinction. Accordingly, auditors should be alert to conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about an entity's ability to continue as a going concern. Such conditions and events include, for example, (1) negative trends such as recurring operating losses or working capital deficiencies, (2) financial difficulties such as loan defaults or denial of trade credit from suppliers, (3) internal matters such as labor difficulties, or (4) external matters such as legal proceedings or legislation that jeopardize the entity's ability to operate. In such circumstances, auditors will have to consider whether, based on conditions and events, there is substantial doubt about the entity's ability to continue as a going concern. Refer to the "Audit Issues and Developments" section of this Audit Risk Alert for further discussion of this matter.

.06 The availability and pricing of agricultural commodities are subject to significant fluctuations given the unpredictability of many factors including weather conditions, governmental farm programs and policies, changes in global demand due to population growth, and the production of similar and competitive crops. It is, therefore, fairly common for agricultural entities to offset or minimize such price risks by hedging commodity transactions. This matter is discussed further in the "Accounting Issues and Developments" section of this Audit Risk Alert.

Legislative and Regulatory Developments

.07 The federal government has a significant impact on the agricultural industry. With various objectives such as ensuring adequate production levels and stabilizing prices, the government has established loan programs that, for example, lend funds to producers that are collateralized by security interests in their crops. These crops may ultimately be used to repay the indebtedness. Programs also exist to provide agricultural producers with income replacements and subsidies in the event of natural disasters or declining price levels. Cost-sharing programs exist whereby the government provides reimbursement for the cost of certain production-related expenses. Additionally, the Internal Revenue Code affords special treatment to many agricultural entities in areas such as the choice of accounting and valuation methods. In evaluating the entity's tax accrual, auditors should be aware that such special elections may create temporary differences between pretax accounting income and taxable income pursuant to Financial Accounting Standards Board (FASB) Statement No. 109, *Accounting for Income Taxes* (AC I27).

.08 Given the recent philosophical shift in the congressional landscape, a change in the role of the federal government in the agricultural arena appears likely. With a mandate to reduce the federal budget deficit and bureaucracy, farm subsidy programs will probably face some reductions and perhaps even elimination. Auditors should be alert to the impact of such changes and the response by agricultural entities to reduced revenues and increased expenses. Testing of sales cutoff and inventory valuation, along with the evaluation of revenue recognition policies and deferred costs, may take on increased significance in such an environment.

Audit Issues and Developments

Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance

.09 With the intent of stabilizing prices and production of domestic agricultural output, the federal government provides direct subsidies and loans, as well as sponsoring cost-sharing and income replacement programs to agricultural producers and cooperatives. Agricultural entities that receive such governmental assistance may be subject to audit requirements associated with some of those programs. Auditors of such entities should consider the guidance set forth in AICPA Statement on Auditing Standards (SAS) No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AU section 801). SAS No. 74 (AU section 801), which supersedes SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance,* is effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994. SAS No. 74 (AU section 801) provides general guidance to practitioners engaged to perform compliance audits of recipients of governmental financial assistance.

.10 SAS No. 74 (AU section 801) continues to recognize three levels of audits—generally accepted auditing standards (GAAS), *Government Auditing Standards,* and certain other federal requirements—of recipients of governmental financial assistance. SAS No. 74 (AU section 801) is applicable when the auditor is engaged to perform an audit under GAAS, and under *Government Auditing Standards,* and in certain other circumstances involving governmental financial assistance, such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations.

.11 SAS No. 74 (AU section 801) also provides general guidance to the auditor to—

- Apply the provisions of SAS No. 54, *Illegal Acts by Clients* (AU section 317), relative to detecting misstatements resulting from illegal acts related to laws and regulations that have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of governmental entities and other recipients of governmental financial assistance.
- Perform a financial audit in accordance with *Government Auditing Standards,* issued by the Comptroller General of the United States.
- Perform a single or organization-wide audit or a program-specific audit in accordance with federal audit requirements.
- Communicate with management if the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of his or her engagement.

.12 Auditors of agricultural producers or cooperatives that receive governmental financial assistance should also be alert to the 1994 Revision of *Government Auditing Standards,* commonly referred to as the "Yellow Book", as issued by the Comptroller General of the U.S. The 1994 Revision provides guidance (rather than requirements) on the auditor's consideration of internal controls for the control environment, safeguarding controls, controls over compliance with laws and regulations, and control risk assessment. It does not establish new responsibilities for testing controls. Some of the more important changes made in the 1994 Revision deal with the following:

- Submission of peer review reports
- Commenting on the status of prior year control weaknesses and other matters
- Responsibility for detection of noncompliance with contract or grant agreement provisions
- Working paper documentation
- Communication of additional services available on controls and compliance
- Report content
- Direct reporting of irregularities and illegal acts
- Applicability of the Yellow Book to other attest engagements

The Audit Risk Alert *State and Local Governmental Developments—1995* [AAM section 8070] contains a detailed discussion of the revisions to the Yellow Book.

Illegal Acts by Clients

.13 During 1995, the Federal Bureau of Investigation initiated an investigation of a major agricultural producer and a number of its competitors to determine the extent of their possible involvement in a conspiracy to fix prices on an animal feed additive. While the auditor does not ordinarily have a sufficient basis for recognizing possible violations of laws and regulations when the financial statement effect is indirect, this event, though not suggestive of an industry-wide problem, should serve as a reminder to auditors of their responsibilities with regard to possible illegal acts by clients. Auditors should design their audits to provide reasonable assurance of detecting material misstatements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts. However, an audit performed in accordance with GAAS does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements (such as the alleged price-fixing scheme noted above). Auditors should, however, be aware of the possibility that such illegal acts may have occurred. Specific guidance in this area is set forth in SAS No. 54 (AU section 317).

Going-Concern Issues

.14 Competitive pressures and anticipated reductions in federal farm subsidies, along with declining prices, may result in increased farm failures. Auditors should be aware of their responsibilities pursuant to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341). SAS No. 59 (AU section 341) provides guidance to auditors in conducting an audit of financial statements in accordance with GAAS for evaluating whether there is substantial doubt about a client's ability to continue as a going-concern for a period not to exceed one year from the date of the financial statements being audited.

.15 Continuation of an entity as a going concern is generally assumed in the absence of significant information to the contrary. Information that significantly contradicts the going-concern assumption 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. SAS No. 59 (AU section 341) does not require the auditor to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

.16 If there is substantial doubt about the entity's ability to continue as a going concern, the auditor should consider whether it is likely that existing conditions and events can be mitigated by management plans and whether those plans can be effectively implemented. If the auditor obtains sufficient competent evidential matter to alleviate doubts about going-concern issues, then consideration should be given to the possible effects on the financial statements and the adequacy of the related disclosures. If, however, after considering identified conditions and events, along with management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern remains, the audit report should include an explanatory paragraph to reflect that conclusion. In these circumstances, auditors should refer to the specific guidance set forth under SAS No. 59 (AU section 341).

Inventory

.17 Inventory is generally one of the most significant assets on the balance sheet of an agricultural producer or cooperative. Auditors should be aware that inventories of agricultural producers or cooperatives often have higher inherent risk and produce greater complexities for auditors than do inventories of other businesses.

.18 AICPA Statement of Position (SOP) 85-3, *Accounting by Agricultural Producers and Agricultural Cooperatives,* provides specific guidance on the generally accepted accounting principles (GAAP) relating to accounting for inventories of agricultural producers and cooperatives. Auditors should pay special attention to the following areas of inventory accounting that may affect audit risk:

- Whether the agricultural producer or agricultural cooperative has established an adequate internal control structure over the inventory—for example, a control structure that safeguards physical quantities and provides accurate quantity and cost data
- Whether all purchases and receipts are properly authorized and recorded
- Whether payroll records are sophisticated enough to allow labor costs to be allocated to the appropriate inventory component

- Whether all direct and indirect costs of developing animals raised for a productive function are accumulated until the animals reach maturity and are transferred to a productive function, at which point the accumulated development costs are depreciated over the animals' estimated productive life

- Whether all direct and indirect costs of developing animals raised for sale are accumulated and the animals are accounted for at the lower of cost or market until they are available for sale. SOP 85-3 provides that agricultural producers should report animals available and held for sale (*a*) at the lower of cost or market or (*b*) in accordance with established industry practice at sales price, less estimated costs of disposal, when all of the following conditions exist:

  — There are reliable, readily determinable, and realizable market prices for the animals.

  — The costs of disposal are relatively insignificant and predictable.

  — The animals are available for immediate delivery.

- Whether agricultural cooperatives are appropriately determining the passing of title for products received from patrons without payment of a set price to the patron

- Whether permanent land development costs are being appropriately capitalized by the agricultural producer or agricultural cooperative

- Whether limited-life development costs and direct and indirect development costs of orchards, groves, vineyards, and intermediate-life plants are appropriately capitalized during the development period and depreciated over the estimated useful life of the land development or of the tree, vine, or plant

.19 Auditors of agricultural producers and cooperatives may consider engaging a specialist to evaluate the quality or value of inventory. In these cases, auditors should follow the guidance of SAS No. 73, *Using the Work of a Specialist* (AU section 336). Other general guidance on auditing inventory can be found in the AICPA Auditing Procedure Study *Audit of Inventories* (Product No. 021045).

Research and Development Costs

.20 Some agricultural producers may be involved in research and development (R&D) programs in attempts to create new products or improve existing product lines. Auditors of these entities should consider whether costs related to such efforts have been appropriately accounted for and disclosed. FASB Statement No. 2, *Accounting for Research and Development Costs* (AC R50), requires that R&D costs be charged to expense when incurred. In evaluating the adequacy of disclosure of the entity's financial statements (see SAS No. 32, *Adequacy of Disclosure of Financial Statements* [AU section 431]) auditors should be aware that FASB Statement No. 2 (AC R50) requires disclosure in the financial statements of the total R&D costs charged to expense in each period for which an income statement is presented.

Derivatives

.21 Recent years have seen a growing use of innovative financial instruments, commonly referred to as derivatives, that often are very complex and can involve a substantial risk of loss. Both agricultural producers and cooperatives regularly enter into forward contracts, futures contracts, and options in order to hedge against losses related to the effect of changing prices and other uncertainties. As interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments obtain their value have increased in volatility, a number of entities have incurred significant losses as a result of their use. The use of derivatives almost always increases audit risk. Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditors' approach to achieving related audit objectives may differ because certain derivatives are not generally recognized in the financial statements.

.22 It is essential that auditors understand both the economics of derivatives used by the entities whose financial statements they audit and the nature and business purpose of their entities' derivatives activities. In addition, auditors should carefully evaluate their clients' accounting for any such instruments, especially those carried at other than market value. To the extent the derivatives qualify as financial instruments as defined in FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), the disclosure requirements set forth in those statements must be met. When derivatives are accounted for as hedges of on-balance-sheet assets or liabilities or of anticipated transactions, auditors should carefully review the appropriateness of the use of hedge accounting, particularly considering whether the criteria set forth in applicable accounting literature are met.

.23 The Securities and Exchange Commission (SEC) staff has indicated in public speeches and letters of comment to registrants during the past year that publicly held companies should disclose the nature and purpose of certain commodity-based derivatives activities, the nature and terms of certain commodity-based derivatives used, and the accounting methods used even when such derivatives do not meet the definition of financial instruments set forth in the FASB Statements cited above.

.24 Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1995/96* [AAM section 8010]. Also, see in the "Accounting Issues and Developments" section—"Disclosures about Derivatives" of this Audit Risk Alert. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations.

Environmental Issues

.25 Environmental remediation liability laws, written at all levels of government, have exposed agricultural producers and cooperatives to an increased vulnerability to environmental claims. The Resource, Conservation and Recovery Act, Superfund, along with various clean air and water acts, may be used to hold agricultural entities liable for the remediation of environmental contamination. Superfund, for example, legally empowers the U.S. Environmental Protection Agency to seek recovery from current and previous owners or operators of a particular contaminated site, or anyone who generated or transported hazardous substances to such a site. The use of herbicides and pesticides by agricultural entities as well as the maintenance of underground storage tanks for hazardous fuel and chemical substances used in agricultural activities may create environmental cleanup issues.

.26 The accounting literature applicable to accounting for environmental remediation liabilities includes FASB Statement No. 5, *Accounting for Contingencies* (AC C59), FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (AC C59), and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10). In addition, guidance is included in the consensuses reached by the Emerging Issues Task Force (EITF) of the FASB in EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal,* Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination,* and Issue No. 93-5, *Accounting for Environmental Liabilities.*

.27 Auditors of publicly held agricultural producers should be aware of the SEC's Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies.* The SAB provides the SEC staff's interpretation of current accounting literature related to the following:

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities.
- Recognition of liabilities for costs apportioned to other potential responsible parties.
- Uncertainties in the estimation of the extent of environmental liabilities.

- The appropriate discount rate for environmental liabilities, if discounting is appropriate.
- Financial statement disclosures of exit costs and other items and disclosure of certain information outside the basic financial statements.

Audit Risk Alert—1995/96 [AAM section 8010] contains further discussion of issues relating to environmental remediation matters. Also, refer to the "Accounting Issues and Developments" section of this Audit Risk Alert for information on AICPA Exposure Draft: *Proposed Statement of Position on Environmental Remediation Liabilities.*

Service-Center Produced Records

.28 Many agricultural producers and agricultural cooperatives use outside service organizations to perform tasks requiring expertise or technology that do not exist within the organization. Service organizations provide various levels of services, ranging from performing a specific task under the direction of an agricultural producer or agricultural cooperative to replacing entire business units or functions. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), provides guidance to auditors of agricultural producers or cooperatives and to service auditors performing procedures and reporting on the control policies and procedures at service organizations.

.29 When an agricultural entity uses a service organization, the functions or processing performed by the service organization may have a significant effect on the entity's financial statements. Because the processing may be subjected to control policies and procedures that are physically and operationally separate from the entity, the internal control structure of the entity may include a component that is not directly under the control and monitoring of its management. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), requires auditors to obtain a sufficient understanding of an entity's internal control structure to plan an audit. For this reason, planning the audit of an agricultural producer or cooperative may require that auditors gain an understanding of the control policies and procedures performed by service organizations. When an agricultural producer or agricultural cooperative relies on a service organization's control policies and procedures over the processing of transactions that are material to their financial statements, those control procedures should be considered by the auditors.

.30 One method of obtaining information about a service center's policies and procedures is to obtain a service auditor's report as described in SAS No. 70 (AU section 324). However, the fact that an entity uses such an organization does not, in itself, require that such a report be obtained. In certain situations, the agricultural producer or cooperative may implement control policies and procedures that will make it unnecessary to obtain a service auditor's report. For example, an entity using a payroll service may routinely compare the data submitted to the service organization with reports received from the service organization to check the completeness and accuracy of the data processed. The agricultural producer or cooperative may also recompute a sample of the payroll checks for clerical accuracy and review the total payroll for reasonableness. In such circumstances, the agricultural producer or cooperative is not relying on the service organization's controls.

.31 Other factors that may be considered in determining whether to obtain a service auditor's report include—

- Whether the transactions or accounts affected by the service organization are material to the agricultural producer or cooperative's financial statements.
- The extent to which the user organization retains responsibility for authorizing the transactions and maintaining the related accountability.
- The availability of other information (for example, user manuals, system overviews, and technical manuals) that may provide the auditors with sufficient information to plan the audit.

Interpretation No. 1 of SAS No. 70, titled "Describing Tests of Operating Effectiveness and the Results of Such Tests" (AU section 9324.01—.03) and Interpretation No. 2 of SAS No. 70, titled "Service Organizations That Use the Services of Other Service Organizations (Subservice Organizations)" (AU section 9324.04—.18) may also be relevant in this area. *Audit Risk Alert—1995/96* [AAM section 8010] contains additional information on these Interpretations.

.32 Additionally, a task force of the AICPA's Auditing Standards Board has drafted an APS that provides guidance to auditors on implementing SAS No. 70 (AU section 324). The APS provides guidance to a service auditor engaged to issue a report on the control structure policies and procedures of a service organization. It also provides guidance to user auditors engaged to audit the financial statements of an entity that uses a service organization. The task force expects to issue the APS by the end of 1995.

Computerized Accounting Systems

.33 The continuing trend by agricultural enterprises of implementing technological advances includes the computerization of in-house accounting and information systems. In the planning stage, auditors should consider the methods used by the enterprises to process accounting information since those methods will have an impact on the design of the entity's internal control structure. The extent to which computer processing is used in significant accounting applications, along with the complexity of such processing, is likely to influence the nature, timing, and extent of audit procedures. While specific audit objectives will not change, regardless of whether the processing of accounting information is automated or performed manually, the methods of applying audit procedures to gather sufficient competent evidential matter may be influenced by the method of data processing used. General guidance on how computer technologies employed by clients will affect audits can also be found in the APSs, *Auditing in Common Computer Environments* (Product No. 021059) and *Consideration of the Internal Control Structure in a Computer Environment: A Case Study* (Product No. 021055).

Agricultural Producers' Financial Statements

.34 In July 1995, the Farm Financial Standards Council issued a revised version of *Financial Guidelines for Agricultural Producers,* the purpose of which is to standardize financial reporting for agricultural producers that do not maintain their accounting records in accordance with GAAP. Auditors should be aware that these guidelines do not constitute GAAP, nor do they have the substantial support required to constitute a comprehensive basis of accounting other than GAAP.

.35 The guidelines set forth guidance that deviates from GAAP in accounting for—

- Raised breeding stock
- Deferred taxes
- Capital assets
- Inventories of grain and livestock
- Items held for resale
- Growing crops
- Government loan programs
- Depreciation

Auditors who report on financial statements prepared in conformity with such guidelines should consider whether, because of the GAAP departures, a qualified or adverse opinion should be issued as described in SAS No. 58, *Reports on Audited Financial Statements,* paragraphs 49 through 69 (AU section 508.49—.69).

Accounting Issues and Developments

Impairment of Long-Lived Assets

.36 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). FASB Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

.37 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.38 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. (Earlier application is encouraged.) Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.39 Given the capital intensive nature of the agricultural industry, auditors should be alert to those events or changes in circumstances which indicate that an impairment of an asset may have occurred. For example, as agricultural producers continue toward the adoption of technologically advanced farming techniques, traditional long-lived agricultural assets may be rendered obsolete. Additionally, environmental regulations may impose restrictions upon the use of a long-lived asset used in crop cultivation, thus significantly reducing its ability to generate future cash flows. In such instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.40 In considering an agricultural entity's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AU section 342).

Hedging Activities

.41 Agricultural entities may enter into futures contracts as a means of reducing their exposure to certain financial risks. In order to qualify as a hedge in accordance with FASB Statement No. 80, *Accounting for Futures Contracts* (AC F80), (1) the item or group of items intended to be hedged must contribute to the price or interest rate risk of the agricultural producer or cooperative and (2) there must be a high correlation of changes in the market value of the futures contracts and the fair value of, or interest income or expense associated with, the hedged items so the results of the futures contracts will substantially offset the effects of price or interest changes

[The next page is 8203-3.]

on the exposed items. Auditors should consider whether management's accounting for futures contracts, designated as hedges, is appropriate in light of the criteria set forth in FASB Statement No. 80 (AC F80).

.42 In evaluating the propriety of presentation and disclosure of hedging activities in the financial statements, auditors should also be aware that FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions* (AC C25), provides that the cash flows from hedging transactions be classified as operating cash items in the statement of cash flows and disclosed as a separate line item if material.

Disclosures About Derivatives

.43 As previously discussed, agricultural producers and agricultural cooperatives regularly employ derivative financial instruments as risk management tools (hedges). Derivatives are complex financial instruments whose values are affected by the volatility of interest rates, foreign currency indices, and commodity and other prices.

.44 In October 1994, the FASB issued Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25). FASB Statement No. 119 (AC F25) requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 (AC F25) and No. 107 (AC F25).

.45 The Statement requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 (AC F25.115P) encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

.46 FASB Statement No. 119 (AC F25) was effective for financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations, the Statement is effective for financial statements issued for fiscal years ending after December 15, 1995.

.47 The FASB Special Report, *Illustrations of Financial Instrument Disclosures,* contains illustrations of the application of FASB Statements No. 105 (AC F25), No. 107 (AC F25), and No. 119 (AC F25).

Risks and Uncertainties

.48 In December 1994, the AICPA's Accounting Standards Executive Committee issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires nongovernmental entities to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires entities to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.49 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of similar estimates that may be included in the financial statements of agricultural producers and cooperatives include:

- Impairment of long-lived assets used in crop cultivation
- Estimates of environmental remediation liabilities resulting from the use of pesticides, herbicides, or fungicides

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of agricultural producers in accordance with paragraph 21 of the SOP include the following:

- Volume of business with a particular cooperative or governmental program
- Revenue from a particular crop or livestock
- Processing, distributing, or marketing agricultural products in a particular geographic area

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

.50 Auditors should be alert to the requirements of the new SOP and its impact upon the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

.51 In June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities.* The exposure draft provides that—

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 (AC C59) are met, and it includes benchmarks to aid in determining when those criteria are met.
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent the employees are expected to devote time to the remediation effort.
- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site, and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- Measurement of the liability should be based on enacted laws and existing regulations, policies and remediation technology.
- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed, and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and clean-up laws and the need to consider various individual state and other non-United States government requirements.

.52 Comments on the exposure draft were due by October 31, 1995.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

.53 The AICPA Audit and Accounting Guide *Audits of Agricultural Producers and Agricultural Cooperatives* is available through the AICPA loose-leaf subscription service. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the Guides as they appear in the service are printed annually.

Agricultural Cooperatives' Financial Reporting Checklist

.54 The AICPA Technical Information Service has published a revised version of *Checklists and Illustrative Financial Statements for Agricultural Cooperatives* as a tool for preparers and reviewers of financial statements of agricultural cooperatives.

Technical Practice Aids

.55 *Technical Practice Aids* is an AICPA publication that, among other things, contains questions received by the AICPA Technical Information Service on various subjects and the service's responses to those questions. *Technical Practice Aids,* which contains questions and answers specifically pertaining to agricultural cooperatives, is available both as a subscription service and in a paperback edition. Order information may be obtained from the AICPA Order Department.

Information Sources

.56 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.57 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.58 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.59 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.60 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

* * * *

.61 This Audit Risk Alert supersedes *Agribusiness Industry Developments—1994.*

* * * *

.62 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

.63

Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250 (f)		*U.S. Government Printing Office's The Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account. User assistance line: (202) 512-1530 (202) 512-1387 (d) Telnet via internet.federal.bbs.gpo.gov 3001	
U. S. Department of Agriculture	1301 New York Ave., NW Washington, DC 20005-4788 (800) 999-6779			
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088 (ext 3) (202) 942-7114 (tty)		*Information Line* (202) 942-8088 (202) 942-7114 (tty)
Farm Financial Standards Council	c/o Mr Steve Hofing Agricultural Education and Consulting Centree Business Center 3 College Park Court Savoy, IL 61874 (217) 352-1190			

AAM Section 8090
Airline Industry Developments—1995/96

Industry and Economic Developments

.01 After incurring losses totaling $13 billion over the past five years, the airline industry is expected to show a significant profit for 1995. Industry-wide cost cutting measures, higher air fares, more passenger traffic resulting from stronger than anticipated summer travel, and increases in foreign tourism due to the weak dollar, have all contributed to making 1995 a profitable year, thus far, for the airline industry. Moreover, for the first time since 1988, no major carriers are operating under bankruptcy protection. By midyear, planes had been flying at an average capacity of 72 percent while air fares had risen approximately 6 percent over 1994 levels. Airline stock prices, bolstered by expectations of continued profitability, have appreciated by approximately 52 percent so far this year.

.02 Many airlines are attempting to solidify their positions of profitability by continuing efforts to reduce costs. Currently the focus of these efforts is travel agent commissions, which are typically the third largest expense behind labor and fuel. Led by a major carrier, most airlines are now cutting commissions by approximately 10 percent, capping them at $50 for domestic round trip tickets. As a result, analysts expect industry-wide savings of over $400 million. On the other side of the equation, the commission cap may have an adverse effect on travel agents. Some agencies may be unable to absorb a 10 percent decrease in commission revenue. Accordingly, auditors should be alert to the possibility that reduced commissions may call into question the collectibility of certain accounts receivable arising from travel agency sales.

.03 Airlines continue to seek wage and work-rule concessions from unions representing transport workers, flight attendants, and pilots. However, industry profitability along with strong demand has strengthened the unions' resolve to resist further give-backs. In response, some airlines have established employee stock programs in lieu of salary increases, to compensate for salary reductions, or as productivity incentives. See "Stock-Based Compensation" in the "Accounting Issues and Developments" section of this Audit Risk Alert for further discussion.

.04 One of the significant factors contributing to the moderate profitability experienced by the airline industry in 1994 was a decrease in fuel costs over the prior year (approximately 13 per- cent lower than 1993). However, this year the industry faces rising fuel prices (10 percent to 15 percent over 1994 prices) in addition to the impending expiration of the gasoline tax exemption. The industry is attempting to lobby Congress to extend the deadline for the exemption from the 4.3 cents per gallon tax increase imposed by the current administration. The Budget Reconciliation Bill before the House of Representatives is expected to include a provision extending the exemption for two more years. However, if the exemption, which expired in October 1995, is not extended, industry profits could be reduced by as much as $700 million. Auditors should be alert to the impact of the tax increase on those carriers with fleets comprised of older, less fuel-efficient aircraft. Smaller, undercapitalized carriers, that are unable to ground these planes, will be forced to absorb significant cost increases unless such increases can be passed on to passengers through fare increases. As such, their ability to continue as going concerns may be called into question (see the following section "Competitive Environment" for discussion of this topic).

Competitive Environment

.05 AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), requires that, in planning their audits, auditors consider matters relating to the entity's business and the industry in which it operates. One such matter for airlines is the intensely competitive environment in which the industry operates. For example, major carriers constantly face the threat of deep fare discounting from low cost rivals. In response, carriers generally lower their own ticket prices to match the competition (a practice that leads to what are commonly referred to as fare wars) thus driving down air traffic revenues. These smaller carriers, some of which are expanding operations, typically maintain lower costs by employing a non-unionized work force, offering low-fare no-frills air travel, and by flying older aircraft which are generally less expensive to own or lease (however, see "Stage II Aircraft" in the "Regulatory Developments" section of this Audit Risk Alert). In contrast, many major carriers are saddled with the higher costs associated with unionized labor and the higher depreciation and interest expense generated by fleets of newer, more expensive aircraft. As a result, the larger carriers are more vulnerable to the effects of fare wars. Many airlines have responded to such competitive pressures by implementing restructuring programs (see "Restructurings" in the "Audit Issues" section of this Audit Risk Alert) to reduce costs. Additionally, some airlines are facing competition from unlikely sources. Carriers that rely heavily on the business traveler are beginning to see that market segment shrink. As businesses cut costs and continue to implement advanced telecommunications technologies there has been a corresponding reduction in their need to incur the expense of air travel.

.06 Despite expected industry profitability for the current year, these competitive pressures, along with higher fuel prices and costly regulatory requirements (see the following section, "Regulatory Developments"), may raise going-concern issues. Auditors should be alert to conditions and events such as those described which, when considered in the aggregate, indicate there could be substantial doubt about the airline's ability to continue as a going concern for a reasonable period of time not to exceed one year from the date of the financial statements being audited. In such circumstances, auditors should be aware of their responsibilities pursuant to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341). SAS No. 59 (AU section 341) provides guidance to auditors for evaluating whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time not to exceed one year from the date of the financial statements being audited.

Regulatory Developments

Passenger Facility Charges

.07 The Federal Aviation Administration (FAA) has in place a passenger facility charge (PFC) program that permits local airport authorities to impose specified per-passenger charges at commercial service airports in order to finance airport improvements. Airlines collecting PFCs under Sections 9110 and 9111 of the Aviation Safety and Capacity Expansion Act of 1990 have the responsibility for remitting such funds and, those carriers that have at least 50,000 passengers annually, are required to have annual audits of their PFCs collected, withheld, refunded/exchanged, and remitted by the carrier for the year and each quarter ended during the year. Further, implementing regulations in Part 158 of FAA regulations outlining policies and procedures for the PFC program require the airlines to obtain a report from their independent auditors on "the fairness and reasonableness of the airline's procedures for receiving, holding, and disbursing PFC revenues." These requirements are satisfied as follows:

1. An audit in accordance with generally accepted auditing standards of a schedule of PFC charges collected, withheld, refunded/exchanged, and remitted by the carrier for the year and each quarter ended during the year

2. An internal control structure examination attestation engagement in accordance with AICPA Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AT section 400)

The AICPA has worked with the FAA and industry representatives to develop the following illustrative reports that satisfy both existing professional literature and the FAA's requirements.

.08

Illustrative Report on Audit of PFC Schedules

Independent Auditor's Report

XYZ Airline Inc.:

We have audited the accompanying Schedules of Passenger Facility Charges Collected, Withheld, Refunded/Exchanged, and Remitted by XYZ Airline, Inc. (the Company) for the year and each quarter during the year ended December 31, 199X (the Schedules). The Schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on the Schedules based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Schedules. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Schedules. We believe that our audit provides a reasonable basis for our opinion.

The Schedules were prepared for the purpose of complying with the regulations issued by the Federal Aviation Administration of the U.S. Department of Transportation to implement Section 9110 and 9111 of the Aviation Safety and Capacity Expansion Act of 1990. Those regulations define collection as the point when agents or other intermediaries remit passenger facility charges to the airlines. Accordingly, our audit did not encompass tests of the underlying documentation supporting the report submitted by such agencies and intermediaries to the Company.

In our opinion, the Schedules referred to above present fairly, in all material respects, the passenger facility charges collected, withheld, refunded/exchanged, and remitted by XYZ Airline, Inc., for the year and each quarter during the year ended December 31, 199X, as defined in regulations issued by the Department of Transportation.

This report is intended solely for the information of the Board of Directors and management of XYZ Airline, Inc., and the appropriate airport authorities. However, this report is a matter of public record, and its distribution is not limited.

[Signature]

[Date]

.09

Illustrative Report on Internal Control Structure Used in Administering PFC's

Independent Auditor's Report

XYZ Airline, Inc.:

We have examined management's assertion included in its representation letter, dated February 15, 19XX, that XYZ Airline, Inc., maintained an effective internal control structure over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted during the year ended December 31, 19XX, for the purpose of complying with the regulations issued by the Federal Aviation Administration of the Department of Transportation to implement sections 9110 and 9111 of the Aviation Safety and Capacity Expansion Act of 1990.

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

Because of inherent limitations in any internal control structure, errors and irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that XYZ Airline, Inc., maintained an effective internal control structure over administering passenger facility charges collected, withheld, refunded/exchanged, and remitted during the year ended December 31, 19XX, is fairly stated, in all material respects, based upon criteria established by the Committee of Sponsoring Organizations of the Treadway Commission.

This report is intended solely for the information and use of the Board of Directors and management of XYZ Airline, Inc., and the appropriate airport authorities. However, this report is a matter of public record, and its distribution is not limited.

[Signature]
[Date]

Passenger Facility Charges - Internal Control Examination Guide

.10 The FAA has expressed interest in developing a guide for use by independent accountants in conducting the internal control structure examination attestation engagement relative to the airline's procedures for receiving, holding, and disbursing PFC revenues. Practitioners should be alert for issuance of a final guide from the FAA.

Stage II Aircraft

.11 The FAA has issued regulations that require airlines to eliminate certain aircraft from their passenger fleets by the end of 1999. These aircraft, referred to as Stage II aircraft, include Boeing 727s, 737-100s/200s, and 747-100s; McDonnell Douglas DC-9s (except 80s) and certain DC-10s; BAC-111s; Fokker 28s; and any Boeing 707s or DC-8s that have been retrofitted to Stage II. The regulations provide airlines with the option to adopt one of the following compliance schedules:

1. Reduce their base-year fleet of Stage II aircraft (determined as of the end of 1990) by 25 percent by the end of 1994, another 25 percent by the end of 1996, another 25 percent by the end of 1998, and the remaining 25 percent by the end of 1999.

2. Increase their percentage of Stage III airplanes to a minimum of 55 percent by the end of 1994, 65 percent by the end of 1996, 75 percent by the end of 1998, and 100 percent by the end of 1999.

The FAA's regulations provide that Stage II aircraft can qualify as Stage III if carriers fit those older model aircraft with so called hush-kits which reduce the excess noise levels they generate. These kits could cost up to $2 million each. Auditors should consider management's assessment of the impact of Stage II regulations on the carrying and residual values of existing aircraft. For a related discussion, see "Impairment of Long-Lived Assets" in the "Accounting Issues and Developments" section of this Audit Risk Alert.

Audit Issues

Ticketless Travel

.12 The continuing trend toward "ticketless" travel raises an issue to be considered by auditors. Under this system, an airline passenger can book a flight over the telephone and be assigned a reservation number (in a manner similar to the way hotel reservations are made) rather than being issued a ticket. Since no ticket is issued, there is no ticket stub available to the auditor as a source of evidential matter. Accordingly, the auditor's consideration of the internal control structure relating to ticketless travel and the performance of analytical procedures on the related revenues and receivables, will take on increased importance.

Code Sharing Agreements

.13 Airlines are increasingly becoming involved in marketing alliances known as code sharing agreements. These agreements may involve the coordination of flight schedules or sharing of seats on a common aircraft to the mutual benefit of the parties to the agreement. For example—

- A code sharing agreement between a regional and international carrier might require the coordination of their flight schedules so that the regional carrier could feed air traffic to the international carrier. The international carrier, in turn, would reciprocate by providing frequent flier miles to customers of the regional carrier.
- A carrier seeking to withdraw from an unprofitable route without losing a significant portion of that customer base, can continue to provide service to that market through a code sharing agreement with another carrier.
- A carrier may enter into a code sharing agreement to gain access to an international market from which it was excluded due to restrictive bilateral agreements between the U.S. and a particular foreign government. This can be accomplished by allocating seats on an airplane, along with the related ticket revenue, between the two carriers.

Such arrangements may give rise to a number of audit and accounting issues. In auditing the financial statements of airlines that are party to these agreements, auditors should become familiar with the provisions of code sharing agreements that may affect financial statement amounts and consider their accounting ramifications. For example, there may be a need to consider the propriety of amounts and timing of revenue to be recognized under the agreement and whether potential liabilities and related costs, have been properly recorded.

Restructurings

.14 To reverse the massive losses incurred over the past few years, many airlines implemented restructuring programs aimed at reducing costs. By revamping route systems and the frequency of flights, redeploying aircraft, obtaining labor concessions, grounding inefficient aircraft, or downsizing overall operations, many airlines have made significant progress in attaining profitability in 1995. Some carriers are likely to continue restructuring efforts in part due to the competitive pressures driving revenues down and regulatory requirements pushing costs up. When airlines restructure, auditors' should consider the impact of reductions in personnel on operations and on the internal control structure; the appropriateness and completeness of recorded liabilities relating to current restructuring plans; the carrying value of aircraft and intangibles (such as route acquisition costs); and the appropriate period for reporting the costs associated with restructurings.

.15 In considering restructuring liabilities and costs, auditors should be aware of Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring),* for authoritative guidance on the appropriate accounting for restructurings. EITF Issue No. 94-3 also provides guidance on the types of costs that should be accrued and the timing of recognition of restructuring charges. It also prescribes disclosures that should be included in the financial statements.

.16 *Internal Control Structure Implications.* If, after obtaining an understanding of an airline's internal control structure, the auditor concludes that the effects of restructuring have had a detrimental impact on the ability of the structure to function, an increased level of control risk may be assessed. Auditors should, therefore, adjust the scope of their audits accordingly. Documentation of the understanding of the airline's internal control structure is required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319). If that understanding reveals that the internal control structure is weak, there is increased risk that material errors and irregularities will result in misstatements in the financial statements, and a reportable condition, as defined in SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU section 325), may exist.

.17 *Publicly Held Airlines.* Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 67 (Topic 5P), *Income Statement Presentation of Restructuring Charges,* requires that restructuring charges be reported as a component of income from continuing operations.

Environmental Issues

.18 Environmental remediation liability laws, written at all levels of government, have exposed airlines to an increased vulnerability to environmental claims. The Resource, Conservation and Recovery Act, Superfund, along with various clean air and water acts, may be used to hold airlines liable for the remediation of environmental contamination. Superfund, for example, legally empowers the U.S. Environmental Protection Agency to seek recovery from current and previous owners or operators of a particular contaminated site, or anyone who generated or transported hazardous substances to such a site. An airline carrier's use, storage, and disposal of significant amounts of fossil fuels may raise issues relating to environmental contamination and, therefore, the possibility of enforced remediation.

.19 The accounting literature applicable to accounting for environmental remediation liabilities includes FASB Statement No. 5, *Accounting for Contingencies* (AC C59), FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (AC C59), and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10). In addition, guidance is included in the consensuses reached by the EITF in Issue No. 89-13, *Accounting for the Cost of Asbestos Removal,* Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination,* and Issue No. 93-5, *Accounting for Environmental Liabilities.*

.20 Auditors of publicly held airlines should be aware of the SEC's SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies.* The SAB provides the SEC staff's interpretation of current accounting literature related to the following:

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities.
- Recognition of liabilities for costs apportioned to other potential responsible parties.
- Uncertainties in the estimation of the extent of environmental liabilities.
- The appropriate discount rate for environmental liabilities, if discounting is appropriate.

- Financial statement disclosures of exit costs and other items and disclosure of certain information outside the basic financial statements.

Audit Risk Alert—1995/96 [AAM section 8010] contains further discussion of issues relating to environmental remediation matters. Also, refer to the "Accounting Issues and Developments" section of this Audit Risk Alert for information on AICPA Exposure Draft: *Proposed Statement of Position on Environmental Remediation Liabilities.*

Accounting Issues and Developments

Stock-Based Compensation

.21 As part of continuing cost cutting measures, some airlines have attempted to reduce payroll costs or increase productivity through the issuance of stock to employees in lieu of cash.

.22 In October 1995, the FASB issued Statement No. 123, *Accounting for Stock-Based Compensation.* The Statement encourages companies to adopt a new fair value based method of accounting for employee stock compensation plans. However, it also allows companies to continue to measure compensation cost for such plans using the intrinsic value based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (AC C47).

.23 The Statement also requires certain disclosures about stock-based employee compensation arrangements regardless of the method used to account for them. Companies that do not adopt the new fair value based method of accounting are required to make pro forma disclosures of net income and, if presented, earnings per share, determined as if the company had applied the new method.

.24 The accounting requirements of FASB Statement No. 123 are effective for transactions entered into in fiscal years that begin after December 15, 1995, though they may be adopted on issuance of the Statement. The disclosure requirements of the Statement are effective for financial statements for fiscal years beginning after December 15, 1995, or for an earlier fiscal year for which the Statement is initially adopted for recognizing compensation cost. Pro forma disclosures required for entities that elect to continue to measure compensation cost using APB Opinion No. 25 (AC C47) must include the effects of all awards granted in fiscal years that begin after December 15, 1994. Pro forma disclosures for awards granted in the first fiscal year beginning after December 15, 1994, need not be included in financial statements for that fiscal year but should be presented subsequently whenever financial statements for that year are presented for comparative purposes with financial statements for a later fiscal year.

.25 Auditors of airlines that issue options and warrants to their employees should consider carefully whether the accounting principles for stock-based compensation plans have been properly applied and whether financial statement disclosures are adequate.

Impairment of Long-Lived Assets

.26 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). FASB Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

.27 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.28 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. Earlier application is encouraged. Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.29 Aircraft carrying values, and their revenue-generating ability, may be affected by economic, regulatory, and physical factors. Such factors might include the price of fuel, air-worthiness directives, required aircraft modifications, and costly maintenance procedures. For example, the increase in fuel prices this year, along with the possible expiration of the gasoline tax exemption, may hasten the obsolescence of less fuel-efficient aircraft. High fuel prices and updated air-worthiness directives may cause airlines to decide that certain types of aircraft should be temporarily grounded. Additionally, regulatory requirements such as the elimination of Stage II aircraft in an airline's fleet may negatively affect the carrying and residual values of flight equipment. In such instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.30 In considering an airline's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AU section 342).

Risks and Uncertainties

.31 In December 1994, the AICPA's Accounting Standards Executive Committee issued Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires nongovernmental entities to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires entities to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.32 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of similar estimates that may be included in the financial statements of airlines include, but are not limited to:

- Useful lives and residual values of flight equipment
- Amortization period of route acquisition costs
- Allowance for obsolescence of expendable parts inventory
- Estimates of liabilities for frequent flier programs

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of airlines in accordance with paragraph 21 of the SOP include the following:

- Routes of regional carriers limited to a particular geographical area
- Revenue derived from flights along a particular route
- Unionized labor subject to collective bargaining agreements
- Flights along international routes

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

.33 Auditors should be alert to the requirements of the new SOP and its impact upon the financial statements of the entity being audited. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

.34 In June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities,* which may be relevant to airlines. The proposed SOP provides that:

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 (AC C59) are met, and it includes benchmarks to aid in determining when those criteria are met.
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent the employees are expected to devote time to the remediation effort.
- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site, and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- Measurement of the liability should be based on enacted laws and existing regulations, policies and remediation technology.
- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed, and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and clean-up laws and the need to consider various individual state and other non-United States government requirements.

.35 Comments on the exposure draft were due by October 31, 1995.

Frequent Travel Award Programs

.36 Since frequent travel award programs were created in the early 1980s, methods of accounting for the programs have been the subject of considerable discussion. Currently, airlines account for frequent travel awards by the incremental cost method, under which the airline identifies an amount based on the incremental cost associated with transporting a passenger in an otherwise empty seat, and establishes an accrual for the future obligation to provide free travel awards.

.37 In a letter sent to publicly held airlines in 1991, the SEC staff requested that the following disclosures concerning frequent travel award programs be included in SEC filings:

- The significant terms of any frequent flyer and other free travel award programs sponsored by the airline.
- The method of accounting for the programs, including the method of accounting for nontravel awards redeemed under the programs.
- If the incremental cost method is used, each material category of cost included in its measurement. In addition, a clear description of when the accrual is made and how the cost is estimated should be provided. If the liability established for provision of future services under the programs does not include a margin representing contribution to overhead and profit, that fact should be disclosed. The amount of the recorded liability or expense should be disclosed if it is material.
- The number of free travel awards outstanding at each balance-sheet date (expressed in terms of mileage, equivalent revenue value, points, trips, or any other similar measure). If the number of awards outstanding does not include partially earned awards, the effect of this exclusion should be quantified.
- The number of awards expected to be redeemed for purposes of estimating the liability recorded by the airline at each balance-sheet date. This may be expressed as a percentage of total awards outstanding. This disclosure should be accompanied by a description of the factors accounting for the difference between awards outstanding and awards expected to be redeemed, quantified to the extent practicable. The discussion should explain any material change in the ratio of expected redemptions to total outstanding awards that has occurred or may reasonably be expected to occur.
- The number of awards actually redeemed in the periods presented.
- The amount of free travel award usage expressed as a percentage of passenger miles flown for each period presented.
- If the displacement of revenue customers is reasonably likely and may materially affect liquidity or operating results, emerging trends should be described in the Management's Discussion and Analysis (MD&A) section of the annual report.

These disclosures may be included in the financial statements, in the MD&A section, or in the description-of-the-business section of the airline's SEC filings. Material changes in frequent travel awards in interim periods should be disclosed in quarterly reports on Form 10-Q.

SEC Accounting Guidance

.38 The SEC has indicated in various public speeches and in letters of comment to registrants during the year that publicly held airlines that are experiencing, or are reasonably likely to experience, liquidity constraints should carefully analyze the adequacy of their MD&A disclosures regarding liquidity. Item 303 of Regulation S-K requires that publicly held companies identify in MD&A any known trends, demands, commitments, events, or uncertainties that will result in, or that are reasonably likely to result in the company's liquidity increasing or decreasing in any material way. Further, if a material deficiency is identified, such companies should indicate the course of action that they have taken or plan to take to remedy the deficiency. Auditors should consider the consistency of the MD&A discussion of liquidity and financial condition with the company's financial statement disclosures and the auditor's report on the company's financial statements.

.39 In regard to the required MD&A discussion of liquidity, in 1994 the SEC issued an Accounting and Auditing Enforcement Release (No. 562) relative to the alleged MD&A deficiencies of an airline. According to the release, the MD&A in certain of the airline's periodic reports failed to describe uncertainties surrounding the company's efforts to obtain additional financing and its ability to meet its existing capital commitments that were conditioned on such financing. In addition, the release states that the MD&A failed to objectively evaluate how the known uncertainties could impact the financial viability of the airline.

.40 In considering MD&A, auditors should be aware of their responsibilities pursuant to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550). The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in the auditor's report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document, such as that presented in MD&A. However, the auditor should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. Auditors should refer to SAS No. 8 (AU section 550) for further specific guidance.

AICPA Audit and Accounting Literature

Industry Audit Guide

.41 The AICPA Industry Audit Guide *Audits of Airlines* is available through the AICPA loose-leaf subscription service. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the Guides as they appear in the service are printed annually.

Information Sources

.42 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.43 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.44 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.45 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.46 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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.47 This Audit Risk Alert supersedes *Airline Industry Developments—1992.*

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.48 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 3 (202) 942-7114 (tty)		*Information Line* (202) 942-8088 (202) 942-7114 (tty)
Federal Aviation Administration	800 Independence Ave., SW Washington, DC	*General Information* (202) 366-4000		
National Business Aircraft Association	1200 18th Street, NW Suite 400 Washington, DC 20036	*General Information* (202) 783-9000		
National Air Transportation Association	4226 King Street Alexandria, VA 22302	*General Information* (800) 808-NATA		

AAM Section 8100

Common Interest Realty Associations Industry Developments—1995/96

Industry and Economic Developments

.01 The term *common interest realty association* (CIRA) is generally used to describe an organization of real estate property owners principally responsible for serving the collective needs of the owners by providing certain services (for example, security and waste removal) as well as managing and maintaining common property that they all share or own. CIRAs are separate legal entities providing the owners, who generally agree to be bound by restrictive covenants, with a means for self-governing.

.02 The major types of CIRAs include condominiums, cooperatives, homeowner associations, and timeshares. Since their emergence during the 1960s, these forms of real estate ownership—especially homeowner associations and condominiums—have grown significantly. Currently, more than thirty million Americans live in some form of development governed by a CIRA. In a number of the country's larger urban centers, including the surrounding suburban areas, CIRA home sales comprised almost 50 percent of all sales for new homes during 1995. It should also be noted that the concept of CIRA developments is not limited to personal residences. Increasingly, common ownership arrangements have spread to resort condominiums in the form of timeshare developments; industrial/commercial condominiums, such as shopping centers and professional offices; and mixed-use developments such as hotels, offices, and residential units.

.03 The current popularity of CIRA developments arises from both the supply and demand side of the economic equation. Those in the construction industry are faced with increasing costs for land, building materials, and financing. Building high-density planned community projects allows developers to spread higher costs over a greater number of units, and increase the likelihood of profitability. Prospective home buyers also face economic constraints. The costs of single-family home ownership (including purchase price, operation, and maintenance) are prohibitive for many buyers. Additionally, market studies have shown that aging baby-boomers and families with two wage earners generally have neither the time nor the inclination to maintain and operate single-family residences. Many of these individuals seek the lower-cost, lower-maintenance features of CIRA developments.

.04 Given current demographic trends, the increasing costs of the construction and ownership of single-family homes, along with life-style preferences, industry observers expect that by the end of the century, almost one-half of the country's population will live in some form of CIRA development.

Legislative Issues

.05 Legislation governing CIRAs is primarily developed at the state level. Most states have adopted the principles set forth in the model legislation drafted by the National Conference of Commissioners of Uniform State Laws, which include the Uniform Condominium Act, the Uniform Planned Community Act, and the Model Real Estate Cooperative Act. The intent of these uniform state laws is to encourage consistency among statutes and to address the conflicting interests of developers, sponsors, buyers, lenders, and others involved in CIRAs. Most states use the uniform laws as models for the development of their own statutes, modifying them to meet individual needs.

.06 All fifty states have adopted legislation governing the management and development of condominiums, generally requiring the formation of CIRAs to manage the common use areas of condominium projects. These laws typically address such issues as the following:

- Financial management and operations

- Governing covenants
- Transference of property
- Owners' rights and obligations

At the local level, some jurisdictions are requiring the formation of CIRAs prior to their approval of site plans submitted by developers in order to ensure that the responsibility to maintain the common area does not fall on the locality.

Audit Issues and Developments

Internal Control Structure

.07 CIRAs tend to be small, financially unsophisticated organizations. As such, the internal control structures of CIRAs may include characteristics that affect an auditor's assessment of control risk. Characteristics that may increase control risk include the following:

- In a number of cases, smaller CIRAs have opted for self-management as a cost-saving measure. In such entities, an inadequate segregation of duties may result because the entire accounting function is the responsibility of one or a few individuals. Additionally, the accounting function may be undertaken by volunteer property owners who do not possess the requisite accounting skills or who are unable to devote adequate time and effort to the job.
- Ownership by sponsors and financial institutions, increased awareness of litigation and the potential for personal liability, along with personal demands, may impede the ability of some CIRAs to find qualified officers, directors, and other volunteers willing to handle the accounting, finance, and administration functions of the organization.
- Smaller CIRAs may be managed by small, understaffed, and frequently inexperienced, management companies. These factors are likely to contribute to an unreliable accounting and reporting function.
- The limited resources of some CIRAs may engender informal accounting systems with inadequate control procedures.

If the internal control structure of a CIRA includes the preceding characteristics, control risk might be assessed at a higher level. Auditors should adjust the scope of their audits accordingly, and should document the understanding of the entity's internal control structure as required by AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319). If that understanding reveals that the oversight function is weak, there is increased risk that material errors and irregularities will result in misstatements in the financial statements, and reportable conditions, as defined in SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU section 325), may exist. In such circumstances, there is a greater need to recognize the increased potential for fraud. Accordingly, auditors may wish to consider the guidance set forth under SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU section 316).

Related Parties

.08 Financial Accounting Standards Board (FASB) Statement No. 57, *Related Party Disclosures* (AC R36), defines related parties as "... parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests." In a CIRA environment, members of the organization's management, the developer, the sponsor, along with the governing board and their families, are generally considered to be related parties. Transactions occurring between the CIRA and such parties may be fairly common. For example, a sponsor or developer may provide managerial, maintenance, insurance, or other services to the CIRA.

.09 FASB Statement No. 57 (AC R36) sets forth the requirements for related-party disclosures. Although certain accounting pronouncements may prescribe a specific accounting treatment for related-party transactions, established accounting principles ordinarily do not require transactions with related parties to be accounted for on a basis other than that which would be appropriate if the parties were not related. Auditors should view related-party transactions within the framework of existing pronouncements, placing emphasis on the adequacy of disclosure. SAS No. 45, *Omnibus Statement on Auditing Standards—1983,* "Related Parties" (AU section 334), provides guidance on procedures auditors should consider to identify related-party relationships and transactions when they are performing an audit of financial statements in accordance with generally accepted auditing standards (GAAS). Auditors should satisfy themselves concerning the required financial statement disclosures.

Interfund Receivable/Payable or Transfer?

.10 When a CIRA uses fund accounting, a payment made by one fund on behalf of another should be recognized as an interfund receivable and payable. However, if that interfund borrowing is permanent, it should instead be recorded as a transfer. The sole distinction between an interfund receivable/payable and an interfund transfer is the ability as well as the intent of the borrowing fund to repay its debt to the disbursing fund. Auditors will need to consider whether such interfund receivables/payables are borrowings or in fact transfers that will not be repaid. In addressing the appropriate accounting for this transaction, auditors may wish to consider the following—

- The manner in which the transaction is reflected in the CIRA's budget
- Whether there is a written promissory note outlining the terms of the borrowing
- The manner in which the board of director's minutes characterizes the transaction
- Whether the reserve study has been modified to reflect the altered cash flow

Information Accompanying a CIRA's Basic Financial Statements

.11 A CIRA's financial statements commonly present additional details or explanations of items in, or related to, the basic financial statements that are not required to be presented. Typically such information might include the following:

- Additional details of a particular revenue or category of expense
- Comparison of actual balances to budgeted amounts
- Details of disbursements from a special fund

When auditors submit a document containing audited financial statements to a CIRA client, auditors have a responsibility to report on all the information included in the document. The auditor's objective in this circumstance is to describe clearly the character of the auditor's work and the degree of responsibility the auditor is taking with regard to the information accompanying the basic financial statements. In such circumstances, auditors should refer to the guidance set forth under SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AU section 551).

Independence

.12 An engagement to audit a CIRA in accordance with GAAS requires independence. Auditors may face unique issues in this regard and should therefore be alert to those circumstances that may impair independence with respect to the CIRA. The AICPA *Code of Professional Conduct* sets forth guidance on matters relating to independence for auditors of CIRAs. Auditors may need to be alert to circumstances that include but are not limited to the following—

- A CIRA might look to a unit owner who is also a CPA to provide necessary services, possibly including an audit. It should be noted that the ownership of a unit in a CIRA is considered to cause an impairment of independence. In such a circumstance, consideration should be given to the guidance set forth under Ethics Ruling No. 31, *Financial Interest in a Cooperative, Condominium Association, Planned Unit Development, Homeowners Association, Timeshare Development, or Other Common Interest Realty Association* (ET section 191.061—.062).
- Smaller, unsophisticated CIRAs may look to their auditors to assist with the day to day accounting of business transactions. It should be noted that auditor independence may be impaired if the auditor is also providing manual or automated bookkeeping or data processing services to CIRA audit clients. Ethics Interpretation No. 101-3, *Accounting Services* (ET section 101.05), sets forth specific criteria that must be met in order to be considered independent.

Additional areas of consideration relevant to an audit of CIRAs might include but are not limited to the following ethics rulings:

- Ethics Ruling No. 3, *Member as Signer or Cosigner of Checks* (ET section 191.005—.006).
- Ethics Ruling No. 4, *Payroll Preparation Services* (ET section 191.007—.008).
- Ethics Ruling No. 6, *Member's Spouse as Accountant of Client* (ET section 191.011—.012).
- Ethics Ruling No. 7, *Member Providing Contract Services* (ET section 191.013—.014).
- Ethics Ruling No. 8, *Member Providing Advisory Services* (ET section 191.015—.016).
- Ethics Ruling No. 72, *Member on Advisory Board of Client* (ET section 191.144—.145).

Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance

.13 Through the Federal Housing Administration, the United States Department of Housing and Urban Development (HUD) regulates the development and operation of all housing projects, some of which include CIRAs, for which it insures mortgages or provides rent subsidies. CIRAs that receive financial assistance from HUD may be required to submit audited financial statements to HUD annually. HUD programs covering CIRAs include the following:

- Section 202, Supportive Housing for the Elderly
- Section 213, Cooperative Housing
- Section 234(c), (d), Condominium Housing
- Section 236, Interest Reduction Program for Lower and Moderate Income Housing
- Section 811, Supportive Housing for Persons with Disabilities

Auditors of these CIRAs should consider the guidance set forth in SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AU section 801).

SAS No. 74 (AU section 801), which supersedes SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*, is effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994. SAS No. 74 (AU section 801) provides general guidance to practitioners engaged to perform compliance audits of recipients of governmental financial assistance.

.14 SAS No. 74 (AU section 801) reduces the level of detail provided at the auditing standard level. The detailed audit and reporting guidance previously in SAS No. 68 is now provided in AICPA Statement of Position (SOP) 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, or will be included in the AICPA Audit and Accounting Guide *Not-For-Profit Organizations* which is expected to be issued in the Spring of 1996 (an exposure draft of this proposed Guide was issued on April 14, 1995).

.15 SAS No. 74 (AU section 801) continues to recognize three levels of audits—GAAS, *Government Auditing Standards*, and certain other federal requirements of recipients of governmental financial assistance. SAS No. 74 (AU section 801) is applicable when the auditor is engaged to perform an audit under GAAS, and under *Government Auditing Standards*, and in certain other circumstances involving governmental financial assistance, such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations.

.16 SAS No. 74 (AU section 801) also provides general guidance to the auditor to:

1. Apply the provisions of SAS No. 54, *Illegal Acts by Clients* (AU section 317), relative to detecting misstatements resulting from illegal acts related to laws and regulations that have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of governmental entities and other recipients of governmental financial assistance.
2. Perform a financial audit in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States.
3. Perform a single or organization-wide audit or a program-specific audit in accordance with federal audit requirements.
4. Communicate with management if the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of his or her engagement.

Elimination of Uncertainty Reporting

.17 In certain instances the outcome of future events that may affect a CIRA's financial statements, including required disclosures, may not be susceptible to reasonable estimation by management. A material uncertainty relating to possible regulatory sanctions, for example, for a CIRA's failure to comply with restrictions against conveying units and common property separately is one such instance. This situation may be regarded as an uncertainty for purposes of considering the need for an explanatory paragraph in the auditor's report. Auditors of CIRAs should therefore note that the Auditing Standards Board (ASB) has issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

.18 The amendment also would expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AU section 508.37), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

.19 The proposal does not affect the provisions of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), which requires that the auditor add an explanatory paragraph to the auditor's report when there is substantial doubt about the entity's ability to continue as a going concern.

.20 The ASB hopes to finalize this SAS late this year and to issue a SAS that would be effective for reports issued on or after June 30, 1996. Comments on the proposed SAS were due on October 20, 1995.

Environmental Issues

.21 Environmental remediation liability laws, written at all levels of government, have exposed entities such as CIRAs to an increased vulnerability to environmental claims. The Resource, Conservation and Recovery Act of 1976, Superfund, and various clean air and water acts may be used to hold CIRAs liable for the remediation of environmental contamination. Superfund, for example, legally empowers the United States Environmental Protection Agency to seek recovery from current and previous owners or operators of a particular contaminated site, or anyone who generated or transported hazardous substances to such a site. Real estate developments such as CIRAs may be subject to environmental cleanup issues on the basis of circumstances such as whether:

- The project area contains wetlands.
- Past activities could have adversely affected the soil or groundwater.
- Current waste disposal practices are appropriate.

The accounting literature applicable to accounting for environmental remediation liabilities includes FASB Statement No. 5, *Accounting for Contingencies* (AC C59), FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (AC C59), and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10). In addition, guidance is included in the consensuses reached by the Emerging Issues Task Force (EITF) of the FASB in EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal*, Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination*, and Issue No. 93-5, *Accounting for Environmental Liabilities.*

.22 *Audit Risk Alert—1995/96* [AAM section 8010] contains further discussion of issues relating to environmental remediation matters. Also, refer to the "Accounting Issues and Developments" section of this Audit Risk Alert for information on AICPA Exposure Draft, *Proposed Statement of Position on Environmental Remediation Liabilities.*

Service-Center Produced Records

.23 Many CIRAs contract with others to perform tasks requiring expertise or technology that do not exist within the organization. For example, a CIRA's board of directors may retain a managing agent to provide services such as bookkeeping and accounting. Such services may have an impact on the nature, timing, and extent of the audit procedures to be performed. In such circumstances, the auditor should consider SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324). SAS No. 70 (AU section 324) provides guidance to auditors of CIRAs and to service auditors performing procedures and reporting on the control policies and procedures at service organizations.

.24 When a CIRA uses a service organization, the functions or processing performed by the service organization may have a significant effect on the CIRA's financial statements. Because the processing may be subjected to control policies and procedures that are physically and operationally separate from the entity, the internal control structure of the entity may include a component that is not directly under the control and monitoring of its management. SAS No. 55 (AU section 319), requires auditors to obtain a sufficient understanding of an entity's internal control structure to plan an audit. For this reason, planning the audit of a CIRA may require that auditors gain an understanding of the control policies and procedures performed by service organizations. When a CIRA relies on a service organization's control policies and procedures over the processing of transactions that are material to their financial statements, those control procedures should be considered by the auditors.

.25 One method of obtaining information about a service center's policies and procedures is to obtain a service auditor's report, as described in SAS No. 70 (AU section 324). However, the fact that an entity uses such an organization does not, in itself, require that such a report be obtained. In certain situations, the CIRA may implement control policies and procedures that will make it unnecessary to obtain a service auditor's report. For example, an entity using a payroll service may routinely compare the data submitted to the service organization with reports received from the service organization to check the completeness and accuracy of the data processed. The CIRA may also recompute a sample of the payroll checks for clerical accuracy and review the total payroll for reasonableness. In such circumstances, the CIRA is not relying on the service organization's controls.

.26 Other factors that may be considered in determining whether to obtain a service auditor's report include the following:

- Whether the transactions or accounts affected by the service organization are material to the CIRA's financial statements
- The extent to which the user organization retains responsibility for authorizing the transactions and maintaining the related accountability
- The availability of other information (for example, user manuals, system overviews, and technical manuals) that may provide the auditors with sufficient information to plan the audit

Interpretation No. 1 of SAS No. 70, titled "Describing Tests of Operating Effectiveness and the Results of Such Tests" (AU section 9324.01—.03) and Interpretation No. 2 of SAS No. 70, titled "Service Organizations That Use the Services of Other Service Organizations (Subservice Organizations)" (AU section 9324.04-.18), may also be relevant in this area. *Audit Risk Alert—1995/96* [AAM section 8010] contains additional information on these Interpretations. Additionally, a task force of the ASB has drafted an Auditing Procedure Study (APS) that provides guidance to auditors on implementing SAS No. 70 (AU section 324). The APS provides guidance to a service auditor engaged to issue a report on the control structure policies and procedures of a service organization. It also provides guidance to user auditors engaged to audit the financial statements of an entity that uses a service organization. The task force expects to issue the APS in early 1996.

Accounting Issues and Developments

Impairment of Long-Lived Assets

.27 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). FASB Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

.28 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.29 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.30 In considering a CIRA's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AU section 342).

Risks and Uncertainties

.31 In December 1994, the AICPA's Accounting Standards Executive Committee issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires nongovernmental entities to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires organizations to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.32 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to changes in the near term. Examples of similar estimates that may be included in the financial statements of CIRAs include, but are not limited to estimates of the following:

- Liabilities arising from lawsuits against the CIRA
- The collectibility of assessments receivable
- Liabilities arising from environmental remediation

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of CIRAs in accordance with paragraph 21 of the SOP include concentrations in the following:

- The available sources of supply of materials, labor, or services
- The number and amount of loans obtained from a particular lender
- The geographic area in which the CIRA is located

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

.33 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

CIRA Investments in Debt and Equity Securities

.34 A CIRA's governing documents may limit the kind of investments that can be made with surplus funds, or that decision may be left to the CIRA's board of directors. CIRAs may choose to invest in marketable securities such as debt securities (for example, U.S. Treasury or municipal securities) or equity securities (for example, common stock, stock rights and warrants). In that CIRA accounting is set forth primarily by the same literature that applies to commercial businesses, FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), should be considered when accounting for a CIRA's investments in marketable securities. It should be noted that while FASB Statement No. 115 (AC I80) does not apply to nonprofit organizations, it is applicable to CIRAs.

.35 FASB Statement No. 115 (AC I80) addresses the accounting and reporting for investments in equity securities that have readily determinable fair values (previously addressed by FASB Statement No. 12, *Accounting for Certain Marketable Equity Securities*) and for all investments in debt securities. Statement No. 115 (AC I80) does not cover securities accounted for by the equity method and investments in consolidated subsidiaries. Statement No. 115 (AC I80) establishes three categories of reporting for debt and marketable equity securities:

- Held-to-maturity securities (debt securities that the entity has the positive intent and ability to hold to maturity), to be reported at amortized cost with realized gains and losses reported in the CIRA's statement of revenues and expenses
- Trading securities (debt and equity securities that are bought and held principally for the purpose of selling them in the near future), to be reported at fair value, with unrealized gains and losses reported in the CIRA's statement of revenues and expenses
- Available-for-sale securities (debt and equity securities not classified as either held-to-maturity or trading), to be reported at fair value with unrealized gains and losses excluded from earnings and reported in a separate component of member's equity until realized

Given the nature of the purpose of CIRAs, it is likely that the securities they hold will be classified either as held-to-maturity or available-for-sale.

.36 FASB Statement No. 115 (AC I80) also requires CIRAs to determine whether declines in the fair value of individual securities classified as either held-to-maturity or available-for-sale below their amortized cost bases are other than temporary. For example, if it is probable that a CIRA will be unable to collect all amounts due, according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment is considered to have occurred. If such a decline is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as the new cost basis, with the amount of the write-down included in earnings (that is, accounted for as a realized loss). The Statement (AC I80) also specifies the accounting treatment for transfers between categories.

.37 Auditors should be aware of some of the issues that are likely to arise when the Statement (AC I80) is applied. Auditing financial statements involving the classification of investments in debt and equity securities pursuant to FASB Statement No. 115 (AC I80) may involve a high degree of judgment about such matters as the following:

- How auditors should evaluate subjective exceptions for sales of securities designated as held-to-maturity (including the interpretation of restrictive terms such as *isolated, nonrecurring,* and *unusual*)
- How auditors should evaluate the ability of a CIRA to hold securities to maturity, particularly when going-concern issues arise
- Whether cash flow projections are needed in conjunction with assessing a CIRA's ability to hold securities to maturity

- How to evaluate whether declines in the value of investments are other than temporary (Refer to Auditing Interpretation No. 1 of SAS No. 1, section 332, *Long-Term Investments* titled "Evidential Matter for the Carrying of Marketable Securities" [AU section 9332.01—.14], for guidance in this area.)

It should also be noted that the FASB has recently released an implementation guide for FASB Statement No. 115 (AC I80) that addresses some of the issues noted above.

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

.38 In June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities.* The exposure draft provides that—

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 (AC C59) are met, and it includes benchmarks to aid in determining when those criteria are met.
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent the employees are expected to devote time to the remediation effort.
- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site, and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- Measurement of the liability should be based on enacted laws and existing regulations, policies, and remediation technology.
- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed, and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and cleanup laws and the need to consider various individual state and other non-United States government requirements. Comments on the exposure draft were due by October 31, 1995.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

.39 The AICPA Audit and Accounting Guide *Common Interest Realty Associations* is available through the AICPA loose-leaf subscription service. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the Guides as they appear in the service are printed annually.

Information Sources

.40 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.41 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.42 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.43 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.44 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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.45 This Audit Risk Alert supersedes *Common Interest Realty Associations Industry Developments—1993.*

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.46 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
Community Associations Institute	1630 Duke Street Alexandria, VA 22314	*General Information* (703) 548-8600		
National Association of Housing Cooperatives	1614 King Street Alexandria, VA 22314	*General Information* (703) 549-5201		

[The next page is 8233.]

AAM Section 8110
Casino Industry Developments—1995/96

Industry and Economic Developments

.01 During 1995, gambling continued its pattern of exponential growth across America. Casino gambling, though once confined to the isolated deserts of Nevada and one square mile in Atlantic City, New Jersey is now, in some form, within two hours of travel time for half of all Americans. While new jurisdictions adopt the legalization of gambling to create new gaming markets, existing markets in the large population centers of the East Coast and Midwest continue to expand. Industry analysts predict, therefore, that before long casinos will be coming to every neighborhood. And, with 125 million visitors lured to the slot machines and card tables last year, Americans now spend more on casino gambling than on books, records, and movies combined. As such, casinos have become the fastest growing segment of the entertainment industry.

.02 Gambling is currently legal in 26 states and all but two states, Hawaii and Utah, have adopted, in some form, provisions regarding legalized gambling. Many other states have had annual referendums on introducing casino gambling, driven by the general view that it is a quick and painless revenue enhancer—and, typically, a very effective one at that. For example, the state of Mississippi will be considering a bill to reduce state taxes solely on the basis of a revenue surplus arising from taxes on casino profits. In New Jersey, the gaming industry is now the state's biggest taxpayer as well as the biggest employer. And, in Nevada, the gambler's paradise, the gaming industry dominates the state economy.

.03 The rate and type of growth of the gaming industry are greatly influenced by the philosophy of local regulatory authorities responsible for the oversight of gambling activities. While many states pattern their regulatory guidelines after the Nevada Gaming Control Act and the New Jersey Casino Control Act, state statutes and regulatory attitudes toward the gaming industry vary considerably. These differences are usually reflected in the mandatory accounting procedures, internal controls, and application requirements set by the various jurisdictions. Nevada, for example, offers a low-tax environment with minimal regulation. As a result, the state's major cities, Reno, Lake Tahoe, and Las Vegas, have become the exclusive domains of the casino industry. Most other jurisdictions, however, view casino gaming solely as a source of revenue rather than an integral part of the social and economic environment. Auditors should gain an understanding of the nature of the regulatory environment in which a casino operates since it is a factor likely to have an impact on the assessment of audit risk. Further discussion of this issue is contained in the "Regulatory Issues and Developments" section of this Audit Risk Alert.

.04 Among the obstacles faced by the industry are the public perception that casino gambling has negative consequences for society, and that it has a detrimental impact on surrounding localities. Riverboat casinos, first introduced by Iowa in 1991, were initially seen by legislators and industry lobbyists as a way to ease the introduction of state sanctioned gambling by allaying such fears. Proponents believed that restricting gaming activities to cruising riverboats would ensure that a casino was not going to be near a school, a church, or in somebody's backyard—thus limiting the amount of community resistance. Since that time casino gambling on riverboat cruises has been a significant growth segment of the gaming industry. So much so that states such as Iowa and Missouri have led the way in easing riverboat regulations by allowing the boats to remain at dockside rather than requiring them to take periodic cruises. Industry observers believe that permanent dockside for riverboat casinos is the wave of the future.

.05 In giving consideration to the industry environment in which their casino clients operate, auditors should be aware that despite the current popularity of gambling, there are some signs of threats to future growth. At the state level, gambling referendums in Florida and Texas have been unsuccessful. Louisiana has gone even further, perhaps to the point of reversing its position on legalized gambling. Published reports have discussed the rise of an anti-gambling sentiment in that state driven by moral objections to gambling, disappointing economic payoffs, an adverse competitive impact on local commercial enterprises, and alleged political scandals. This sentiment has been fueled by the Federal Bureau of Investigation's (FBI's) recent release of wiretap transcripts in which a Louisiana state legislator allegedly discussed taking bribes from a representative of the gaming industry (see "Illegal Acts by Clients" in the "Audit Issues" section of this Audit Risk Alert). At the national level, published reports documenting concerns by some about the penetration of organized crime into the realm of legitimate gambling—as well as concerns about the moral implications of government sanctioned gambling—underlie a bill presented in the House of Representatives that seeks to establish a national commission to investigate economic and social effects of gambling.

.06 While the cumulative effect of these events is uncertain, they may ultimately have some adverse impact on the gaming industry. It is likely to take the form of more restrictive legislation or tighter regulatory monitoring of casino operations, or perhaps a reduction of growth in the expansion of legalized gambling to new jurisdictions. Auditors may wish to consider the impact of these events, and their possible ramifications on legislative and regulatory initiatives when planning their audits and considering the internal control structure of their gaming clients.

Competitive Environment

.07 Casinos face direct competition from other entities in the gaming industry for such things as limited gaming licenses, desirable locations for casino construction, qualified personnel and, of course, customers. And although the spread of legalized gambling to new jurisdictions, including Indian Reservations and riverboats, is likely to present opportunities for casinos with the expertise and financial ability to gain footholds in these newly created markets, there will also be a corresponding increase in the level of competition. Casinos also face indirect competition from other forms of legalized gambling including state-sponsored lotteries, off-track wagering, charity bingo as well as the emerging area of electronic gambling (for example, lotteries conducted on-line or by telephone). Industry analysts expect the competitive environment to become even more intense in the near term as existing casinos expand their operations, and as new enterprises emerge to meet the growing demand for gambling. Some observers have suggested that the race to meet this demand may result in an oversaturated market, with the threat of a glut facing some major gambling centers. For example, Las Vegas is now being forced to absorb its second significant wave of casino construction since the early 1990s. Auditors may wish to consider whether potential asset realization problems could result from this circumstance. See "Impairment of Long-Lived Assets" in the "Accounting Developments" section of this Audit Risk Alert for further discussion.

.08 As a competitive strategy, new casinos have adopted more exotic and creative themes to differentiate themselves from the numerous gaming enterprises with which they compete. Plans for the construction of new Las Vegas mega-casinos include an opulently designed casino-resort situated on an island in the middle of a 50-acre artificial lake. Another casino under construction will use Paris as a central theme, featuring a 50-story replica of the Eiffel Tower. The estimated price tags of such projects run as high as $1 billion. As such, these undertakings generate huge financing needs and, typically, the related loan agreements contain highly restrictive covenants. The audit implications of such loan covenants are addressed under "Loan Covenants" in the "Audit Issues" section of this Audit Risk Alert.

.09 The impact of external influences that affect a casino's operations, and matters relating to the industry in which a casino operates, such as the current competitive environment issues discussed above, are among the factors to be noted by auditors when—

- considering the control environment of a casino's internal control structure pursuant to AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), and

- planning the audit in accordance with SAS No. 22, *Planning and Supervision* (AU section 311).

Casino Specialization

.10 The casino business has generally been considered to be a natural extension of the hotel industry for many major companies. In the early days of gambling, when such activities were confined to Nevada and Atlantic City, most customers came from out of state. The casino-hotel tandem was, therefore, a natural outgrowth of the business environment. As such, several large hotel chains have been prominent in casino gaming. With the proliferation of casino gambling, however, a trend appears to be developing toward separating the two segments. As a result, casino specialization is becoming more prevalent.

.11 During 1995, two major hotel companies announced their intention to spin-off their casino operations into separate companies to allow the casinos to focus their attention on the expanding opportunities in the gaming industry. Authoritative accounting guidance for the disposal of a business segment by, for example, "spinning-off" the unit, is set forth under Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13), along with paragraph 23 of APB Opinion No. 29, *Accounting for Nonmonetary Transactions* (AC N35.113). In order to qualify for discontinued operations treatment, an entity must meet all the criteria established by APB Opinion No. 30 (AC I13). These include, a formal plan to dispose of a business segment, and the expectation that the plan of disposal will be carried out within a one-year period from the measurement date. In these circumstances, auditors should consider whether management has appropriately accounted for the disposal of a business segment in accordance with the guidelines of APB Opinion No. 30 (AC I13). See "Restructuring Charges" and "Impairment of Long-Lived Assets" in the "Accounting Developments" section of this Audit Risk Alert for further discussion of this matter.

.12 For publicly held casinos, the Securities and Exchange Commission's (SEC's) Staff Accounting Bulletin (SAB) No. 93 (Topic 5Z), *Accounting and Disclosures Regarding Discontinued Operations*, expresses certain views of the SEC staff regarding accounting and disclosures related to discontinued operations. The SEC SAB indicates that an entity's plan of disposal would not meet the criteria in APB Opinion No. 30 (AC I13) if the method of disposal of the business segment has not been determined or if the plan of disposal requires more than one year. The SEC SAB also discusses accounting for the abandonment of a business segment, disposal of an operation with a significant interest retained, classification and disclosure of contingencies relating to discontinued operations, and accounting for subsidiaries that an entity intends to sell.

Regulatory Issues and Developments

.13 Gaming is regulated in every jurisdiction in which it is currently legalized, and regulations generally require the receipt of a non-transferable, renewable, license prior to the commencement of gaming operations. Typically the casino's officers, directors, and certain key employees, must be licensed by local gaming authorities. Regulatory frameworks impose restrictions and costs, including additional taxes, that may materially detract from the feasibility or profitability of gaming operations. Gaming regulations, and their enforcement, are within the discretion of the regulating jurisdictions. In addition, floating gaming ventures, such as riverboat casinos, require compliance with certain maritime laws and U.S. Coast Guard regulations. The issue of compliance with regulatory guidelines may have audit significance in that violations could result in the suspension or revocation of the casino's license to operate.

Bank Secrecy Act

.14 Money laundering—the funneling of cash generated from illegal activities through legitimate businesses that handle cash—has spread outward from the banking sector to non-bank financial institutions and non-financial businesses. The Bank Secrecy Act (BSA), enacted to address this problem, authorizes the Treasury Department to issue regulations requiring financial institutions, as well as casinos, to file reports, keep certain records, implement counter-money laundering programs and compliance procedures, and report suspicious transactions to the government. The Money Laundering Suppression Act of 1994 further empowers the Treasury Department to extend BSA regulations to the full range of gaming establishments in the U.S.

.15 Failure to comply with the provisions of the BSA may result in the assessment of severe penalties on casinos. The BSA was instituted to discourage the use of currency in illegal transactions and to identify unusual or questionable transactions that could aid in criminal, tax, and other regulatory investigations. The government is vigorously enforcing the BSA, and casino operators need to closely review their compliance with its reporting and recordkeeping requirements. Auditors may wish to gain an understanding of the BSA and the nature of its stringent reporting and recordkeeping requirements on casinos. Also, see "Illegal Acts by Clients" in the "Audit Issues" section of this Audit Risk Alert.

.16 Concerned with possible money laundering in Native American casinos, the U.S. Treasury Department issued proposed regulations under the BSA during 1995 that will bring tribal gaming under its regulatory purview and away from that of the Interior Department where it has been (Indian casinos are presently regulated under the Indian Gaming Regulation Act [IGRA] of 1988). The proposed regulations would amend the definition of casinos to include those operated on Indian lands. By the first quarter of 1996, about 120 tribal casinos of all types in 16 states, whose aggregate wagering exceeds $27 billion, will be required to comply with various provisions of the BSA.

.17 The inclusion of Native American casinos under BSA regulations will tend to level the competitive playing field for casinos that operate in the U.S. However, that still leaves Nevada casinos outside the reach of BSA regulations and Treasury Department supervision. Casinos in that state received an exemption from the BSA in 1985, with the Treasury Department's approval, that may provide them with some competitive advantages over gaming operators in other states.

Casino Taxation

.18 The level of casino taxation varies greatly from one jurisdiction to the next and typically reflects the local philosophy and attitudes toward the industry. While gaming taxes range from 3 percent to 6.25 percent in Nevada, they start at 8 percent in Atlantic City, New Jersey. The riverboat markets of Illinois, Indiana, and Missouri start at a rate of 20 percent.

.19 In New Orleans the minimum tax on gaming revenues of 18.5 percent is mitigated to some extent through the granting of exclusive rights to land-based gaming. And, while the combination of high taxes and exclusive licensing generally benefits both the jurisdiction and the gaming operator, high-tax locales, that have liberal licensing guidelines, pose significant business risks for gaming operators. A number of riverboat casinos in such venues have recently failed or have been forced to seek new locations. The implications of high tax rates, intense competitive pressures, along with other circumstances discussed above, may give rise to substantial doubts about the ability of a casino to continue as a going concern. Auditors should consider their responsibilities pursuant to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341). SAS No. 59 (AU section 341) provides guidance to auditors for evaluating whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period not to exceed one year from the date of the financial statements being audited.

Audit Issues

Audit Planning Considerations

.20 In planning their audits of casinos pursuant to SAS No. 22 (AU section 311), it is important for auditors to familiarize themselves with the unique aspects of the casino industry. Among other things, auditors may wish to consider—

- The regulatory requirements applicable to the casino.

- Whether the casino is under investigation by a regulatory body and if so, management's and counsel's expectations of the outcome.
- The increased likelihood of irregularities given the handling of large amounts of cash by casino employees. If necessary, auditors should refer to the guidance set forth under SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU section 316).
- Regulatory requirements which dictate that casinos maintain an internal audit staff. Auditors should be aware of the difficulties in considering the work of internal auditors in a casino environment. A significant portion of the work of internal auditors in this environment involves the observation of casino operations thus limiting the documentary evidential matter available. Auditors should be aware of the authoritative guidance set forth under SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AU section 322).

Internal Control Structure

.21 *Gaming Revenues.* Due to the limited amount of physical evidence supporting gaming revenue transactions, auditors of casinos must generally place reliance on the entity's internal control structure. Reliance on the internal control structure may involve a significant amount of on-line testing of controls since there may be little or no documentary evidence available for evaluation. Auditors may therefore be limited to corroborative inquiries and unannounced observations of casino floor operations, and cage and count room activities. Auditors should be aware that a scope limitation may arise due to the inability to obtain sufficient competent evidential matter about the effectiveness of the design and operation of a casino's internal control structure policies and procedures that are relevant to those financial statement assertions concerning gaming revenues. As such, there may be no basis to support an assessed level of control risk that allows the auditor to conclude that the risk of material misstatement of the balance has been reduced to an acceptable level. If so, the auditor may consider modifying his or her opinion accordingly.

.22 *Reports on a Casino's Design of an Internal Control Structure.* Guidelines imposed on casinos by gaming regulators typically include a requirement for the submission of a detailed proposal setting forth a system of controls over the casino's accounting system. While requirements vary from one jurisdiction to the next, it is common that such proposals are accompanied by the report of an independent accountant stating whether the proposed system of controls conforms to the standards established by the gaming authority. Authoritative guidance for reports of this type is set forth under AICPA Statement on Standards for Attestation Engagements No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AT section 400).

Casino Revenues—Analytical Procedures

.23 Given the lack of sufficient underlying documentation, auditors face difficulties in applying tests of details to casino revenues. As such, the use of analytical procedures take on increased importance. Ratio and fluctuation analyses, comparisons of financial statement assertions with auditor developed expectations, and comparisons of accounting data with operating data, are some of the techniques available to auditors. In performing analytical procedures on casino revenues, auditors may consider, along with other information, the following factors—

- Demographic data of casino clientele
- Betting limits established by regulatory agencies
- Effects of adverse weather conditions or special events, such as conventions, on casino attendance
- Seasonality of casino operations
- General economic conditions
- Effects of intense competition

- Impact of promotional programs
- Probable win ratios

.24 Plausible relationships among data may reasonably be expected to exist, and continue, in the absence of known conditions to the contrary. The detection of variations in such relationships may uncover the existence of unusual transactions or events, accounting changes, business changes, random fluctuations, or misstatements. However, auditors of casinos should note that statistical information for casinos may be prone to more significant fluctuations than that of other industries due to the element of chance, which is a fundamental characteristic of casino operations. And, while over the long term such fluctuations may be more likely to conform to expected patterns, short term fluctuations are not uncommon.

.25 Auditors should note that authoritative guidance on the use of analytical procedures is set forth under SAS No. 56, *Analytical Procedures* (AU section 329), which requires the use of analytical procedures in the planning and overall review stages of all audits.

Illegal Acts by Clients

.26 During 1995, the FBI initiated an investigation into public gaming in the state of Louisiana involving money laundering and the bribery of state legislators. The FBI is looking into allegations of payoffs to the legislators from video-poker interests in the state including owners of so-called "mini-casinos" where these machines are in abundance.

.27 While the auditor does not ordinarily have a sufficient basis for recognizing possible violations of laws and regulations when their financial statement effect is indirect, this event, though not suggestive of an industry-wide problem, should serve as a reminder to auditors of their responsibilities with regard to possible illegal acts by clients. Auditors should design their audits to provide reasonable assurance of detecting material misstatements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts. However, an audit performed in accordance with generally accepted auditing standards does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Auditors should, however, be aware of the possibility that such illegal acts may have occurred. Specific guidance in this area is set forth in SAS No. 54, *Illegal Acts by Clients* (AU section 317).

Loan Covenants

.28 The intense competitive pressures in such venues as Las Vegas and Atlantic City have forced new operators seeking entrance to those markets, and existing operators embarking upon expansion, to build mega-resorts that incorporate fanciful and extravagant themes. These projects are extremely expensive and generate significant financing requirements. The restrictive covenants that frequently accompany the loan agreements negotiated for such projects can be an area of considerable audit risk in the current year. Auditors should be alert to the possibility that covenant violations could cause long-term debt to be reclassified as a current liability.

.29 Loan agreements may contain covenants requiring the borrower to adhere to specified financial ratios or to maintain amounts for certain financial statement items within a given range. Others may contain restrictions on capital expenditures and dividends, and some may place restrictions on executive compensation and benefits. If a covenant violation on a long-term debt agreement has occurred and exists at the balance-sheet date, no matter how "insignificant" or "technical," Financial Accounting Standards Board (FASB) Statement No. 78, *Classification of Obligations That Are Callable by the Creditor* (AC B05), requires that the obligation be classified as a current liability, unless one of the following conditions is met:

- The creditor waives (see FASB Emerging Issues Task Force (EITF) Issue No. 86-30, *Classification of Obligations When a Violation is Waived by the Creditor*) or subsequently loses, for more than one year from the balance-sheet date, its right to demand repayment.

- The obligation contains a grace period within which the debtor may "cure" the violation, and it is "probable" that the violation will be cured.

In addition, if the second condition occurs, thereby resulting in a reclassification of long-term debt, paragraph 5 of FASB Statement No. 78 (AC B05.109A and .118) requires that the circumstances be disclosed. For public entities, Rule 4.08(d) of SEC Regulation S-X requires that if a default exists but acceleration of the debt has been waived for a stated period of time beyond the date of the most recent balance sheet being filed, the footnotes to the financial statements should disclose the amount of the obligation and the period of the waiver.

.30 Some long-term debt agreements may contain a subjective acceleration provision that gives the lender the power to call a loan without an objectively determinable cause (for example, a material adverse change occurs). In such cases, FASB Technical Bulletin No. 79-3, *Subjective Acceleration Clauses in Long-Term Debt Agreements* (AC B05), which incorporates criteria set forth in FASB Statement No. 5, *Accounting for Contingencies* (AC C59), should be followed to evaluate the likelihood of debt acceleration. Such evaluations may be highly subjective, and, therefore, the rationale for the entity's conclusion should be carefully assessed by the auditor.

.31 Some loans may contain "due on demand" clauses along with a schedule of payments for principal and interest. The demand clause gives the lender the right to call a loan at any time. EITF Issue No. 86-5, *Classifying Demand Notes with Repayment Terms,* concludes that loans with "or on demand" clauses should always be considered current liabilities in accordance with FASB Statement No. 78 (AC B05) (except in the rare instance that a lender waives that right for a period of one year).

.32 Auditors may wish to carefully consider the requirements imposed by loan covenants while planning and performing the audit. Auditors may consider employing the following procedures:

- Obtain written confirmation of lender waivers of loan covenant violations and of lenders' lack of knowledge of any violations or intent to call a loan.
- Consider obtaining an opinion from the entity's attorney regarding technical covenant violations.
- Obtain specific management representations regarding known covenant violations and any communications with lenders regarding violations or waivers during the year.
- Give particular consideration to potential audit adjustments that, if made, would affect loan covenant provisions.

Additionally, for highly leveraged casinos, auditors may wish to consider the effect such a reclassification may have on that entity's ability to continue as a going concern.

Casino Receivables

.33 Casino receivables arise from the extensive use of credit for casino play. Receivables are also known as markers, hold checks, or IOUs. Extensive procedures involving checks and balances are built into the systems, relating to the issuance, collection, and administration of casino credit. From an audit and financial presentation standpoint, the primary audit objectives are—

- Valuation of receivables.
  - — Specification of proper amounts of receivables, including proper accounting for the markers and any payment made against the total balance
  - — Recognition of the bona fide nature of the receivables, through traditional procedures of confirmation
  - — Adequacy of valuation reserves, including those for uncollectibles, as well as provisions for foreign exchange losses on markers denominated in a foreign currency

- Consistent methods of revenue recognition from credit play.

.34 The recent trend in corporate gaming has resulted in the increasing formalization of credit procedures, from credit approval, which may be evidenced by the use of credit cards, to collection methods, which are standardized and include monthly statements. In these circumstances, procedures are becoming more like accounts receivable in other industries, and the process of confirmation—both positive and negative, as appropriate—is finding increasing use in the auditing of casinos. When using confirmations to obtain evidence from third parties about financial statement assertions made by management, auditors should refer to the guidance contained in SAS No. 67, *The Confirmation Process* (AU section 330).

.35 Factors that affect the nature, timing, and extent of confirmation procedures include the following:

- *The effectiveness of the internal control structure*— Documents supporting casino receivables may be found in several locations, and segments of the receivable balance may be included in more than one area of accountability, such as the casino cage, branch offices, or collection agencies. Because there is a possibility that assets from one area might be used to cover shortages in another, it is generally advisable to consider all casino receivables as one population to be confirmed as of a single date. Internal control structure policies and procedures may be different for each area; accordingly, the effectiveness of the internal control structure for each should be considered separately.

- *The possibility of disputes and the possibility that debtors will be unable to confirm the information requested*—The possibility of disputes and the possible inability to confirm information are greater than normal in casino operations because customers do not generally receive copies of documents evidencing indebtedness; they rely primarily on their own records, if any, or on their memories.

- *Customers' knowledge of components of account balances*—Confirmation procedures may be directed to account balances or to individual items included in such balances. Although casino customers' balances may include several separately executed instruments, it is likely that the customers will be able to confirm only their account balances. They do not generally know, nor do they usually have records of, the individual components of their balances.

In addition, casino customers may be more sensitive to contact about their accounts than customers in other businesses. Customers' true names may not be on the credit file (generally, though, such records are maintained), or the record of their true names may be kept elsewhere. Customers may have requested that they not receive mail or perhaps not be contacted at all regarding their accounts. Such situations require care by auditors and cooperation from management so that the casino customers are not alienated and so that the auditors can satisfactorily confirm the accounts, thus avoiding a possible significant limitation on the scope of the audit.

Chip and Token Liability

.36 A unique issue of casino liability is the existence and nature of chip and gaming token liability. Virtually all casinos have issued various denominations of gaming chips for use in their casino operations.

.37 From an operational standpoint, the chips and tokens that a casino has outstanding must be redeemed by the casino upon presentation by a patron or another casino. At any time, the amount of liability is the difference between the total amount of chips and tokens issued by the casino and the amount actually on hand within the casino. Over a period of years, the amount of chip liability generally tends to increase, as the casino has more of its chips and tokens outstanding in circulation.

.38 The primary reason for this increase over time is not merely transaction float in the immediate casino trading area, but also the propensity for customers to keep chips and tokens for souvenirs. A second factor is that the redemption of the $1.00 tokens from casino to casino is lagging, since the physical separation of tokens is very difficult and time consuming.

Accounting Developments

Impairment of Long-Lived Assets

.39 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). FASB Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

.40 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by APB Opinion No. 30 (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.41 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. Earlier application is encouraged. Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.42 In order to attract gamblers and maintain an advantage over the competition, casinos periodically upgrade their gaming machines with the latest technological advances. During the current year several casinos have replaced their slot machines with state-of-the-art devices with embedded bill acceptors. Thus, older, outdated long-lived assets such as slot machines may not generate adequate future cash flows. Additionally, significant adverse changes in a casino's business climate or an adverse action taken by a gaming regulator could affect the value of other casino gaming assets. In such instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.43 In considering a casino's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AU section 342).

Risks and Uncertainties

.44 In December 1994, the AICPA's Accounting Standards Executive Committee issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires nongovernmental entities to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires entities to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.45 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of similar estimates that may be included in the financial statements of casinos include, but are not limited to:

- Net realizable value of casino receivables
- Capitalization and amortization of costs relating to a casino's major entertainment production

Examples of concentrations that may be subject to disclosure in the financial statements of casinos may include:

- volume of business with a particular class of customer such as convention business, "tour-package" vacationers or consistent wagerers;
- revenue from a particular gaming operation such as slot machines or table games;
- operations in a single geographic location such as a riverboat casino

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995 and for complete financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

.46 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements of the entity being audited. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

Restructuring Charges

.47 During 1995, two major hotel-casino operators announced their intention to spin-off their casino operations into separate companies. Another major casino owner agreed to be acquired by a large gaming concern. These actions are designed to enable the constituent companies to gain access to new markets through acquisition or allow them to concentrate on their core business by divesting themselves of unrelated divisions. Restructuring often accompanies these activities as redundant functions are eliminated and existing areas streamlined. Auditors should consider the impact of such activities on the entity's operations and internal control structure; the reserves relating to current restructuring plans; and the appropriate period for reporting the costs associated with restructurings.

.48 In considering restructuring liabilities and costs, auditors should be aware of EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, for authoritative guidance on the appropriate accounting for restructurings. EITF Issue No. 94-3 also provides guidance on (1) the types of costs that should be accrued, (2) the timing of recognition of restructuring charges, and (3) prescribing disclosures that should be included in the financial statements.

.49 For publicly held entities, SEC SAB No. 67 (Topic 5P), *Income Statement Presentation of Restructuring Charges*, requires that restructuring charges be reported as a component of income from continuing operations.

Promotional Allowances or Complimentary Expenses

.50 It is customary for casinos to provide many customers with free rooms, food, beverages, and other amenities without cost. These free services are known in the industry as complementaries or promotional allowances. The services are usually rendered by the casino's support departments, such as the hotel or food and beverage operation, to encourage customers to play in the casino.

.51 The standard financial reporting rules for the Nevada Gaming Control Board, for example, require the inclusion of these complimentary services at full retail value in the reported revenues of the appropriate department (rooms, restaurant, bar). This requirement follows the widespread hotel industry practice of valuing these items at retail value. Although there may be many different ideas of what constitutes retail, most casinos have established standard charge rates, usually slightly below premium prices for the valuation of complimentary services. The primary use of including these services at retail is to avoid distorting the operating ratios and performance measures in these support areas, particularly in the food and beverage area.

.52 The accounting treatment of the costs of these complimentary services is much less uniform. In some cases, the retail value is merely subtracted from the total sales to arrive at a net sales figure. This presentation then usually labels the deductions as promotional allowances and has become known as the promotional allowances method.

.53 The second method, known as the complimentary expense method, treats the retail amount of the complimentary service either as a cost of operation of the department providing the service or, by using some form of transfer allocation, as a cost of business of the casino department. In some cases, the complimentary expenses are merely regarded as overall administrative expense, and the retail value of the goods and services are included in this area of expense.

.54 The promotional allowance method of presentation is preferred, and results in the correct statement of net income of the casino operation. SEC SAB No. 69, *Disclosures by Non-bank Holding Companies Engaged in Lending and Deposit Activities and Casino-Hotels,* requires the separate presentation of revenues and related costs and expenses applicable to major revenue-providing activities of hotel-casinos. Thus, for promotionals, the financial statements should reflect the actual cost of promotionals as an expense of the activity that gave rise to them (for example, if the casino issued a food complimentary, the cost of this complimentary is to be included in casino expenses in the financial statements).

AICPA Audit and Accounting Literature

Audit and Accounting Guide

.55 The AICPA Audit and Accounting Guide *Audits of Casinos* is available through the AICPA's loose-leaf subscription service. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the guides as they appear in the service are printed annually.

Information Sources

.56 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.57 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.58 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.59 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.60 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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.61 This Audit Risk Alert supersedes *Casino Industry Developments—1994.*

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.62 Practitioners should also be aware of the economic, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants (AICPA)	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board (FASB)	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. Securities and Exchange Commission (SEC)	*Publication Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 3 (202) 942-7114 (tty)		*Information Line* (202) 942-8088 (202) 942-7114 (tty)
Casino and Theme Party Operators Association	2120 G S Highland Dr. Las Vegas, NV 89102	*General Information* (702) 385-2963		

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AAM Section 8120

Construction Contractors Industry Developments—1995/96

Industry and Economic Developments

.01 The construction industry is one of the largest segments of the U.S. economy. Construction activities contribute more to the gross national product, and employ more people, than any other single industry.

.02 The U.S. government's Standard Industrial Classification groups construction activities into the following three categories: (1) *Building construction*—which includes the construction of single-family homes, apartment and office buildings, and hospitals, (2) *Nonbuilding construction*—which includes heavy construction projects on streets, highways, tunnels, and bridges, and (3) *Specialty construction*—which includes services such as masonry, carpentry, plumbing, and electrical work.

.03 Historically, construction contractors have been small, family-owned businesses. Accordingly, in terms of organizational structure, many construction contractors operate as sole proprietorships. The advent of large-scale projects such as sports arenas, nuclear power plants, shopping malls, and commercial buildings, however, has given rise to large national and international construction corporations. These entities have the financial resources and specialized skills to undertake and complete such projects. Nevertheless, despite a continuing trend toward larger, more specialized entities, the majority of small to midsized construction projects in the United States are handled by local and regional contractors.

.04 During 1995, the construction industry is expected to continue its three-year recovery, climbing a modest 3 percent in overall output. Residential housing prices are expected to rise to a median price of approximately $115,000, gaining 4.5 percent nationwide. Contrary to early expectations, interest rates on 30-year fixed-rate mortgages, which averaged 9.15 percent at the beginning of 1995, dropped to 7.61 percent by midyear. As a result, housing starts, which are particularly sensitive to interest rate changes, showed their biggest gain in 16 months, rising 6.7 percent in July 1995 to an annualized rate of 1.38 million. As home buyers took advantage of lower mortgage rates, single-family starts—which represent approximately 80 percent of all housing starts—rose 6.8 percent in July 1995. Geographically, the southern and western regions of the country showed the largest gains, reflecting the migration of people and industries to those areas. Housing starts continue to decline in the Northeast and, to a lesser extent, in the Midwest.

.05 Current economic forecasts of low inflation and slow growth suggest to some observers that the Federal Reserve may cut interest rates again before year end. If so, this should have a continued positive impact on the housing sector of the construction industry. Additionally, an increase in applications submitted for building permits, which are generally considered to be a barometer of future housing construction activity, suggests that the increase in housing starts will continue through 1995. In spite of these positive signs, most industry analysts do not expect 1995 to be a period of significant growth for the construction industry.

.06 After several years of decline, construction of apartment buildings increased in 1994. An additional 275,000 units are expected to be started during 1995. By midyear, construction of new apartments and condominiums rose 6.5 percent. And although prices of apartment properties have been rising steadily, significant gains are not expected for 1995.

.07 Nonresidential construction is generally less interest-rate sensitive than housing construction being more reliant on the overall level of corporate profits. Accordingly, given the current strength of corporate profits, nonresidential construction activity is expected to increase. Modest increases are predicted for heavy construction projects on streets, highways, and the like. These projects are long-term ventures that are usually publicly financed. As such they are typically less sensitive to economic indicators than are other segments of the construction industry.

.08 Positive indicators such as the increase in housing starts and lower than expected interest rates point to improved economic conditions for the construction industry. However, even under these circumstances there is a high level of inherent risk associated with management's judgments underlying estimates of, for example, progress toward completion of construction contracts. Such estimates, in turn, affect the determination of revenues, cost of revenues, accounts receivable, unbilled receivables, retentions receivable, and inventory. Auditors should be aware that current favorable economic conditions may cause management to use overly optimistic assumptions when developing estimates. Auditors should also note that business decisions made by construction contractors during periods of economic recovery (such as, undertaking new construction projects) may not have an immediate impact on the contractor's results of operations due to the length of the start-up period and the contract term.

Competitive Environment

.09 The construction industry operates in an intensely competitive environment. As such, competitive pressures may affect a great number of construction contractors' business decisions. For example, contractors may enter into high-risk contracts with uncreditworthy customers in hopes of gaining access to new markets. In this circumstance, the auditor's assessment of the proper valuation of receivables from such customers—by reviewing subsequent cash receipts, customer financial viability, past payment performance, the adequacy of allowances for doubtful accounts, and the like—may take on increased importance.

.10 Along with competition, construction contractors face other significant business risks such as the limited availability of financing and the increasing costs of materials and labor. As a result, construction contractors are subject to an unusually high rate of business failure. Auditors, should, therefore be aware of their responsibilities pursuant to AICPA Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341). The "Audit Issues and Developments" section of this Audit Risk Alert includes further discussion of this matter.

Legislative and Regulatory Developments

.11 In addition to state and local ordinances (for example, building codes and zoning restrictions) construction contractors are subject to significant federal oversight. Regulatory bodies such as the Environmental Protection Agency (EPA), the Occupational Safety and Health Administration (OSHA), and the Equal Employment Opportunity Commission impose numerous restrictions on construction contractors. Such restrictions, while having an impact on the operating activities of construction contractors generally do not affect their financial statement reporting.

.12 The recent philosophical shift in the congressional landscape portends a change in the role of the federal government. With a mandate to reduce the federal budget deficit and bureaucracy, legislative action relaxing restrictions on businesses such as construction contractors is likely to be enacted. In anticipation of such changes, the current administration has taken some steps on their own to restrain certain regulatory initiatives. For example, the EPA has issued more lenient rules on Superfund site cleanups, while OSHA has slowed planned regulations on tighter standards for construction worker safety. However, in spite of the likely regulatory relief ahead, construction contractors have a responsibility to comply with existing laws and regulations. The auditor's responsibilities in this area are set forth in SAS No. 54, *Illegal Acts by Clients* (AU section 317). SAS No. 54 (AU section 317) provides guidance on the nature and extent of the consideration an auditor should give to the possibility of illegal acts by a client in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS).

Independent Contractor or Employee?

.13 The Internal Revenue Service (IRS) continues to pursue the issue of the appropriate classification of workers as independent contractors or as employees. The IRS has specifically targeted construction contractors for increased scrutiny given the industry's extensive use of subcontractors. Auditors should be aware of the risk that unrecorded liabilities may exist when an employee has, for tax purposes, been incorrectly classified as an independent contractor. For example, additional liabilities accrue when contractors have failed to—

- Withhold appropriate employee payroll taxes such as employee/employer portions of Social Security and Medicare, unemployment, income, etc., along with possible penalties and interest.
- Pay appropriate overtime compensation in accordance with wage and hour laws.
- Make appropriate pension plan contributions, thereby running the risk of the possible loss of allowable tax deductions for an employee benefit plan contribution, or jeopardizing the plan's tax-exempt status.

IRS Revenue Ruling 87-41 provides a list of factors affecting the classification of a worker as an independent contractor or as an employee.

Audit Issues and Developments

Auditing Estimates

.14 Given the unique nature of a construction contractor's business, and the extensive use of estimates, audits of construction contractors can be relatively complex. Estimates relating to future events affect the determination of contract costs, revenues, gross profits, and percentage of completion.

.15 Proper implementation of the percentage-of-completion method (see "Revenue Recognition" following this discussion) requires that contractors have the ability to make reasonable, dependable estimates. Although the development of estimates is generally considered to be a normal and essential part of a contractor's business, auditors should, nevertheless, give careful consideration to whether the contractor is capable of making sufficiently dependable estimates.

.16 Auditors should consider the effect of current industry and economic conditions, and expected future trends, on management's estimation process. With slow economic growth currently forecast, and intense competition expected to continue, there is increased risk that construction contractors may be inclined to offset low revenue growth by underestimating costs to complete. For example—

- Based on projections of continued low inflation, management may underestimate future price escalations.
- In anticipation of declining interest rates, management may reduce estimates of future financing costs.
- In expectation of regulatory relief, management may underestimate expected compliance costs.

Auditors should carefully review contractors' estimated costs to complete to determine whether it is probable that losses may be incurred on contracts. When evaluating the propriety of estimated costs, auditors should review representations of management and obtain explanations of apparent disparities between estimates and past performance on contracts, experience on other contracts, and information gained in other areas of the audit. Auditors should also consider the internal control structure policies and procedures relating to the contractor's estimation process. There is usually a high degree of inherent risk associated with management judgments underlying estimates of progress towards completion as well as costs to complete. These estimates have a significant impact on the construction contractor's revenue recognition, accounts receivable, and inventory.

.17 Given the significant effect that the estimating process has on the profit or loss associated with each contract, auditors should carefully evaluate evidence supporting all material estimates. SAS No. 57, *Auditing*

Accounting Estimates (AU section 342), provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit. Auditors should note that while the nature of evidential matter supporting financial statement assertions for most commercial enterprises is typically factual (shipping documents, suppliers invoices, etc.), evidential matter for a construction entity is generally more varied and its analysis requires greater auditor judgment. As such, evaluating estimates of progress toward completion, estimated gross profit, and their underlying methodologies is a significant area of audit risk. Additionally, when considering the reasonableness of management's estimates of project completion dates, auditors should be alert to the potential risks for not meeting scheduled deadlines (for example, cost overruns or litigation).

.18 The pervasive impact of estimates used by construction contractors may also affect working capital, equity, and income statement accounts. Plausible relationships between contract billings, contract costs incurred, and gross profit, may reasonably be expected to exist, and continue, in the absence of known conditions to the contrary. The detection of variations in such relationships may uncover the existence of unusual transactions or events, accounting changes, business changes, random fluctuations, or misstatements. Analytical procedures, which consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data, provide useful tools for this purpose. The application of such procedures can assist the auditor in developing independent expectations as to the estimates used by construction contractors. Authoritative guidance on the use of analytical procedures by auditors is set forth under SAS No. 56, *Analytical Procedures* (AU section 329), which requires the use of analytical procedures in the planning and overall review stages of all audits.

.19 The technical complexities and subjectivity of estimates relating to future events, or the unique nature of the contractor's work may necessitate consideration of using the work of independent specialists as discussed in SAS No. 73, *Using the Work of a Specialist* (AU section 336). Expert opinions and analyses from engineers, architects, appraisers, or attorneys may serve as a basis to obtain sufficient competent evidential matter in performing substantive tests to evaluate material financial statement assertions. A specialist may be engaged by management, or the auditor, to interpret complex contractual arrangements, evaluate a construction project's percentage of completion or estimates of costs to complete.

.20 Auditors should also carefully consider the effect of post-balance sheet events on the estimation process, as well as their impact on revenue recognition or loss accrual on construction contracts. Auditors of construction contractors should refer to SAS No. 1, section 560, *Subsequent Events* (AU section 560). SAS No. 1, section 560 (AU section 560) provides guidance on events or transactions that have a material effect on financial statements and that occur subsequent to the balance sheet date, but prior to the issuance of the financial statements and the auditor's report. Such events or transactions may require adjustment or disclosure in the financial statements.

Revenue Recognition

.21 Accounting Research Bulletin (ARB) No. 45, *Long-Term Construction-Type Contracts* (AC Co4), addresses the accounting issues relevant to construction-type contracts for commercial organizations engaged in the contracting business. Under generally accepted accounting principles, there are two methods of recognizing revenues on construction contracts:

1. The percentage-of-completion method allows the contractor to recognize income over the term of the contract. Under this method, a contractor computes the extent of progress toward completion for each contract in progress at a given point in time. For example, if a contract is 75 percent complete on a particular date, the contractor will then recognize 75 percent of the contract's revenues, costs, and gross income.

2. The completed-contract method defers income recognition until a contract is substantially complete. Under this method, revenues, costs, and gross income are not recognized during the period of construction. Instead, recognition is deferred until the project's completion.

.22 AICPA Statement of Position (SOP) 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts,* establishes a strong preference for the percentage-of-completion method, virtually requiring that it be used as the basic method of accounting by most construction contractors. The only time the completed-contract method should be used is when either of the following conditions exists:

1. The results do not vary materially from those achieved under the percentage-of-completion method.
2. With persuasive evidence, the contractor can overcome the basic presumption of having the ability to make reasonable dependable estimates.

Job Site Visits

.23 For certain audit engagements, job site visits to selected construction sites will enable auditors to understand the construction contractor's operations and to compare internal accounting information to events that occur at the job sites. For example, current favorable economic forecasts may increase the risk that construction contractors will be overly optimistic in establishing estimates (as discussed in the "Auditing Estimates" section of this Audit Risk Alert). Job site visits can assist the auditor in assessing the reasonableness of such estimates by comparing their underlying principles with actual conditions at the construction site. Such visits provide valuable firsthand information about the physical status of construction projects and the existence of operational problems. Job site visits are also important when the auditor intends to assess control risk at the site as low or when the related accounts cannot be substantiated by other procedures. One objective of an on-site visit is to obtain information and supporting documentation to evaluate the reasonableness of the progress of the project to date. The auditor may perform such procedures as—

- Identifying uninstalled materials that should be excluded when measuring progress toward completion and noting physical security over such materials.
- Discussions with job site personnel as to the status of labor hours incurred to date and estimates to complete, including evaluating those estimates by observing the physical progress of the project. If the project is complex, the auditor should consider engaging the services of a specialist.
- Observing contractor-owned or rented material.
- Discussing with job site personnel issues that may affect the estimated total gross margin—such as problems encountered or operational inefficiencies.

Going-Concern Issues

.24 The construction industry's extreme sensitivity to changes in economic conditions (such as interest rates, personal income, unemployment levels, consumer confidence, etc.), and its intense competition, along with, profit margins averaging as low as 2 percent in some segments, have resulted in an historically high rate of business failure. And, despite the current favorable economic environment, these factors increase the level of business risk faced by many construction contractors. Accordingly, auditors should be alert to conditions and events which, when considered in the aggregate, indicate that there could be substantial doubt about the construction contractor's ability to continue as a going concern. For example, such conditions and events could include (*a*) negative trends such as recurring operating losses or working capital deficiencies, (*b*) financial difficulties such as construction project loan defaults or denial of trade credit from suppliers of building materials, (*c*) internal matters such as trade union difficulties, or (*d*) external matters such as legal proceedings or environmental legislation that could jeopardize the entity's ability to operate. In such circumstances auditors will have to consider whether, based upon such conditions and events, there is substantial doubt about the contractor's ability to continue as a going concern.

.25 Auditors should be aware of their responsibilities pursuant to SAS No. 59 (AU section 341). SAS No. 59 (AU section 341) provides guidance to auditors in conducting an audit of financial statements in accordance with

GAAS for evaluating whether there is substantial doubt about a client's ability to continue as a going concern for a period not to exceed one year from the date of the financial statements being audited.

.26 Continuation of an entity as a going concern is generally assumed in the absence of significant information to the contrary. Information that significantly contradicts the going-concern assumption 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. SAS No. 59 (AU section 341) does not require the auditor to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

.27 If there is substantial doubt about the entity's ability to continue as a going concern, the auditor should consider whether it is likely that existing conditions and events can be mitigated by management plans and whether those plans can be effectively implemented. If the auditor obtains sufficient competent evidential matter to alleviate doubts about going-concern issues then consideration should be given to the possible effects on the financial statements and the adequacy of the related disclosures. If, however, after considering identified conditions and events, along with management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern remains, the audit report should include an explanatory paragraph to reflect that conclusion. In these circumstances, auditors should refer to the specific guidance set forth under SAS No. 59 (AU section 341).

.28 For those construction contractors emerging from bankruptcy reorganization pursuant to chapter 11 of the Bankruptcy Code, the auditor should consider whether the contractor is following the accounting guidance of SOP 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code.*

Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance

.29 There may be instances in which construction contractors are recipients of governmental assistance. For example, contractors may receive subsidies through loans and guarantees from the U.S. Department of Housing and Urban Development for construction activities in certain targeted geographical areas. Auditors of such entities should consider the guidance set forth in SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AU section 801). SAS No. 74 (AU section 801), which supersedes SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance,* is effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994. SAS No. 74 (AU section 801) provides general guidance to practitioners engaged to perform compliance audits of recipients of governmental financial assistance.

.30 SAS No. 74 (AU section 801) continues to recognize three levels of audits—GAAS, *Government Auditing Standards,* and certain other federal requirements—of recipients of governmental financial assistance. SAS No. 74 (AU section 801) is applicable when the auditor is engaged to perform an audit under GAAS, and under *Government Auditing Standards,* and in certain other circumstances involving governmental financial assistance, such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations.

.31 SAS No. 74 (AU section 801) also provides general guidance to the auditor to—

- Apply the provisions of SAS No. 54 (AU section 317), relative to detecting misstatements resulting from illegal acts related to laws and regulations that have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of governmental entities and other recipients of governmental financial assistance.

- Perform a financial audit in accordance with *Government Auditing Standards,* issued by the Comptroller General of the United States.
- Perform a single or organization-wide audit or a program-specific audit in accordance with federal audit requirements.
- Communicate with management if the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of his or her engagement.

.32 Auditors of construction contractors that receive governmental financial assistance should also be alert to the 1994 Revision of *Government Auditing Standards,* commonly referred to as the "Yellow Book", as issued by the Comptroller General of the U.S. The 1994 Revision provides guidance (rather than requirements) on the auditor's consideration of internal controls for the control environment, safeguarding controls, controls over compliance with laws and regulations, and control risk assessment. It does not establish new responsibilities for testing controls. Some of the more important changes made in the 1994 Revision deal with the following:

- Submission of peer review reports
- Commenting on the status of prior year control weaknesses and other matters
- Responsibility for detection of noncompliance with contract or grant agreement provisions
- Working paper documentation
- Communication of additional services available on controls and compliance
- Report content
- Direct reporting of irregularities and illegal acts
- Applicability of the Yellow Book to other attest engagements

The Audit Risk Alert *State and Local Governmental Developments—1995* [AAM section 8070] contains a detailed discussion of the revisions to the Yellow Book.

Environmental Issues

.33 As a result of legislation and regulation, written at all levels of government, construction contractors have become increasingly vulnerable to environmental claims. The Resource, Conservation and Recovery Act of 1976 and the Comprehensive Environmental Response, Compensation and Liability Act of 1980, along with various clean air and water acts, put contractors at increased risk of being held liable for the remediation of environmental contamination. Examples of construction activities that may expose contractors to environmental claims include, but are not limited to—

- The use of hazardous chemicals or materials at construction job sites.
- Demolition or excavation projects that involve transporting hazardous materials.
- The discovery of hazardous materials at construction job sites.
- Construction projects involving the removal of hazardous waste materials.
- Contamination from storage tanks containing chemical or fuels designated as hazardous substances.

.34 Auditors should be aware that contractors may be held liable for cleanup costs in circumstances such as those noted above, despite the lack of intent or knowledge. Auditors of construction contractors that face such claims should carefully consider whether the accounting and disclosure requirements of Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies* (AC C59), have been met. FASB Statement No. 5 (AC C59) requires that an estimated loss be accrued when—

1. Information available prior to the issuance of financial statements indicates that it is probable that an asset has been impaired or that a liability has been incurred at the date of the financial statements.

2. The amount of the loss can be reasonably estimated.

The nature and amount of the accrual should be disclosed if it is necessary for the financial statements not to be misleading. Additionally, other disclosures may be necessary when the above conditions are not met and, therefore, no loss has been accrued or if the exposure to loss exceeds the amount accrued and the loss or additional loss is at least a reasonable possibility. In such circumstances, disclosures should include the nature of the contingency, an estimate of the possible loss or range of loss, or a statement that an estimate of the loss cannot be made.

.35 Auditors should also be aware of the consensus reached by the FASB's Emerging Issues Task Force (EITF) in Issue No. 93-5, *Accounting for Environmental Liabilities,* which states that, among other things, an environmental liability should be evaluated independently from any potential recovery and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization. Additional accounting guidance in this area is included in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (AC C59), FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal,* and EITF Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination.*

.36 Auditors of publicly held construction contractors should be aware of the Securities and Exchange Commission's (SEC) Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies.* The SAB provides the SEC staff's interpretation of current accounting literature related to the following:

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities
- The recognition of liabilities for costs apportioned to other potential responsible parties
- The uncertainties in estimation of the extent of environmental liability
- The appropriate discount rate for environmental liabilities, if discounting is appropriate
- Accounting for exit costs
- Financial statement disclosures of exit costs and other items and disclosure of certain information outside the basic financial statements

Audit Risk Alert—1995/96 [section 8010] contains further discussion of issues relating to environmental remediation matters. Also, refer to the "Accounting Issues and Developments" section of this Audit Risk Alert for information on AICPA Exposure Draft: *Proposed Statement of Position on Environmental Remediation Liabilities.*

Litigation, Claims, and Assessments

.37 Legal disputes, with customers and others, against construction contractors tend to be relatively common and much more significant than in many other commercial enterprises. A recent AICPA survey of construction contractors indicated that a majority of them viewed litigation costs to be either significant or very significant.

.38 A letter of audit inquiry to an entity's lawyer is the primary means of obtaining corroboration of the financial information furnished by management concerning litigation, claims, and assessments. Auditors should be aware of the requirements of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU section 337). SAS No. 12 (AU section 337) provides guidance to auditors to satisfy themselves as to the financial accounting and reporting of litigation, claims, and assessments.

Accounting Issues and Developments

Joint Ventures

.39 Contractors faced with limited financial resources and lack of access to new markets commonly overcome such obstacles by forming joint ventures. By combining resources with other construction entities, a contractor may be able to bid on and complete larger, more complex construction projects as well as expand into other geographic locations.

.40 Joint ventures may be formed to complete one specific project or create a permanent business relationship designed to pool resources and bid on all contracts of a specific type for an indefinite period of time. Joint ventures may take the form of a general partnership, limited partnership, or corporation.

.41 There are several different methods of accounting for a construction contractor's interest in a joint venture (see SOP 78-9, *Accounting for Investments in Real Estate Ventures*). The more common methods are the cost method, the equity method, and consolidation. The method of accounting for investments in joint ventures is generally determined by the extent of control the construction contractor has over the joint venture's operations.

.42 During the year, the EITF discussed several matters that may affect the appropriate accounting for investments in joint ventures. Those matters include—

- Issue No. 95-6, *Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation,* which sets forth criteria for determining whether significant influence exists. While the criteria were developed specifically for real estate investment trusts and service corporations, they may be useful in making that determination for other entities as well.
- Issue No. 94-1, *Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects,* which describes the Task Force's consensus position about how an entity that invests in a qualified affordable housing project through a limited partnership should account for its investment.
- Appendix D-46, *Accounting for Limited Partnership Investments,* which describes discussion of the SEC staff's position that investments in all limited partnerships should be accounted for pursuant to paragraph 8 of SOP 78-9. That guidance requires the use of the equity method unless the investor's interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies."

Auditors should consider these developments as they evaluate the appropriateness of construction contractor's accounting for investments in joint ventures and similar entities.

.43 In addition to evaluating the propriety of the contractor's method of accounting for an investment in joint ventures, the auditor should be aware that such arrangements may create relationships that meet the definition of related parties as set forth in FASB Statement No. 57, *Related Party Disclosures* (AC R36). Auditors should consider the guidance contained in SAS No. 45, *Omnibus Statement on Auditing Standards—1983,* "Related Parties" (AU section 334), which outlines procedures to identify related party relationships and transactions, and to assess the propriety of the required financial statement accounting and the adequacy of related disclosures.

Impairment of Long-Lived Assets

.44 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). FASB Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

.45 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.46 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. Earlier application is encouraged. Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.47 As previously discussed, current economic conditions suggest slow revenue growth for many construction contractors. As a means of increasing profits, cost reduction efforts may be implemented. This could, for example, delay planned capital outlays intended to refurbish or replace existing productive assets. Additionally, environmental regulations may impose restrictions on the use of a long-lived asset, thus significantly reducing its ability to generate future cash flows. In such instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.48 In considering a construction contractor's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57 (AU section 342).

Risks and Uncertainties

.49 In December 1994, the AICPA's Accounting Standards Executive Committee issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires nongovernmental entities to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires entities to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.50 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of similar estimates that may be included in the financial statements of construction contractors include:

- Construction project estimates of progress toward completion
- Estimates of gross profit or loss accrual on construction projects

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of construction contractors in accordance with paragraph 21 of the SOP include the following:

- Revenue from a particular type of construction activity
- Sources of building materials

- Construction labor subject to collective bargaining agreements
- Construction activities limited to a particular geographic area

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

.51 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

.52 Under environmental laws and regulations, construction contractors may be held responsible for cleanup costs related to the use of toxic or otherwise hazardous materials, or for contaminating land or water located near construction sites.

.53 In June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities*. The exposure draft provides that—

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 (AC C59) are met, and it includes benchmarks to aid in determining when those criteria are met.
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent the employees are expected to devote time to the remediation effort.
- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site, and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- Measurement of the liability should be based on enacted laws and existing regulations, policies and remediation technology.
- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed, and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

.54 The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and clean-up laws and the need to consider various individual state and other non-United States government requirements.

.55 Comments on the exposure draft were due by October 31, 1995.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

.56 The AICPA Audit and Accounting Guide *Construction Contractors* is available through the AICPA loose-leaf subscription service. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the Guides as they appear in the service are printed annually.

Construction Contractors' Financial Reporting Checklist

.57 The AICPA Technical Information Service has published a revised version of *Checklists Supplement and Illustrative Financial Statements for Construction Contractors* as a tool for preparers and reviewers of financial statements of construction contractors.

Technical Practice Aids

.58 *Technical Practice Aids* is an AICPA publication that, among other things, contains questions received by the AICPA Technical Information Service on various subjects and the service's responses to those questions. Several sections of *Technical Practice Aids* contain questions and answers specifically pertaining to construction contractors. *Technical Practice Aids* is available both as a subscription service and in paperback form.

Information Sources

.59 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.60 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.61 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.62 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.63 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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.64 This Audit Risk Alert supersedes *Construction Contractors Industry Developments—1994.*

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.65 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (extension. 3) and the AICPA Meetings and Travel Division (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P O Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext 444)
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088 ext. 3 (202) 942-7114 (tty)		*Information Line* (202) 942-8088 (202) 942-7114 (tty)
Telecommunications Industry Association	2001 Pennsylvania Ave. NW Suite 800 Washington, DC 20006-1813	*General Information* (202) 457-4912		
American Electronics Association	5201 Great American Pky Suite 520 P.O. Box 54990 Santa Clara, CA 95056	*General Information* (408) 987-4200		
Computing Technology Association	450 E. 22nd Street - Suite 230 Lombard, IL 60148	*General Information* (708) 268-1818		
American Software Association c/o ITAA	1616 N. Fort Meyer Dr. Suite 1300 Arlington, VA 22209-998	*General Information* (703) 522-5055		

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AAM Section 8130

Federal Government Contractors Industry Developments—1995/96

Industry and Economic Developments

.01 Throughout 1995, the U.S. economy as a whole continued its steady recovery from several years of recession. However, the recovery has not necessarily improved the economic outlook for many federal government contractors. There is mounting pressure in Congress to balance the federal budget. As a result, funding for many government programs is being reduced, and several programs are under consideration for elimination entirely. The cuts in government spending have resulted in fewer and smaller government contracts.

Mergers, Consolidations, and Downsizing

.02 Mergers, consolidations, and downsizing in the government contractors industry continued during 1995 in response to the decrease in federal spending. Such restructurings allow contractors to eliminate overlapping staff, broaden their technological base and, in some cases, increase their market base. Often, costs incurred in such restructurings are substantial. However, recent legislation may delay reimbursement of otherwise allowable costs until overall net savings to the federal government from the restructuring activities are demonstrated and certified by the Department of Defense (DOD). The legislation also would make certain restructuring costs unallowable in circumstances where a contractor undertakes restructuring activities that cannot be reasonably projected to result in net overall savings to the government. (See the "Regulatory and Legislative Developments" section of this Audit Risk Alert for a further discussion of legislative, government policy, cost accounting, and regulatory developments related to restructuring costs.) In addition, such reorganizations may call into question the carrying values of certain long-lived assets, such as goodwill and other intangibles, and fixed assets. Auditors of financial statements of federal government contractors that have been parties to such transactions should carefully consider whether the carrying values of such long-lived assets have been impaired.

Unexpected Losses and Claims Activity

.03 Federal government contractors are subject to complex regulations and statutes that expose them to significant business risk for noncompliance. Many contractors have recently experienced unexpected losses due to violation of regulations (for example, defective pricing under the Truth in Negotiations Act). Such violations typically result in a liability to the federal government for amounts that have been disallowed. Although the disallowed amounts may be immaterial, the contractor also may be subject to fines and penalties that could be material to the financial statements. In addition, violations could result in criminal charges, subjecting the contractor to even larger losses. AICPA Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AU section 317), requires auditors to consider laws and regulations that generally are recognized to have a direct and material effect on the determination of financial statement amounts. The AICPA Audit and Accounting Guide *Audits of Federal Government Contractors* addresses the auditor's responsibility to consider illegal acts, including suspension and debarment of contractors and civil and criminal fraud charges. In planning their audits of federal government contractors, auditors should carefully evaluate the financial statement effect of the applicable laws and regulations. See the "Regulatory and Legislative Developments" section of this Audit Risk Alert for a discussion of new laws and regulations of which auditors should be aware.

.04 The ongoing budget cuts have caused the federal government to cancel or substantially scale back several programs. Contractors may suffer adverse financial consequences as a result of those program cancellations and curtailments. For example, cancellation or curtailment of a significant program could substantially increase overhead rates on a contractor's remaining contracts because the base over which the costs are spread would be greatly reduced. In addition, many contractors continue to experience increases in claim activity related to the cancellation of contracts. Some contractors have filed, or are in the process of filing, contract claims to recover the additional costs.

.05 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), states that auditors have a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year from the date of the financial statements being audited. That evaluation is based on the auditor's knowledge of relevant conditions and events that exist at, or have occurred prior to, the completion of fieldwork. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited.

.06 SAS No. 59 (AU section 341) requires that if, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about an entity's ability to continue as a going concern, he or she should consider management's plans for dealing with the adverse effects of the conditions or events. As they make the evaluation described in SAS No. 59 (AU section 341), auditors should consider the effects that spending cuts and other changes in the economy may have on the ability of contractors to continue as going concerns. Auditors should be cognizant of the fact that, because of recent business restructurings and the entry of many contractors into new lines of business, historical data and trends in the industry may no longer be meaningful indicators of current and future performance. Auditors should consider whether contractors have evaluated the effects of the changes in the business environment, prepared business plans to respond to the changes, and have the ability to execute those plans. In addition, after considering management's plans, auditors should consider the possible effects on the financial statements, the adequacy of the related disclosures, and the possible effects on the auditor's report.

Regulatory and Legislative Developments

Regulatory Developments

.07 *Cost Accounting Standards Board Initiatives.* The Cost Accounting Standards Board (CASB), which was established by Congress, develops Cost Accounting Standards (CASs) to provide uniformity and consistency in the accounting principles used by federal government contractors and subcontractors. (CAS are not included in the hierarchy of generally accepted accounting principles (GAAP) established by SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AU section 411). Applicable laws and regulations regarding CASs established by the CASB may affect cost allowability and, as a result, the amount of revenue and costs accrued under government contracts, depending on the type of contract involved. Auditors should carefully evaluate the financial statement effect of CASs and cost allowability (cost principles) on contract revenues and costs.

.08 The CASB is continuing to address issues relating to the measurement of costs, the assignment of costs to accounting periods, and the allocation of costs to objectives. In promulgating new or revised CASs, the CASB must, by law, undertake a four-step process by issuing (1) Staff Discussion Papers, (2) Advance Notices of Proposed Rulemaking (ANPRMs), (3) Notices of Proposed Rulemaking (NPRMs), and (4) final Rulemakings. This rulemaking process can take several years from the development of a staff discussion paper to the issuance of a final rule.

.09 Below is a summary of current CASB initiatives and each one's status.

Staff Discussion Paper	*Issued*
Contract Price Adjustments for Organizational Changes	April 1993
Advance Notices of Proposed Rulemaking	
Changes in Cost Accounting Practices	April 1995
Notice of Proposed Rulemaking	
Revisions to the CASB Disclosure Statement Form (CASB DS-1)	November 1994
Treatment of Gains or Losses Subsequent to Mergers or Business Combinations by Government Contractors	March 1995
Final Rules	
Composition, Measurement, Adjustment, and Allocation of Pension Costs	March 1995

.10 CASB activities are discussed below in relation to other activities and developments affecting their applicability to government contractors.

.11 *Composition, Measurement, Adjustment, and Allocation of Pension Costs.* In March 1995, the CASB issued a final rule to revise CASs relating to accounting for pension costs under negotiated government contracts. The CASB addressed certain problems that have emerged since the original promulgation of the pension standards, CAS No. 412, *Cost Accounting Standards for Composition and Measurement of Pension Costs,* and CAS No. 413, *Adjustment and Allocation of Pension Costs.* The final rule includes requirements for the components, measurement, assignment, and allocation of pension costs for qualified and nonqualified defined benefit pension plans. The most significant changes relate to qualified pension plans subject to limits on federal tax deductions, recognition of costs on nonqualified plans, and accounting for segment closures. The final rule is effective on or after the start of the contractor's next cost accounting period following receipt of a contract or subcontract awarded on or after March 30, 1995, that is subject to full CAS coverage.

.12 The final rule provides for a four-step process of computing, assigning, funding, and allocating pension costs. An entity's accrual for periodic pension cost is subject to a floor of $0 and a ceiling equal to the maximum tax-deductible amount plus prepayment credits. Portions of pension costs computed for a period that fall outside of this range must be amortized over ten years as either an "assignable cost deficit" or an "assignable cost credit." The final rule also includes an "assignable cost limitation" (ACL) that prevents the assignment of period costs to an overfunded pension plan. The costs assigned to a period cannot exceed the ACL. Failure to comply with the new rules will result in the cost being lost forever.

.13 The final rule also substantially changes the accounting for nonqualified defined benefit pension plans. Under the final rule, nonqualified pension costs assignable on an accrual basis must be funded at a level equal to the percentage of the compliment of the highest published federal corporate income-tax rate in effect on the first day of the cost accounting period. Alternatively, contractors may treat those costs on a pay-as-you-go basis.

.14 In addition, the final rule includes new definitions of pension plan terminations and segment closures. The existing accounting rules for adjusting previously determined pension costs related to segment closures now applies to segment closures, plan terminations, or curtailments of benefits. The final rule also adds new requirements for measuring the pension adjustment.

.15 Because the final rule includes significant new requirements, auditors should consider whether their clients have adopted transition plans to implement the rule into their accounting systems, forward pricing rates, and actuarial assumptions. Failure to comply may result in severe limitations on future cost recovery.

.16 *Gains or Losses Subsequent to Mergers and Business Combinations.* The CASB continues to study the treatment of gains or losses that are attributable to tangible capital assets subsequent to mergers or business combinations of government contractors. The CASB issued an NPRM on this subject in March 1995. To resolve the problems identified in this area, the CASB proposes to amend CAS No. 404, *Capitalization of Tangible Capital Assets.* The proposed amendments are based on an approach involving "no step-up, no step-down" of asset bases and no recognition of gain or loss on a transfer of assets following a business combination by contractors subject to CASs.

.17 CAS No. 404-50(d) currently requires that, under the purchase method of accounting, acquired assets be written to fair value, which is consistent with GAAP. In other words, asset bases could be stepped down. The NPRM instead would prescribe that for federal government contract costing purposes, tangible capital assets after a business combination and accounted for under the "purchase method" of accounting would retain their net book value recognized prior to the business combination, provided that the assets had previously generated costs that were chargeable to federal government contracts subject to CASs. The cost of tangible capital assets would be restated after the business combination at a figure not to exceed the fair value at the date of the acquisition pursuant to a business combination in which the assets prior to the business combination did not generate costs that were chargeable to federal government contracts subject to CASs. (See "Consensus Decisions of the FASB's EITF" in the "Accounting Issues and Developments" section of this Audit Risk Alert for further discussion of issues relating to business combinations.)

.18 In addition, CAS No. 409, *Depreciation of Tangible Capital Assets,* currently requires that gains and losses on disposition of tangible capital assets be considered adjustments of previously recognized depreciation costs and assigned to the period in which disposition occurs. The NPRM clarifies that the CAS No. 409 provisions dealing with the recapture of gains and losses on disposition of tangible capital assets should not apply when assets are transferred subsequent to a business combination, because it is assumed that the assets will be transferred at their net book values.

.19 The approach involving no "step-up, no step-down" of assets, embodied in the NPRM, is not consistent with the Federal Acquisition Regulation (FAR) cost principle (section 31.205-52), *Asset Valuations Resulting from Business Combinations,* which prohibits step-ups but does not rule out step-downs. If the NPRM is adopted, it would replace, for government purposes, the current CASs and GAAP.

.20 Guidance issued by the Defense Contract Audit Agency (DCAA) to its auditors suggests that for business combinations that occurred prior to July 23, 1990 (effective date of FAR 31.205-52), the government contracting officer should examine each situation "on a case-by-case basis to achieve equity or protect the government's interests . . ." DCAA auditors are further instructed to advise the contracting officer to enter into an advance agreement if they encounter those prior business combinations, in order to provide equitable treatment to both the government and the contractor and to minimize future disputes.

.21 An appeal from a contracting officer's final decision on the issue of applicability filed with a board of contract appeals is likely. Auditors should be alert to the outcome of any such appeal that may be filed. Auditors also should carefully evaluate the allowability of costs under section 31.205-52, including a review of any agreements between the government and contractor on the treatment of such costs.

.22 *Proposed Revisions to the CASB Disclosure Statement Form.* Contractors with more than $25 million in government contracts covered by CASs are required to file a disclosure statement containing details of the accounting practices of all recognized business segments doing business with the federal government. In November 1994, the CASB issued an ANPRM on a revised draft of CASB DS-1, which solicited views from the government procurement community with respect to the current format of the disclosure statement. Comments were requested by February 23, 1995.

.23 *Changes in Cost Accounting Practices.* In April 1995, the CASB issued an ANPRM to revise the current definitions and illustrations governing changes in cost accounting practices. Among other things, the revision will indicate explicitly that a change in the manner in which costs are grouped and accumulated constitutes a change in cost accounting practices. It also will clarify that organizational changes must be evaluated on a case-by-case basis to determine if a change in cost accounting practice has occurred. The new definition likely will cause many organizational changes to be classified as accounting practice changes. This change is significant because increased costs arising from a voluntary accounting practice change may not be reimbursable on CAS-covered contracts.

.24 The ANPRM also proposes the addition of a new subpart to clarify the process for determining and resolving the cost impact on covered contract prices or contract costs, or both, when a contractor makes a change to its cost accounting practices, fails to comply with a CAS, or fails to consistently follow its established cost accounting practices. Comments were requested by July 10, 1995.

.25 *Department of Defense Initiatives.* In June 1995, the DOD issued *Defense Acquisition Circular* (DAC) 91-7, which amends the Defense FAR Supplement (DFARS) to revise, finalize, or add language to various rules (see *Federal Register*, vol. 60, No. 107, June 5, 1995). DAC 91-7 includes thirty-nine rules and miscellaneous editorial amendments. Among other things, DAC 91-7 addresses contract accounting controls, predetermined indirect cost rates, limitations on allowable individual compensation, restructuring costs under defense contracts, and indirect costs of institutions of higher learning.

.26 Under the final rule, contractors receiving cost-reimbursement or incentive-type contracts, or contracts that provide for progress payments based on costs or on a percentage or stage of completion, must maintain an accounting system and related internal controls that provide reasonable assurance that (1) applicable laws and regulations are complied with; (2) the accounting system and cost data are reliable; (3) risk of misallocations and mischarges is minimized; and (4) contract allocations and charges are consistent with invoice procedures.

.27 The final rule also provides that indirect cost rates for educational institutions may be predetermined for a period of up to four years when cost experience and other pertinent facts are sufficient to assess the probable level of indirect costs during subsequent accounting periods. In addition, it prohibits the DOD from placing any limitation on the reimbursement of otherwise allowable indirect costs incurred by an institution of higher learning, unless that same limitation is applied uniformly to all other organizations performing similar work under DOD contracts.

.28 DAC 91-7 limits allowable costs for individual compensation to $250,000 per year. This limitation applies to contracts that are awarded after April 15, 1995, and that are funded with fiscal year 1995 appropriations. It also restricts the DOD from reimbursing restructuring costs associated with a business combination unless certain conditions are met. (See the "Regulatory and Legislative Developments" section of this Audit Risk Alert for a further discussion of allowability of restructuring costs.)

.29 The rule was effective May 17, 1995.

Cost Allowability and Allocability Issues

.30 *New DCAA Audit Guidance.* New guidance provided to DCAA auditors in the DCAA January 1995 and July 1995 *Contract Audit Manuals* addressed the following areas:

- Understanding, evaluating, and reporting on the contractor's internal control structure
- Assessing control risk and translating the risk to audit scope
- Allowability of executive compensation costs
- Auditing contractors that are subject to suspension or debarment agreements
- Review and follow-up on internal and external auditor reports and findings
- Relying on the work of internal and external auditors
- Maintaining coordinated audit matrices to manage coordinated audits at participating contractors
- Allowability of environmental clean-up costs

- Contractor internal controls for screening unallowable costs and directly associated costs
- Allowability of costs related to employee stock ownership plans
- Real-time discussions of audit findings
- Inclusion of cost of money in corporate aircraft costs
- Joint-venture partners' cost accounting practices and internal controls
- Depreciating assets below residual values
- Application of cost accounting standards to educational institutions
- Review of the contractor's billing system internal controls for identifying and notifying the government of overpayments
- Review of the contractor's internal controls for briefing contract terms for special provisions affecting the allowability of costs
- Application of penalties on unallowable costs
- A contractor's responsibilities for monitoring subcontractors
- Allowability of costs associated with air shows, special events, and trade shows
- Revised independent research and development and bid and proposal cost ceilings
- The contractor's use of management-reduction factors instead of having internal controls to identify and segregate unallowable costs
- Application of agreed-upon procedures to the review of proposals
- Evaluating a contractor's estimates at completion for use in progress payment requests and cost performance reports
- Use of statistical sampling techniques in the contract audit environment
- Audits of progress payment requests and related internal controls
- Use of electronic media to store records

.31 The DCAA will provide new guidance to its auditors in the 1996 *Contract Audit Manuals* in the following areas:

- Contractor reorganization and restructuring costs
- Allowability of gift, recreation, employee morale, and entertainment costs
- Accounting for the impairment of long-lived assets
- Internal controls for reviewing outside attorney billings
- Systemic defective pricing issues
- Allowability of costs incurred in defense of stockholder suits
- Composition, measurement, and allocation of pension costs
- Cost realism reviews
- Audits of government depots

- Sampling of incurred cost proposals for audits at small, low-risk contractors

.32 The DCAA *Contract Audit Manual* (DCAAM 7640.1) is printed semiannually, January and July. It can be obtained by calling the Superintendent of Documents, U.S. Government Printing Office, at (202) 512-1800. The order processing code is 7679. The cost of the manual is $32.00 per year ($40.00 foreign).

.33 The DCAA also publishes a *Guide for New Government Contractors,* which includes information for those companies that have government contracts. The Guide can be obtained by writing to: the Defense Contract Audit Agency (Attention: CMO), 8725 John J. Kingman Road, Suite 2135, Fort Belvoir, VA 22060-6219.

.34 See the "Audit Issues" section of this Audit Risk Alert for a discussion of allowable and allocable costs charged to contracts.

.35 *DCAA Internal Control Assessments.* The DCAA has issued guidance to help DCAA auditors understand a contractor's internal control structure and assess control risk in the contract audit environment. The guidance is designed to enable DCAA auditors to place reliance on the contractor's internal control structure, if appropriate, and to identify areas for improvement.

.36 The DCAA has identified the following ten accounting and management systems that it believes are the most important in the contract audit environment:

1. Environment and overall accounting controls (accounting system)
2. Billing system
3. Budget and planning system
4. Compensation system
5. EDP system
6. Estimating system
7. Indirect and other direct cost system
8. Labor system
9. Material system
10. Purchasing system

.37 The new guidance uses a matrix approach—identifying control objectives, control procedures, and audit steps—for understanding and assessing control risk for each control objective within each of the ten systems.

.38 Audits of each of the ten systems are performed on a cyclical basis (for example, every year or every two years) depending on the significance of the system at a particular contractor. The assessed level of control risk for each control objective and for the overall system is documented in the DCAA's *Internal Control Audit Planning Summary* (the *Summary*). The *Summary* is also used to document the translation of control risk to the audit scope of other planned DCAA audits at the contractor. At large contractors, the DCAA updates the *Summary* annually. The *Summary* is provided to, and discussed with, contractor executives in the annual audit planning and risk assessment meetings. At those contractors audited by DCAA, the auditor may wish to consider reviewing the summaries during their assessment of the contractor's internal control structure.

.39 *Educational Institutions That Receive Federal Research Awards.* In November 1994, the CASB issued a final rule that requires educational institutions awarded negotiated contracts or subcontracts in excess of $500,000 (excluding contracts awarded for the operation of federally funded research and development centers, which already are subject to CASs) to comply with four new CASs:

1. CAS No. 501, *Consistency in Estimating, Accumulating and Reporting Costs by Educational Institutions*

2. CAS No. 502, *Consistency in Allocating Costs Incurred for the Same Purpose by Educational Institutions*
3. CAS No. 505, *Accounting for Unallowable Costs—Educational Institutions*
4. CAS No. 506, *Cost Accounting Period—Educational Institutions*

Those new standards prescribe essentially the same practices that are embodied in CASs No. 401, 402, 405, and 406. They are set forth in a new FAR Part 9905, *Cost Accounting Standards for Educational Institutions,* and are generally effective as of January 9, 1995. The Office of Management and Budget (OMB) has indicated it will amend OMB Circular A-21, *Cost Principles for Educational Institutions,* to incorporate the CAS requirements. For more information, see *Federal Register,* vol. 59, No. 215, November 8, 1994.

.40 Auditors should consider the financial statement effects of allowable and unallowable indirect costs on revenues, receivables, and income.

Legislative Developments

.41 *Federal Acquisition Streamlining Act.* The most significant legislative and regulatory changes affecting government contractors in the past year relate to the Federal Acquisition Streamlining Act of 1994 (FASA). A major goal of FASA is to create a uniform procurement system in which civilian and defense agencies are governed by the same statutes.

.42 By modifying fifteen statutes, FASA removes nearly all restrictions on acquisitions of less than $100,000 by raising the simplified acquisition threshold from $25,000 to $100,000. FASA also encourages agencies to buy more off-the-shelf products by expanding the definition of *commercial items* to include products customarily used by the general public as well as certain commercial products and services using evolving technology that may not currently be available in the commercial marketplace. Under FASA, contracting officers will be encouraged to obtain data other than cost or pricing if it can be used to establish a fair and reasonable price.

.43 FASA sets a $500,000 government-wide threshold, to be adjusted for inflation every five years, under which cost and pricing data need not be certified. Previously, that threshold was $100,000. FASA also makes all government contracts over $500,000 in which unallowable costs are charged to the government subject to penalties. Previously, only DOD contracts were subject to penalties for unallowable costs.

.44 FASA clarifies those activities and items that represent allowable and unallowable recreation, entertainment, and gift costs. In addition, agencies also are required under FASA to consider a contractor's past performance in evaluating whether that contractor should receive future contracts.

.45 FASA is effective for contracts issued on or after October 1, 1995. Additional proposed legislation, referred to as FASA-2, currently is being drafted to further clarify and streamline the process.

.46 *Allowability of Restructuring Costs.* As discussed in the "Industry and Economic Developments" section of this Audit Risk Alert, the decline in defense spending has caused many government contractors to undergo major business restructurings and to incur substantial costs in those restructurings. For example, contractors might incur costs related to relocating and retraining personnel, fixed-asset dispositions, facility closings and lease terminations, and idle facilities.

.47 In July 1993, the undersecretary of defense issued a policy that established a basis for treating restructuring costs incidental to an acquisition or merger as allowable as long as the contractor expects that, over time, those costs will result in overall reduced costs for the DOD or will preserve a critical capability that would otherwise be lost.

.48 In October 1994, the National Defense Authorization Act for Fiscal Year 1995 (the Act), which sets strict review and certification requirements for the reimbursement of restructuring costs, was signed into law. Section 818 of the Act states:

> The Secretary of Defense may not, under section 2324 of title 10, United States Code, pay restructuring costs associated with a business combination undertaken by a defense contractor until the Department of Defense reviews the projected costs and savings that will result for the Department from such business combination and an official of the Department of Defense at the level of Assistant-Secretary of Defense or above certifies in writing that projections of future cost savings resulting for the Department from the business combination are based on audited cost data and should result in overall reduced costs to the Department.

The requirements for such a review and certification do not apply to any business combination for which restructuring costs were paid or otherwise approved by the secretary of defense before August 15, 1994.

.49 In addition, the Act required the secretary of defense, by January 1, 1995, to prescribe regulations on the allowability of restructuring costs associated with business combinations under defense contracts. Such regulations are required to include a definition of the term *restructuring costs* and to address the issue of contract novations under such contracts.

.50 As required by the legislation, a DFARS interim regulation that addresses the reimbursement of *external* restructuring costs was issued in January 1995 (see *Federal Register,* vol. 60, No. 1747, January 5, 1995). In addition, a DFARS interim regulation related to *internal* restructuring costs and *not* mandated by the legislation also was issued in January 1995 (see *Federal Register,* vol. 60, No. 2924, January 12, 1995).

.51 The interim DFARS regulations define restructuring activities to include nonroutine, nonrecurring, or extraordinary activities associated with the reduction of facilities or workforce, or consolidation of facilities or operations, in an effort to improve future operations and reduce overall costs. For example, restructuring costs may include costs of closing or relocating facilities, disposing of assets, or eliminating jobs. Routine or ongoing activities, such as repositioning or redeployment of a contractor's productive facilities or workforce, are not considered restructuring activities for purposes of the interim regulations. External restructuring activities are those occurring after a business combination that may involve facilities or workforce from both of the previously separate companies. Internal restructuring activities are those occurring after a business combination that involve facilities or workforce from only one of the previously separate companies, or, when there has been no business combination, restructuring activities undertaken within one company.

.52 The Act and implementing regulations may have a significant effect on certain federal government contractors. Companies that have recently undergone business restructurings may be faced with significant unrecoverable costs if they fail to meet the required criteria.

.53 In March 1995, the CASB issued Interim Interpretation 95-01, *Allocation of Contracts Restructuring Costs Under Defense Contracts,* which was designed to address period cost assignment and allocability criteria for both external and internal restructuring costs incurred under certain national defense contracts. Restructuring costs may be deferred and amortized over a period not to exceed five years, or may be treated as period costs if they result in an equitable assignment of costs. The Interpretation is applicable to contractor restructuring costs paid or approved on or after August 15, 1994.

.54 As they consider the appropriateness of restructuring charges recorded by their clients, auditors should be aware of the consensus reached by the Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) in Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring).* That consensus provides authoritative guidance on (1) the types of costs that should be accrued, (2) the timing of recognition of restructuring charges, and (3) prescribes disclosures that should be included in financial statements. Auditors of financial statements of publicly held entities that record restructuring charges should also be aware of the Securities and Exchange Commission's (SEC's) Staff Accounting Bulletin (SAB) No. 67 (Topic 5P), *Income Statement Presentation of Restructuring Charges,* which requires that restructuring charges be reported as a component of income from continuing operations. (See "Consensus Decisions of the FASB's EITF" in the "Accounting Issues and Developments" section of this Audit Risk Alert for a discussion of other EITF Issues that should be considered when a contractor is involved in a restructuring.)

.55 In addition, differences between GAAP and the FAR that are related to the accounting treatment of certain costs, such as pension curtailments and settlements, that may be included in restructuring charges exist. Auditors should be aware of those differences and should consider the related accounting and reporting issues involved in business restructurings of government contractors.

Audit Issues

Claims, Change Orders, and Requests for Equitable Adjustment

.56 In the current economic environment, it is likely that contractors will encounter significantly more claims activity, either with the government or subcontractors. Auditors should discuss with appropriate client personnel the need for an opinion of legal counsel to support claims, Requests for Equitable Adjustment (REAs), and, if necessary, unnegotiated change orders. They also should consider the contractor's history in negotiating similar claims and REAs when evaluating the estimated net realizable value of such amounts. Auditors should refer to the criteria for recognizing claims as set forth in *Audits of Federal Government Contractors.* Auditors also should consider the adequacy of financial statement disclosure for significant claims, REAs, and unnegotiated change orders.

High-Risk Contracts

.57 Contractors occasionally experience difficulty in performing on certain contracts and may believe that the government may be responsible, to some extent, for the problems. In those instances, contractors may include the effect of claims or other adjustments that they believe will result in additional revenues from the government in their estimates at completion. Such claims and adjustments may reduce the amount of the estimated loss on such contracts or avoid a reduction in the level of profit recognized. As a result, auditors should evaluate the evidence supporting the contractor's basis for claims and adjustments, especially in contracts on which the contractor is known to have had difficulty performing. Auditors also should carefully consider the adequacy of the financial statement disclosure of significant claims and unnegotiated change orders.

Costs in Excess of Contractual Funding

.58 Many contractors, for various business reasons, will continue to perform on a contract and incur costs in excess of the government's current appropriation of funds. Auditors should carefully review such costs for recoverability and consider the potential need for an allowance against the ultimate collectibility of such costs.

Recoverability of Environmental Liability Costs

.59 Some federal government contractors have been designated by the Environmental Protection Agency as potentially responsible parties on hazardous waste sites and, as such, are subject to cleanup requirements under the Resource Conservation and Recovery Act. The cleanup costs related to hazardous waste sites often are quite substantial. Federal government contractors may seek to recover all or a portion of those cleanup costs from the federal government. In such cases, the contractors may record a receivable for the amount they expect to recover.

.60 The EITF reached a consensus in EITF Issue No. 93-5, *Accounting for Environmental Liabilities,* that the amounts of the contingent liability and any claim for recovery should be estimated and evaluated independently. In addition, any loss arising from the recognition of an environmental liability should be reduced by a potential claim for recovery only when realization of that claim is probable. In June 1993, the SEC issued SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies,* which states that "separate presentation of the gross liability and related claim for recovery in the balance sheet must fairly present the potential consequences of the contingent claim on the company's resources and is required unless the company has the legal right of setoff as discussed in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* [(AC B10)]." It also states that "registrants should ensure that notes to the financial statements include information necessary to an understanding of the material uncertainties affecting both the measurement of the liability and the realization of recoveries." See the "Accounting Issues and Developments" section of this Audit Risk Alert for a discussion of the AICPA's exposure draft proposed Statement of Position on environmental remediation liabilities.

.61 Auditors should evaluate the probability that the contractor will recover environmental costs included in the contract pricing. Auditors also should carefully consider the adequacy of the financial statement disclosure of the contingent costs and the realization of recoveries. See the "Accounting Issues and Developments" section of this Audit Risk Alert for additional information on accounting for, and disclosure of, environmental cleanup costs.

Accounting Issues and Developments

Postretirement Benefits Other Than Pensions (OPEB)

.62 FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (AC P40), is likely to create an OPEB cost that is greater than the expense allowed as a contract cost used to determine contract revenue. The full amount of the OPEB liability calculated in accordance with GAAP may be allowable if the contractor elected to fully fund it and used the cumulative-effect method in a prior year to adopt FASB Statement No. 106 (AC P40). A number of issues, including tax laws regarding deductibility of OPEB costs, changes in CASs, funding, negotiation of forward pricing arrangements with respect to OPEB expenses, and the timing of adoption of FASB Statement No. 106 (AC P40), may further complicate the allowability of such costs. In addition, auditors should be aware that the DCAA has taken the position that a change from the pay-as-you-go method of accounting for OPEB costs to that required by FASB Statement No. 106 (AC P40) may result in a change in cost accounting practice for contract costing purposes. Such a change would result in the disallowance of any increased costs allocated to current contracts, including cost-type contracts.

.63 On adoption of FASB Statement No. 106 (AC P40), some contractors recorded a related asset. The future recoverability of such an asset, and the timing thereof, may have a significant degree of uncertainty resulting from—

1. The current industry environment and related business-base concerns when the OPEB expense is projected to be recovered via contract costing.
2. The computations and assumptions used (including the amounts and years in which the amounts are recovered) to support the asset, which may be subjective. For example, given the current environment, questions arise of whether future contract values should include funded backlog, total contract backlog, loss contracts, contracts with small margins, or contract options.

Because of the significance of the uncertainties, auditors should carefully consider the appropriateness of recording any deferred costs (or, alternatively, accrued revenues) by contractors to account for the difference between FASB Statement No. 106 (AC P40) and CAS requirements related to OPEB costs. The staff of the SEC has indicated that it will scrutinize the realizability of such assets and look for sufficient disclosure in the registrant's Management's Discussion and Analysis regarding the uncertainties related to recovery of those assets.

Commercial Nonrecurring Costs

.64 Many federal government contractors are moving into commercial markets and using the program method of accounting for products manufactured for delivery under production-type contracts, which may result in the deferral of costs. Under this method, costs are accumulated and accounted for by programs rather than by individual units or contracts. A program consists of the estimated number of units of a product to be produced by an enterprise in a continuing, long-term production effort for delivery under existing and anticipated contracts.

Auditors should be aware that the AICPA Audit and Accounting Guide *Audits of Federal Government Contractors* states that program accounting has had very limited applications because of the significant uncertainties associated with making reasonably dependable estimates of the total number of units to be produced and sold, the length of time to produce and sell them, and the associated production costs and selling prices. Additionally, the recoverability of the deferred costs is subject to a greater degree of risk and, accordingly, becomes more difficult to estimate in the current uncertain business environment. Program accounting is further discussed in paragraphs 3.57 through 3.60 of *Audits of Federal Government Contractors*.

Discontinued Operations

.65 To qualify for discontinued operations treatment, an entity must meet all the criteria in Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). These include a formal plan to dispose of a business segment, as well as the expectation that the plan of disposal will be carried out within a one-year period. In November 1993, the SEC staff issued SAB No. 93, *Accounting and Disclosures Relating to Discontinued Operations*, which expresses certain views of the SEC staff regarding accounting and disclosures related to discontinued operations. The SAB indicates that an entity's plan of disposal would not meet the criteria in APB Opinion No. 30 (AC I13) if the method of disposal of the business segment has not been determined or if the plan of disposal requires more than one year. The SAB also discusses accounting for the abandonment of a business segment, disposal of an operation with a significant interest retained, classification and disclosure of contingencies relating to discontinued operations, and accounting for subsidiaries that an entity intends to sell.

Impairment of Long-Lived Assets

.66 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). FASB Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the contractor estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.

.67 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by APB Opinion No. 30 (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of carrying amount or net realizable value.

.68 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. (Earlier application is encouraged.) Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.69 Auditors of federal government contractors should be aware that the current industry climate of downsizing, contract cancellations, consolidations, and mergers has increased the likelihood that events or changes in circumstances that indicate that assets have been impaired may have occurred. In these instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.70 In considering a federal government contractor's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AU section 342).

.71 Impairment losses recognized under FASB Statement No. 121 (AC I08) for financial accounting purposes are not recognized for government contract costing. The federal government follows the provisions of CAS 409, and FAR 31.205-16, *Gains and Losses on Disposition of Depreciable Property or Capital Assets,* regarding asset valuation, depreciation, and amortization. Consequently, an impairment loss is recognized only upon disposal of the impaired asset. Until an impaired asset is disposed of, depreciation or amortization is calculated on the basis of asset value before any impairment loss that may have been recognized for financial reporting.

Consensus Decisions of the FASB's EITF

.72 The EITF frequently discusses accounting issues of interest to federal government contractors. A description of issues discussed during the year is provided here; however, readers should consult detailed minutes of EITF meetings for additional information.

.73 EITF Issue No. 95-10, *Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109,* addresses whether a deferred tax asset should be recognized for the tax benefits of future tax credits that will be realized when income previously taxed at the undistributed rate is subsequently distributed.

.74 EITF Issue No. 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination,* addresses what criteria should be used to determine how contingent consideration based on earnings should be accounted for.

.75 EITF Issue No. 95-4, *Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease,* addresses whether a manufacturer is precluded from recognizing a sale of a product to a dealer if the customer subsequently enters into an operating lease with the manufacturer or its financial affiliate who acquires that product subject to the lease.

.76 EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination,* addresses what types of direct, integration, or exit costs to accrue as liabilities in a purchase business combination and when to recognize those costs.

.77 EITF Issue No. 95-2, *Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party,* addresses what constitutes a significant economic penalty to a consolidated entity under EITF Issue No. 91-1, *Hedging Intercompany Foreign Currency Risks.*

.78 EITF Issue No. 94-10, *Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109,* addresses whether tax effects caused by transactions among or with shareholders should be included in the income statement or in equity in the separate financial statements of the company affected.

.79 EITF Issue No. 94-6, *Accounting for the Buyout of Compensatory Stock Options,* addresses how to determine the total amount of compensation cost recognized as expense for compensatory stock options when they are repurchased by the issuing company.

.80 Appendix D-45 contains FASB staff views on *Implementation of FASB Statement No. 121 for Assets to Be Disposed Of.*

.81 Readers should consult the minutes for the following issues to understand the effect of issuance of FASB Statement No. 121 (AC I08) on related consensuses.

- EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*
- EITF Issue No. 90-16, *Accounting for Discontinued Operations Subsequently Retained*
- EITF Issue No. 90-6, *Accounting for Certain Events Not Addressed in Issue No. 87-11 Relating to an Acquired Operating Unit to Be Sold*
- EITF Issue No. 87-11, *Allocation of Purchase Price to Assets to Be Sold*
- EITF Issue No. 84-28, *Impairment of Long-Lived Assets*

Risks and Uncertainties

.82 In December 1994, the AICPA's Accounting Standards Executive Committee issued Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires federal government contractors to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of their financial statements. In addition, if specified disclosure criteria are met, SOP 94-6 also requires federal government contractors to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.83 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Because of the pervasive use of estimates in determining amounts reported in the financial statements of federal government contractors, auditors of those entities should carefully consider the requirements of SOP 94-6. Examples of such estimates often found in federal government contractor financial statements include the following:

- Cost and revenue estimates
- Inventory subject to rapid technological obsolescence
- Specialized equipment subject to technological obsolescence
- Valuation allowances for deferred tax assets based on future taxable income
- Capitalized computer software costs
- Environmental remediation-related obligations
- Litigation-related obligations
- Contingent liabilities for obligations of other entities
- Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits
- Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets
- Amounts relating to long-term contracts

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of federal government contractors in accordance with paragraph 21 of the SOP include—

- Concentrations in the volume of business transacted with a particular customer, (for example, the federal government) supplier, lender, grantor, or contributor.
- Concentrations in revenue from particular products, services, or fund-raising events.
- Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations.
- Concentrations in the market or geographic area in which an entity conducts its operations. For purposes of the SOP, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied. Early application is encouraged but not required.

.84 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

AICPA Exposure Draft: Proposed SOP on Environmental Remediation Liabilities

.85 In June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities.* The proposed SOP provides that—

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5, *Accounting for Contingencies* (AC C59), are met. (It includes benchmarks to aid in determining when those criteria are met.)
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent that the employees are expected to devote time directly to the remediation effort.
- Measurement of liabilities should include (1) the entity's specific share of the liability for a specific site, and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- Measurement of liabilities should be based on enacted laws and existing regulations, policies, and remediation technology.
- Measurement of liabilities should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed, and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

.86 The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and clean-up laws and the need to consider various individual state and other non-U.S. government requirements.

SEC Staff Accounting Bulletin

.87 SEC SAB No. 94, *Recognition of a Gain or Loss on Early Extinguishment of Debt,* expresses SEC staff views about the period in which a gain or loss should be recognized on the early extinguishment of debt. .

Information Sources

.88 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.89 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.90 Electronic bulletin board services allow users to read, retrieve (download), and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.91 Recorded announcements allow users to call and listen to announcements about a variety of recent or scheduled actions or meetings.

.92 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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.93 This Audit Risk Alert supersedes *Federal Government Contractors Industry Developments—1994.*

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.94 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Cost Accounting Standards Board	Room 9001 NEOB 725 17th Street, NW Washington, DC 20503 (202) 395-3254 (202) 395-5105 (f)		*Acquisition Reform Network* Internet http://www-far.npr.gov	
Defense Contract Audit Agency	8725 John J Kingman Road Suite 2135 Fort Belvoir, VA 22060-6219 (703) 767-1066			
Financial Accounting Standards Board	*Order Department* P O Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext 10			*Action Alert Telephone Line* (203) 847-0700 (ext 444)
U.S. Department of Defense	*Order Desk* 1000 Defense Pentagon Washington, DC 20301-1000 (703) 487-4650 (703) 487-4028		*Fed World* Internet Homepage: http.// www.dtic.dla.m,l/defenselink	
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250 (f)		*U.S. Government Printing Office's The Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account. User assistance line (202) 512-1530 (202) 512-1387(d) Telnet via Internet federal.bbs.gpo.gov 3001	
U.S. Securities and Exchange Commission	*Publication Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 3 (202) 942-7114 (tty)	World Wide Web home page http://=www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)

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AAM Section 8140

Finance Companies Industry Developments—1995/96

Industry and Economic Developments

.01 Finance companies provide a wide variety of lending and financing services. And though not easily classified, given the diverse nature of the industry, they can be broadly defined as those companies that, at a minimum, provide such services to both consumer and commercial markets. In consumer markets, finance companies may provide mortgage loans—collateralized by the underlying property or, more commonly, the borrower's equity in the property (that is, second mortgages); direct consumer loans—usually collateralized by household goods and repayable in installments; financing for sales of consumer goods and services through retail sales contracts; and increasingly, credit card services. In commercial markets, finance companies may extend working capital and installment loans—usually collateralized by the borrower's accounts receivables or capital assets; provide funding for the acquisition of equipment through leasing arrangements or purchase trade receivables (generally referred to as factoring).

.02 Finance companies typically operate by borrowing money at wholesale and, in turn, lending those funds at retail for many of the purposes described above. Some companies involved in captive finance activities limit their lending to the financing of purchases of products manufactured by an affiliated company, while others have diversified into other related financial services. See "Industry Diversification" below for further discussion.

.03 In the current economic environment interest rates have stabilized and credit demand has been robust in both the commercial and consumer credit markets. Short-term interest rates have stopped climbing, thereby easing some of the pressure on lending margins from rising funding costs earlier in the year. As such, finance companies involved in credit card issuance, as well as commercial and consumer lending, are expected to perform well during 1995.

.04 Loan delinquencies, an important issue in the assessment of audit risk, often track overall economic conditions—rising when the economy weakens and falling as the economy strengthens. Current economic growth is strong and therefore likely to prevent any rapid ascent in problem loans. At the same time, many finance companies have improved their management of credit risks, reflecting the extensive use of comprehensive credit scoring systems. Accordingly, the expenses of carrying, writing down, and reserving for problem assets continue to decline, although at a slower pace than in the past few years.

Credit Card Services

.05 Individual credit card use has been increasing at a high double-digit rate over the past few years. One major credit card issuer announced that its outstanding credit cards worldwide climbed 23 percent in the first quarter of 1995. Industry analysts expect continued growth from this segment given the trend of credit cards to gain growing acceptance as a major medium of exchange. The trend toward a "plastic-economy" should be bolstered by credit card issuers as they extend incentives (for example, money-back offers, product guarantees, etc.) and as the base of nontraditional merchants outlets that accept credit cards (for example, movie theaters, grocery stores, supermarkets, fast-food restaurants, etc.) grows. Continued expansion is also expected of the co-branded segment of the credit card industry.

.06 Some finance companies involved in credit card issuance have expanded their customer base by issuing co-branded credit cards. These cards, which have become increasingly popular in recent years, typically carry the name of a merchant outlet (for example, a department store or retail chain) and may also include the issuer's name. Auditors may wish to consider whether revenue sharing or fee allocation arrangements arise from co-branded credit cards, and if so, whether or not they have any audit or accounting implications. If such contractual obligations exist, auditors should consider the propriety of the accounting treatment used. Issues discussed by The Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) relating to credit card services include:

- EITF Issue No. 88-20, *Difference between Initial Investment and Principal Amount of Loans in a Purchased Credit Card Portfolio*
- EITF Issue No. 88-22, *Securitization of Credit Card and Other Receivable Portfolios*
- EITF Issue No. 90-18, *Effect of a "Removal of Accounts" Provision on the Accounting for a Credit Card Securitization*
- EITF Issue No. 92-5, *Amortization Period for Net Deferred Credit Card Origination Costs*
- EITF Issue No. 93-1, *Accounting for Individual Credit Card Acquisitions*

Mortgage Related Services

.07 Last year's earnings for underwriters of residential mortgages were crippled by the Federal Reserve's tough stance against inflation. In the aftermath of successive interest rate increases, mortgage volume collapsed leaving behind an industry deluged with overcapacity. This is no longer the case given the significant increase in credit demand during 1995.

.08 Industry-wide shipments of manufactured homes are expected to increase by approximately 10 percent during 1995, reflecting the growing popularity of such homes as a lower-cost alternative to traditional site built homes. Finance companies involved in funding the purchase of manufactured homes should expect increased growth in this market segment.

.09 Home improvement lending continues to be a source of significant revenue growth for finance companies. This segment of the industry will extend loans amounting to approximately $45 billion in the current year. Many home improvement loans involving major renovations are taken in the form of home equity lines of credit (that is, second mortgages). In assessing the adequacy of the related loan loss allowance, auditors should consider that in the event of default, such loans, although collateralized by the underlying property, are usually subordinate to the claims of other lenders.

Industry Diversification

.10 An industry-wide trend toward diversification is growing as many finance companies broaden their product lines in order to take advantage of new opportunities as well as to offset the risk of economic downturns in other, more traditional lending areas. This activity is likely to fuel business combinations as well-capitalized firms make acquisitions aimed at broadening their product lines and geographic markets. In these circumstances, auditors should consider whether management has appropriately accounted for transactions related to such combinations. Other audit implications of acquisitions, along with other forms of business combinations, are discussed in "Restructuring Charges" under the "Accounting Issues and Developments" section of this Audit Risk Alert (also see EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*). Additionally, as finance companies embark upon diversification, consideration should be given to whether the auditor has adequate knowledge of matters relating to the entity's new line of business and the industry in which it operates. Some of the areas into which finance companies have expanded, or have an increased presence, are discussed below.

.11 *Refund Anticipation Loan (RAL) Program.* Some finance companies have expanded into the RAL program whereby taxpayers, expecting refunds on their federal income tax returns, forego a portion of the proceeds in order to receive the funds immediately. In substance, the taxpayer has been extended a loan by a finance company with the reduction in total proceeds they receive representing an interest charge. The growth of this service has been significant given minimal collectibility problems along with interest rates that run as high as 20 percent. At the initiation of this program, the Internal Revenue Service (IRS), with the authorization of the filer, would remit the tax refund directly to the finance company. However, the IRS has changed this policy and instead sends the refund to the filer, who is then responsible for repaying the loan extended by the finance company. The initial effects of this change have caused an increase in collectibility problems and loan defaults. The IRS is making efforts to resolve these problems, however, the nature of their solution is uncertain. Auditors of finance entities participating in the RAL program should be alert to the collectibility problems inherent in refund anticipation loans and carefully consider the adequacy of the related loan loss allowance.

.12 *Insurance services.* Finance companies have become more involved in offering life, accident, health and property policies written for borrowers for the purpose of paying off their remaining loan balances, continuing their loan payments or protecting the value of loan collateral. Finance companies may provide these policies through insurance subsidiaries or, more commonly, by acting as insurance brokers. Auditors of finance companies involved in insurance activities should consider whether management has appropriately accounted for transactions related to these activities pursuant to the guidance set forth under relevant pronouncements such as: FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (AC In6), FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (AC In6), and FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (AC In6). The Audit Risk Alert *Insurance Industry Developments—1995/96* [AAM section 8040] contains information that may be relevant to auditors of the financial statements of finance companies with significant involvement in insurance related financial services.

.13 *Additional services.* Finance companies whose core business is commercial and consumer lending are seeking to broaden their product mix by expanding into revolving credit and home equity lending, thus providing cross-selling opportunities to existing customers. Additionally, for those finance companies providing residential mortgages, the acquisition of mortgage servicing entities, which are typically counter-cyclical to mortgage lending (income generated from loan servicing becomes more reliable in a rising rate environment when prepayment risk typically declines), has become more prominent. Some finance companies are also diversifying their lending mix to consumer and commercial applications, such as financing pianos, boats, motorcycles, tractor trailers and the like.

.14 In general, auditors should be alert to the audit and accounting implications of diversification by their finance clients as they enter into areas that are new or not directly related to the client's existing business. For example, auditors may wish to consider the effects of the development of new product lines or the expansion of existing services, through internal or external means on the entity's:

- existing internal control structure along with the corresponding effect on the auditor's assessment of control risk.
- ability to implement industry specific accounting pronouncements previously inapplicable to the financial services offered as well as other accounting practices common to the industry.
- obligation to comply with regulatory guidelines (for example, state banking or insurance agencies) with which the entity may be unfamiliar. The auditor may wish to consider whether the client has sufficient expertise in this area, and, if not, the impact on the accounting and reporting function.
- financing requirements of diversification, and its impact, if any, on the entity's solvency, along with the possible existence of any restrictive loan covenants. Since finance companies borrow funds to lend to others and thus have debt-to-equity ratios that are generally higher than many other industries, debt incurred to finance diversification may have a significant impact on audit risk.

- modification of credit or documentation standards to accommodate new products. Such actions may increase the audit risk associated with loan loss estimates.

Auditors may also wish to consider whether the entity's diversification will involve the application of auditing standards previously inapplicable to the audit of that entity's financial statements. For example, a finance company that ventures into insurance related areas may require auditors to consider using the work of a specialist, such as an actuary.

Competitive Environment

.15 AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), requires that, in planning their audits, auditors consider matters relating to the entity's business and the industry in which it operates. One such matter for finance companies is the fierce competitive environment in which the industry operates.

.16 For example, the credit card segment of the industry is highly competitive and has become an increasingly saturated market. Many issuers must offer incentives on their cards in order to attract new customers. Low teaser-rates, no annual fees, balance-transfer options, and rebates are often needed to attract borrowers, as too are frequent mailings and promotions, all of which may add significant costs to customer acquisitions. Auditors should consider whether such incentives have been appropriately accounted for. Further, profit margins have come under pressure due to intense pricing by some card issuers in their attempts to gain market share. However, industry-wide growth in receivables has, thus far, been sufficient to offset the shortfall for a number of finance companies offering credit card services. Auditors should note that low teaser-rates are introductory offers that typically expire after several months and then return to their much higher market levels. Auditors may wish to consider the effects such increases could have on the borrowers' ability to repay.

.17 In mortgage banking, even the largest residential mortgage lenders and servicers must contend with pricing competition from lenders willing to write unprofitable loans in order to increase market share. Despite being burdened by severe credit quality problems during the last market downturn, some finance companies have chosen to combat the competitive pressures by sacrificing asset quality to achieve desired levels of volume. Some finance companies may relax lending policies in order to maintain, if not gain, market share. Significant industry-wide credit quality problems have yet to emerge, however, auditors may wish to consider the effects of a finance entity's increase in loan volume on such issues as liquidity, loan receivable collectibility as well as the adequacy of the related loan loss allowance. Additionally, some finance companies may sell securities or loans to generate cash with which to fund higher volume. Auditors should consider the effects of such transactions on management's intent for, classification of, and valuation of securities and loans for financial reporting purposes. Auditors should also be alert to the effects of sales with recourse on credit risk and recognition of gains and losses and the appropriateness of the accounting for the securitization and/or sale of loans or securities.

.18 Industry observers believe that over the coming years growth for finance companies is likely to slow due to the increasing level of competition. Revenue growth has tapered off dramatically for many banks and it is likely that they will attempt to regain lost market share by adding new product lines, or expand existing services, that will compete with services provided by finance companies. Auditors should consider the effects of the competitive nature of the industry on their finance company clients.

Audit Issues and Developments

Asset Quality and Valuation Issues

.19 Auditors of the financial statements of finance companies, especially those adopting new or more aggressive lending strategies, should give special attention to credit quality issues surrounding the loans extended by these entities. Auditors also should give special attention to other asset quality issues related to areas such as real estate, troubled debt restructurings, foreclosed assets and other real estate owned; off-balance-sheet financial instruments, and other assets. Auditors should obtain sufficient competent evidence to evaluate the adequacy of management's loan loss allowance and liabilities for other credit exposures. The subjectivity of determining such amounts reinforces the need for careful planning and execution of audit procedures in this area, as well as evaluation of results of those procedures.

.20 Lack of an effective system to evaluate credit exposure and other sources of impairment, or the failure of a finance company to document adequately its criteria and methods for determining loan loss allowances, may suggest a reportable condition or a material weakness in the finance company's internal control structure over financial reporting. These deficiencies generally would—

1. increase the degree of judgment auditors and regulatory examiners must apply in evaluating the adequacy of management's related allowances and liabilities, and

2. increase the likelihood that differences in judgments will result.

The guidance in SAS No. 57, *Auditing Accounting Estimates* (AU section 342), is useful when considering this area. The AICPA Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks* (Product No. 021050) may provide relevant information on auditing estimated credit losses.

.21 Auditors also should be alert to valuation issues related to classification and impairment of securities and other finance company investments. Paragraph 16 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80.115), requires that, for individual securities classified either as available-for-sale or held-to-maturity (as defined), a finance company determines whether a decline in fair value below the amortized cost basis is other than temporary.

.22 Regarding the appropriateness of a finance company's classification of securities, paragraph 69 of FASB Statement No. 115 (AC I80) says that "if the sale of a held-to-maturity security occurs without justification, the materiality of that contradiction of the enterprise's previously asserted intent must be evaluated."

.23 Other factors that may affect audit risk include a finance company's exposure to interest-rate, liquidity, prepayment, and related risks. For example, finance companies heavily invested in fixed-rate assets (or variable-rate assets subject to caps on interest-rate increases) may face narrower spreads in a rising-rate environment. Auditors may wish to consider the effects that interest-rate increases could have on borrowers' ability to repay loans and the effects interest-rate decreases could have on the realization of assets that are sensitive to prepayments (such as mortgage servicing rights and interest-only securities).

Noncompliance With Regulatory Requirements

.24 Events of noncompliance with regulatory requirements by finance companies involved in providing services that are subject to state or federal oversight (for example, participation in impermissible activities or investments), expose finance companies to regulatory action, such as the forced disposition of those impermissible investments. Events of noncompliance may be brought to the auditor's attention during the application of normal auditing procedures, during the review of regulatory examination reports, or because of actions required by regulators.

.25 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), provides that "the auditor has a responsibility to evaluate whether there is substantial doubt 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 audited." Events of noncompliance with laws and regulations or the need to dispose of substantial assets are conditions, when considered with other factors, that could indicate substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. SAS No. 59 (AU section 341) identifies examples of other factors that the auditor may evaluate.

Elimination of Uncertainty Reporting

.26 The Auditing Standards Board (ASB) has issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

.27 The amendment also would expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AU section 508.37), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

.28 The proposal does not affect the provisions of SAS No. 59 (AU section 341), which requires that the auditor add an explanatory paragraph to the auditor's report when there is substantial doubt about the entity's ability to continue as a going concern.

.29 Currently, auditors of the financial statements of finance companies may consider it necessary to add an uncertainty explanatory paragraph to their reports when there is a material uncertainty relating to possible regulatory sanctions as discussed above. If the proposed SAS is issued in final form, that requirement will be eliminated. Nonetheless, auditors reporting on financial statements that include such an uncertainty may wish to emphasize that fact by adding an emphasis-of-a-matter paragraph to their reports. Such paragraphs, however, are optional and are added solely at the auditor's discretion.

.30 The ASB hopes to finalize this SAS late this year and to issue an SAS that would be effective for reports issued on or after June 30, 1996. Comments on the proposed SAS were due on October 20, 1995.

Mortgage Banking Engagements

.31 In May 1995, the Mortgage Bankers Association of America (MBA) released its revised *Uniform Single Attestation Program for Mortgage Bankers* (USAP). The USAP supersedes the MBA's existing program (published in 1983) with an opinion-level attestation engagement performed following AICPA Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AT section 500). Specifically, the MBA redefined the engagement to address mortgage servicing companies' compliance with the USAP's specified minimum servicing standards. The USAP will be effective for fiscal years ending on or after December 15, 1995, and later, with earlier application encouraged.

.32 In a September 27, 1995 letter to its members, the MBA said that commercial and multifamily loan servicers could report using the USAP, except that minimum standards V.4 and VI.1 could be omitted from management's assertion and the auditor's attestation reports. In the letter, the MBA described a project under way to consider amending or expanding the USAP to explicitly address reporting by commercial and multifamily loan servicers.

.33 The USAP addresses reporting on management assertions about an entity's compliance with specified criteria. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), provides guidance on factors auditors should consider when auditing the financial statements of entities that use service organizations (such as mortgage bankers that service mortgages for others). Information about the control structure policies and procedures at mortgage bankers or other loan servicing organizations may affect assertions in the user entity's financial statements. Also, some service auditors' reports prepared according to SAS No. 70 (AU section 324) include descriptions and results of tests of operating effectiveness of specified control policies and procedures. Accordingly, those SAS No. 70 (AU section 324) reports may enable an auditor of the financial statements of a user entity to assess control risk below the maximum of relevant financial statement assertions.

Readers should consult SAS No. 70 (AU section 324) for additional information on how to use a service auditor's report when auditing the financial statements of a user organization.

.34 The Federal Home Loan Mortgage Corporation (Freddie Mac) sent a September 29, 1995 letter to chief financial officers of its seller/servicers announcing that, effective immediately, Freddie Mac no longer requires an independent accountant's agreed-upon procedures attestation report on compliance with requirements of Freddie Mac's programs. The report previously was required by Freddie Mac's 1993 *Compliance Reporting Guide.* Readers should be alert to a Freddie Mac bulletin that will be issued explaining the change and clarifying Freddie Mac's other independent audit requirements.

SAS No. 70 Auditing Procedure Study

.35 A task force of the ASB has drafted an auditing procedure study that provides guidance to auditors on implementing SAS No. 70 (AU section 324). The study provides guidance to a service auditor engaged to issue a report on the control structure policies and procedures of a service organization and to user auditors engaged to audit the financial statements of an entity that uses a service organization. An example of a service organization is a bank trust department that invests and holds assets for employee benefit plans. The task force expects to issue the study in early 1996.

Agreed-Upon Procedures Engagements

.36 In September 1995, the ASB issued SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622), which supersedes SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement.* The ASB also issued SSAE No. 4, *Agreed-Upon Procedures Engagements* (AT section 600), which, among other things, in amending agreed-upon procedure reports prepared in accordance with SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600):

- Prohibits negative assurance about whether management's assertion is fairly stated from being included in reports on agreed-upon procedures.
- Clarifies that SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AU section 322), does not apply to agreed-upon procedures engagements.
- States that the concept of materiality does not apply to agreed-upon procedures engagements unless the definition of materiality is agreed to by the specified users.

SSAE No. 4 (AT section 600) also requires a written management assertion as a condition of engagement performance. SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) are effective for reports dated after April 30, 1996, with earlier application encouraged.

Accounting Issues and Developments

Mortgage Servicing Rights

.37 FASB Statement No. 122, *Accounting for Mortgage Servicing Rights* (AC Mo4), amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (AC Mo4), to require that finance companies involved in mortgage banking activities recognize as separate assets rights to service mortgage loans for others, however those servicing rights are acquired. Finance companies involved in mortgage banking activities may acquire mortgage servicing rights through either the purchase or origination of mortgage loans. A finance company that acquires mortgage servicing rights through the origination of mortgage loans and sells or securitizes those loans with servicing rights retained is required by FASB Statement No. 122 (AC Mo4) to allocate the total cost of the mortgage loans to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on their relative fair values if it is practicable to estimate those fair values. If it is not practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights), the Statement (AC Mo4) requires that the entire cost of purchasing or originating the loans should be allocated to the mortgage loans (without the mortgage servicing rights) and no cost should be allocated to the mortgage servicing rights.

.38 FASB Statement No. 122 (AC Mo4) requires that a finance company involved in mortgage banking activities assess its capitalized mortgage servicing rights for impairment based on the fair value of those rights. The Statement (AC Mo4) requires that a finance company should stratify its mortgage servicing rights that are capitalized after the adoption of the Statement (AC Mo4) based on one or more of the predominant risk characteristics of the underlying loans. The Statement (AC Mo4) requires that impairment should be recognized through a valuation allowance for each impaired stratum.

.39 FASB Statement No. 122 (AC Mo4) applies prospectively in fiscal years beginning after December 15, 1995, to transactions in which a finance company sells or securitizes mortgage loans with servicing rights retained and to impairment evaluations of all amounts capitalized as mortgage servicing rights, with earlier application encouraged. The Statement (AC Mo4) prohibits retroactive capitalization of mortgage servicing rights retained in transactions in which a finance company originates mortgage loans and sells or securitizes those loans before the adoption.

.40 In July 1995, the FASB staff announced that the Board agreed to clarify the transition provisions of FASB Statement No. 122 (AC Mo4), noting in FASB's Action Alert No. 95-21 that:

> ...earlier application is encouraged as of the beginning of a fiscal year for which annual financial statements or annual financial information has not been issued or as of the beginning of an interim period within that fiscal year for which interim financial statements or interim financial information has not been issued. For example, Public Company X issued financial information for the first quarter. In the second quarter, management of Public Company X has two choices for early adoption: (1) adopt as of the beginning of the fiscal year because annual financial statements or annual financial information has not been issued for that fiscal year or (2) adopt as of the beginning of the second quarter because interim financial statements or interim financial information has not been issued for that quarter.

Impairment of Long-Lived Assets

.41 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). FASB Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the finance company estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.

.42 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and*

Transactions (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.43 Paragraph 16 of FASB Statement No. 121 (AC I08.135) states that assets to be disposed of that are within the scope of that Statement (AC I08), such as other real estate owned, should "not be depreciated (amortized) while they are held for disposal."

.44 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. (Earlier application is encouraged.) Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.45 Auditors of finance companies should be aware that the current industry climate of diversification has increased the likelihood that events or changes in circumstances that indicate that assets have been impaired may have occurred. For example, diversification by way of acquisition may result in duplication of branch office locations within certain geographic areas that would compete for business. In these instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.46 In considering a finance company's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57 (AU section 342).

Disclosures About Derivatives

.47 In October 1994, the FASB issued Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25). FASB Statement No. 119 (AC F25) requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics.

.48 The Statement (AC F25) also amends existing requirements of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), and FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25). The Statement (AC F25) requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 (AC F25.115P) encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

.49 FASB Statement No. 119 (AC F25) was effective for financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations the Statement (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1995.

.50 The FASB Special Report *Illustrations of Financial Instrument Disclosures* contains illustrations of the application of FASB Statements No. 105 (AC F25), No. 107 (AC F25), and No. 119 (AC F25).

Income Recognition on Impaired Loans

.51 In October 1994, the FASB issued Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (AC I08), which amends FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC I08), to allow creditors to use existing methods for recognizing interest income on impaired loans. To accomplish that, it eliminates the provisions in FASB Statement No. 114 (AC I08) that describe how creditors should report income on impaired loans.

.52 FASB Statement No. 118 (AC I08) does not change the provisions in FASB Statement No. 114 (AC I08) that require creditors to measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral-dependent.

.53 FASB Statement No. 118 (AC I08) also amends the disclosure requirements in FASB Statement No. 114 (AC I08) to require disclosure of information about the recorded investment in certain impaired loans and about how creditors recognize interest income related to those loans.

.54 FASB Statement No. 118 (AC I08) is effective concurrent with the effective date of FASB Statement No. 114 (AC I08), that is, for financial statements for fiscal years beginning after December 15, 1994.

Impairment of a Loan

.55 In May 1993, FASB Statement No. 114 (AC I08) was issued to address the accounting by creditors for impairment of certain loans. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Statement (AC I08) is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller balance homogeneous loans that are collectively valued for impairment (for example, credit-card, residential mortgage, and consumer installment loans), loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115 (AC I80). It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms, including groups of smaller balance homogeneous loans that may otherwise have been excluded from the scope of the Statement (AC I80).

.56 FASB Statement No. 114 (AC I08) requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent. The impairment is recognized by creating or adjusting a valuation allowance for the impaired loan with a corresponding charge to bad debt expense.

.57 The Statement (AC I08) amends FASB Statement No. 5, *Accounting for Contingencies* (AC C59), to clarify that a creditor should evaluate the collectibility of both the contractual interest and contractual principal of all receivables in assessing the need for a loss accrual. The Statement (AC I08) also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (AC D22), to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

.58 The Statement (AC I08) applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

Offsetting

.59 APB Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7 (AC B10.101-103), says that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), defines *right of setoff* and specifies what conditions must be met to permit offsetting. FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* (AC B10), modifies FASB Interpretation No. 39 (AC B10), to permit offsetting in the statement of financial position of payables and receivables that represent repurchase agreements and reverse repurchase agreements and that meet all of the conditions specified in FASB Interpretation No. 41 (AC B10). FASB Interpretation No. 41 (AC B10) was effective for financial statements issued for periods ending after December 15, 1994.

Consensus Decisions of the FASB's EITF

.60 The EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to finance companies. A description of issues discussed during the year follows; readers should consult detailed minutes for additional information.

- EITF Issue No. 95-5, *Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights,* addresses certain issues related to sales of mortgage loan servicing rights.
- EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination,* addresses what types of direct, integration, or exit costs to accrue as liabilities in a purchase business combination and when to recognize those costs.
- EITF Issue No. 95-2, *Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party,* addresses what constitutes a significant economic penalty to a consolidated entity under EITF Issue No. 91-1, *Hedging Intercompany Foreign Currency Risks.*
- EITF Issue No. 94-9, *Determining a Normal Servicing Fee Rate for the Sale of an SBA Loan,* discusses how, when applying EITF Issue No. 88-11, *Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold,* addresses how an enterprise should determine a normal servicing fee rate for United States Small Business Administration loans without a major secondary market maker. A secondary issue is how to account for a change in the normal servicing fee rate.
- EITF Issue No. 94-5, *Determination of What Constitutes All Risks and Rewards and No Significant Unresolved Contingencies in a Sale of Mortgage Loan Servicing Rights under Issue No. 89-5,* involves issues associated with sales recognition on a transfer of mortgage servicing rights.

.61 Appendix D to the *EITF Abstracts* contains EITF discussions of technical matters that have long-term relevance and do not relate specifically to a numbered EITF Issue. Readers should be alert to the following topics of recent discussion:

- Appendix D-45, *Implementation of FASB Statement No. 121 for Assets to Be Disposed Of,* contains FASB staff views on issues relating to implementation of FASB Statement No. 121 (AC I08).
- Appendix D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value,* contains a FASB staff announcement concerning implementation of FASB Statement No. 115 (AC I80).
- Appendix D-43, *Assurance That a Right of Setoff is Enforceable in a Bankruptcy under FASB Interpretation No. 39,* contains FASB staff views on that subject.

.62 Readers should consult the minutes for the following issues to understand the effect of issuance of FASB Statement No. 122 (AC Mo4) on related consensuses.

- EITF Issue No. 88-11, *Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold*
- EITF Issue No. 86-39, *Gains from the Sale of Mortgage Loans with Servicing Rights Retained*

- EITF Issue No. 86-38, *Implications of Mortgage Prepayments on Amortization of Servicing Rights*

.63 Readers should consult the minutes for the following issues to understand the effect of issuance of FASB Statement No. 121 (AC I08) on related consensuses.

- EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*
- EITF Issue No. 90-16, *Accounting for Discontinued Operations Subsequently Retained*
- EITF Issue No. 90-6, *Accounting for Certain Events Not Addressed in Issue No. 87-11 Relating to an Acquired Operating Unit to Be Sold*
- EITF Issue No. 87-11, *Allocation of Purchase Price to Assets to Be Sold*
- EITF Issue No. 84-28, *Impairment of Long-Lived Assets*

Risks and Uncertainties

.64 In December 1994, the AICPA's Accounting Standards Executive Committee issued Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires that finance companies include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires financial statement disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.65 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Besides valuation allowances for business and real estate loans, examples of similar estimates that may be included in financial statements of finance companies include, but are not limited to, the following:

- Impairment of long-lived assets, for example, marginal branch offices.
- Estimates involving assumed prepayments, for example, discounts or premiums on financial assets (such as securities or loans), mortgage servicing rights and excess servicing receivables, and mortgage-related derivatives.
- Lives of goodwill and identifiable intangible assets.

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of finance companies in accordance with paragraph 21 of the SOP include the following:

- Sale of a substantial portion of or all receivables or loan products to a single customer.
- Concentration of sales of loans to a third party.
- Concentration of revenue from mortgage banking activities.

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

.66 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

Restructuring Charges

.67 Entities offering financial services have seen an increased rate of mergers and acquisitions given the current industry trend toward diversification. These entities may be seeking access to new markets through acquisition or concentrating on their core business by divesting themselves of unrelated divisions. Greater cost efficiencies and economies of scale are being sought through such vertical and horizontal integrations. Restructuring often accompanies these activities as redundant functions are eliminated and existing areas streamlined. When finance companies implement restructuring programs, auditors should consider the impact of reductions in personnel on operations and on the entity's and internal control structure, the appropriateness and completeness of recorded liabilities relating to current restructuring plans, and the appropriate period for reporting the costs associated with restructurings.

.68 In considering restructuring liabilities and costs, auditors should be aware of EITF Issue No. 94-3 that provides authoritative guidance on the appropriate accounting for restructurings. EITF Issue No. 94-3 also provides guidance on (1) the types of costs that should be accrued, (2) the timing of recognition of restructuring charges, and (3) prescribing disclosures that should be included in the financial statements.

.69 For publicly held entities, Securities and Exchange Commission Staff Accounting Bulletin No. 67 (Topic 5P), *Income Statement Presentation of Restructuring Charges,* requires that restructuring charges be reported as a component of income from continuing operations.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

.70 The AICPA Audit and Accounting Guide *Audits of Finance Companies* is available through the AICPA's loose-leaf subscription service. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the guides as they appear in the service are printed annually.

Information Sources

.71 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.72 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.73 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.74 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.75 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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.76 This Audit Risk Alert supersedes *Finance Companies Industry Developments—1994.*

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.77 Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants (AICPA)	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext 3) and the AICPA Meetings and Travel Division· (201) 938-3232	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board (FASB)	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext 444)
U.S. Securities and Exchange Commission (SEC)	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 3 (202) 942-7114 (tty)		
Mortgage Bankers Association of America	1125 15th Street, NW Washington, DC 20005-2766 *Publications Department* (800) 793-MBAA			
Federal Home Loan Mortgage Corporation	8200 Jones Branch Drive McLean, VA 22102-3107 *General Information* (800) FREDDIE			
American Financial Services Association (AFSA)	919 18th Street NW Washington, DC 20006 *General Information* (800) 843-3280			
Commercial Finance Association (CFA)	225 W. 34th Street New York, NY 10122 *General Information* (212) 594-3490			

[The next page is 8311.]

AAM Section 8150

Investment Companies Industry Developments—1995/96

Industry and Economic Developments

.01 Following a brief respite in 1994, the phenomenal growth of investment companies—both open-end or mutual and closed-end funds—resumed in 1995. The second quarter of 1995 was the best quarter that mutual funds as a whole have seen in two-and-a-half years. At midyear, the total value of mutual fund assets was $2.5 trillion, an increase of $300 billion from year-end 1994. That increase was more than three times the increase for all of 1994. U.S. stock funds, principally technology and financial services funds, were significant factors in this growth.

.02 The rapid growth in the mutual fund industry continues to be fueled by factors that include a growing network of bank-affiliated fund products, the trend in corporate America away from defined-benefit retirement arrangements and toward defined-contribution plans that are organized around a variety of mutual fund products, as well as the growing globalization of investment products and markets. It is estimated that over 31 percent (30.2 million) of U.S. households own shares in mutual funds. As a result, the investment company industry is subject to extensive media coverage as well as to increasing scrutiny from Congress and the Securities and Exchange Commission (SEC).

.03 The growth in the mutual fund industry is likely to give rise to a number of factors that may deserve consideration by auditors as they plan audits of financial statements of investment companies. For example,

- Increases in transaction activity may place burdens on internal control structures that may affect auditors' assessments of control risk.
- The inflow of dollars for investment may require changes in investment strategies as portfolio managers attempt to maintain or improve returns to attract new investors and retain current investors. Such strategies frequently entail the use of derivative financial instruments either as risk management tools or as speculative investment vehicles.
- Innovative marketing strategies are resulting in increasingly complex capital structures such as multiple-class funds and "hub and spoke" fund structures.
- The trend toward concentration of similar funds into larger economic units is resulting in an increase in fund mergers and acquisitions.
- The success of mutual funds in recent years has also given rise to an increasing variety of fund products whose objectives range from global to ultra-specific, modern-derivative investment strategies.

As they assess audit risk, auditors of financial statements of investment companies should be sensitive to issues that are inherent in the current business environment, particularly those relating to matters such as security valuations, portfolio custody (particularly foreign securities held by foreign subcustodians or foreign central depositories), and funds' internal control structures.

.04 Despite the overall success of mutual funds as an investment vehicle in 1995 (they are second only to commercial banks as financial intermediaries), regulators, industry representatives, and investors agree that there is much room for improvement and streamlining in materials used to communicate with fund shareholders and potential shareholders. To this end, the SEC issued a concept release seeking comment on a range of proposals for risk disclosures. Eight major fund companies, with the SEC's encouragement, have issued abbreviated profile prospectuses, which are meant to be easy-to-read summaries of fund risks, fees, and objectives. However, these developments have not affected the SEC's requirements regarding financial statements.

Regulatory and Legislative Developments

.05 Regulation of investment companies is discussed in chapter 1 of the AICPA Audit and Accounting Guide *Audits of Investment Companies.* The following discussion is intended to help auditors stay abreast of developments that affect the regulation of investment companies.

.06 AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), requires that, in planning their audits, auditors consider matters affecting the industry in which an entity operates, including, among other things, government regulations. Auditors consider such regulations in light of their potential impact on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AU section 317), distinguishes between two types of laws and regulations:

1. Those that have a direct and material effect on the determination of financial statement amounts

2. Those that relate more to an entity's operating aspects than to its financial and accounting aspects and therefore have only an indirect effect on the financial statements

Although auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that directly and materially affect financial statement amounts, normally an audit performed in accordance with generally accepted auditing standards (GAAS) does not include audit procedures specifically designed to detect illegal acts that would have indirectly affected the financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

SEC Releases

.07 *SEC Release No. IC 20915.* In April 1995, the SEC adopted rule 18f-3 under the Investment Company Act of 1940 (the 1940 Act) which, subject to certain conditions, allows a fund to adopt a multiple-class structure without obtaining exemptive relief from Section 18f of the 1940 Act. The new rule also eliminates the requirement for an initial and ongoing expert's opinion (generally issued by funds' auditors) on the initial design and subsequent operation of the internal control structure as it affects allocations among classes, which is currently a condition of receiving such exemptive relief. Those electing to operate under exemptive relief obtained before the rule was effective must still file an ongoing expert's opinion.

.08 *SEC Release No. IC 21221.* Effective September 1, 1995, the SEC adopted rule and form amendments relating to the reporting of expenses by investment companies. The amendments require that investment companies, in their statements of operations and other financial information for fiscal periods ending after September 1, 1995, include in gross expenses certain amounts paid by broker-dealers under so-called "brokerage/service arrangements" and amounts reduced through explicit "expense offset" arrangements (for example, a reduction in custody fees as a result of maintaining cash with the fund's custodian). Effective December 1, 1995, yields computed under SEC regulations are to be reduced by expenses paid under "brokerage/service arrangements". In addition, the amendments require, for fiscal years beginning September 1, 1995, that investment companies report in their financial highlights the average commission rate paid per share on commissionable purchases and sales of portfolio securities, subject to a de minimis exception. Retroactive restatement of financial statements is not required. The amendments are intended to enhance the information provided to investors so that they may be better able to assess and compare investment company expenses and yield information. A more detailed discussion of the compliance dates appears in section II.G of the release.

Other SEC Concerns

.09 The SEC's Division of Investment Management has noted, in letters and various public forums, the matters in the following sections that frequently give rise to comments on materials filed with the SEC or that have been identified by the SEC's field inspection process. If auditors become aware during the course of an audit that such transactions have not been reported in the financial statements as recommended, they should consider the effect on the amounts presented in the financial statements of such deviations and whether the audit committee or the board of directors knows of the SEC staff's position and approves of the accounting and financial statement presentation that is in conflict with that position.

.10 The Chief Accountant of the SEC Division of Investment Management issued letters dated November 1, 1994 and February 3, 1995, to chief financial officers of investment companies to assist investment company registrants and their auditors in addressing certain accounting-related matters. The letters discuss—

1. Accounting for certain transactions with affiliates
2. Valuation of certain portfolio investments
3. An audited balance sheet for new series
4. Securities with zero value
5. Applying Financial Accounting Standards Board (FASB) Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), to investment companies
6. Presentation and accounting for enhanced securities

In a letter dated August 21, 1995, the AICPA Investment Companies Committee (the Committee) commented on the views expressed by the Chief Accountant regarding how auditors should test a company's valuation of certain securities. In its letter, the Committee stated that implementing the SEC staff's views would expand auditors' responsibilities beyond what is required under GAAS and in SEC Accounting Series Release 118.

.11 *Postmerger Performance.* As noted in the "Industry and Economic Developments" section of this Audit Risk Alert, fund mergers have become a common phenomenon. Following the merger of two or more investment companies, the issue of how to compute the historical performance of the continuing entity arises. In a no-action response to a letter from North American Security Trust (publicly available August 5, 1994), the SEC staff stated it would not object if a fund formed as a result of the mergers of other funds used the historical performance data of the fund that it most closely resembled for purposes of presenting historical performance information for periods prior to the reorganization. The staff said that in determining whether a surviving fund or a new fund resulting from a reorganization may use the historical performance of any of the predecessor funds, funds should compare the attributes of the surviving or new fund and the predecessor funds to determine which predecessor fund, if any, the new or surviving fund most closely resembles. Among the factors to be considered are the comparability of the various funds' (1) investment advisors; (2) investment objectives, policies, and restrictions; (3) expense structures and expense ratios; (4) asset sizes; and (5) portfolio compositions. The SEC staff believes that the survivor of a business combination for accounting purposes (that is, the fund whose financial statements and other financial information are carried forward) typically will be the fund whose historical performance may be used by a new or surviving fund. While this letter involved open-end funds, it stated that the same rationale would apply to a merger of closed-end funds.

.12 Auditors of funds involved in merger transactions should refer to paragraphs 8.27 through 8.31 of *Audits of Investment Companies* for further guidance.

.13 *Cash Collateral.* Transactions in which funds lend investments and receive other investments as collateral generally are treated as off-balance-sheet transactions. However, any cash received as collateral for such loans is recorded as an asset of the fund, and the investment of the collateral cash is subject to the same limitations as the fund's investments. The SEC staff has stated that income from such arrangements should not be offset against custody charges for financial reporting purposes because that would misstate such expenses; it should be reflected separately as a part of investment income.

.14 *Securities Lending Income.* Investment companies that have subcustodians that lend securities receive a portion of the fees the subcustodians earn for lending the securities. The SEC staff has stated that if subcustodians are engaged solely to allow investment companies to participate in income from the securities lending activities, investment companies may, for financial statement-presentation and expense-ratio purposes, reduce reported subcustodian fees by investment companies' portions of the securities lending income, with parenthetical disclosures of the amount by which subcustodian fees have been reduced by securities lending income. If the amount of securities lending income exceeds total subcustodian fees, the staff believes that should not be reflected as an additional reduction of the fees of the primary custodian. Such excess should be presented separately as part of investment income.

Audit Issues and Developments

Derivative Financial Instruments

.15 Recent years have seen a growing use of derivatives, innovative financial instruments that often are very complex and can involve a substantial risk of loss. Investment companies sometimes use such instruments as risk management tools (hedges) or as speculative investment vehicles. As interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments obtain their values have increased in volatility, a number of entities have incurred significant losses as a result of their use. The use of derivatives almost always increases audit risk.

.16 It is essential that auditors understand both the economics of derivatives used by the investment companies whose financial statements they audit as well as the nature and business purpose of their derivatives activities. In addition, auditors should evaluate their clients' accounting for any such instruments, especially those carried at other than market value. To the extent the derivatives qualify as financial instruments as defined in FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), and No. 119 (AC F25), the disclosure requirements set forth in those statements must be met.

.17 Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1995/96* [AAM section 8010]. Also, see "FASB Statement on Derivatives" in the "Accounting Issues and Developments" section of this Audit Risk Alert. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations.

Valuation of Securities

.18 The valuation of investment securities continues to be a prime concern for auditors of investment companies. Investments generally represent the most significant asset in an investment company's statement of assets and liabilities. Additionally, the daily purchase and redemption prices of fund shares are based almost exclusively on the value of a fund's investment portfolio.

.19 Chapter 2 of *Audits of Investment Companies* describes the estimation of fair values of securities valued in good faith by boards of directors. In auditing securities' valuations determined by the board of directors, auditors should review the information considered by the board in determining the value of the securities, ascertain that the procedures followed were reasonable, review the supporting documentation, and read relevant minutes. In some instances, auditors may consider using the work of a specialist in auditing the valuation of such securities.

SAS No. 73, *Using the Work of a Specialist* (AU section 336), provides guidance when auditors decide to consider the work of any specialist used. Auditing the valuation of such securities is an area that requires a high degree of judgment and scrutiny to ensure that the carrying amounts approximate fair value.

Continuing Globalization of Fund Products

.20 Total assets of domestic funds investing in foreign securities (global and international funds) increased from $152.5 billion at December 31, 1993, to $193.3 billion at December 31, 1994, as investors continued to look beyond the borders of the United States for investment opportunities. Foreign investments raise currency, taxation, and custodial issues.

.21 Auditors should be alert to factors that affect financial statements of entities with foreign investments, such as currency risk, foreign tax considerations, portfolio custody (particularly foreign securities held by foreign subcustodians or foreign central depositories) and obtaining reliable market values.

.22 *Audits of Investment Companies,* AICPA Statement of Position (SOP) 93-1, *Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies,* and SOP 93-4, *Foreign Currency Accounting and Financial Statement Presentation for Investment Companies,* include further guidance on testing portfolio valuations, including estimates of values of foreign securities determined in good faith by boards of directors.

Service Auditor's Reports

.23 Investment companies frequently use the services of fund custodians, transfer agents, and other service organizations that affect assertions in an investment company's financial statements. In obtaining an understanding of an investment company's internal control structure and assessing control risk, auditors should consider carefully the functions or processing performed by such service organizations. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), provides guidance to auditors of entities, including investment companies, that use service organizations. SAS No. 70 (AU section 324) may specifically impact custodian and transfer agent third-party internal control report, as well as multiple-class fund design and operation reporting on expense allocation and the calculation of net asset value per share and distributions.

.24 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), requires an auditor to obtain a sufficient understanding of an entity's internal control structure to plan the audit. When an investment company uses a service organization, internal control structure policies and procedures at the service organization that affect the functions or processing performed by the service organization may have a significant effect on assertions in the investment company's financial statements. For this reason, planning the audit of an investment company may require that the auditor gain an understanding of the control structure policies and procedures performed by a service organization. When an investment company relies on a service organization's control structure policies and procedures over the processing of transactions that are material to the investment company's financial statements, these policies and procedures should be considered by the auditor.

.25 One method of obtaining information about these policies and procedures is to obtain a service auditor's report as described in SAS No. 70 (AU section 324). Auditors frequently ask whether it is necessary to obtain a service auditor's report when their clients use service organizations. The fact that an entity uses a service organization does not, in itself, mean that such a report must be obtained. In certain situations, the investment company may implement control policies and procedures that will obviate the need for a service auditor's report. In such circumstances, the investment company is not relying on the service organization's controls.

.26 Some additional factors that may be considered in determining whether to obtain a service auditor's report are—

- Whether the transactions or accounts affected by the service organization are material to the investment company's financial statements.

- The extent to which the user organization retains responsibility for authorizing the transactions and maintaining the related accountability.

- The availability of other information (for example, user manuals, system overviews, and technical manuals) at the investment company. Such information may provide the auditor with sufficient information to plan the audit.

The AICPA's Auditing Standards Division will issue an Auditing Procedure Study titled *Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations,* early in 1996.

Complex Capital Structures

.27 To increase flexibility in pricing and access to alternative distribution channels for their shares, many investment companies have adopted complex capital structures. Such structures often include multiple-class funds and "hub and spoke" or master/feeder funds.

.28 *Multiple-Class Funds.* Multiple-class funds are those that issue more than one class of shares. Each class of shares usually has a different sales charge structure, such as the traditional "front-end" load charges, contingent or deferred "back-end" charges that may be tied to an annual 12b-1 fee (asset based distribution charge), so-called "level-load" charges that are assessed annually for as long as the shares are held, or combinations of such sales charges. Multiple-class funds may charge different classes of shares for expenses such as distribution (Rule 12b-1) fees, transfer-agent fees, registration fees, and printing expenses related specifically to each class.

.29 The multiple-class structure raises a number of regulatory, tax, operational, accounting, and financial reporting issues, many of which relate to allocations of income, expenses, realized and unrealized gains and losses, and distributions among the different classes of shares. In obtaining the understanding of the internal control structure required by SAS No. 55 (AU section 319), auditors should consider whether management has implemented procedures for allocating fund income, expenses, realized and unrealized gains, and distributions to the multiple classes of shares.

.30 SEC Rule 18f-3 of the 1940 Act requires that such allocations be based on the relative value of net assets among share classes, except for funds that seek to maintain net asset values at a constant dollar amount (such as money-market funds), for which allocations based on relative values of settled shares are also acceptable. Specific reports on the design and functioning of a fund's systems of expense measurement and allocation to particular classes, as well as the daily net asset value per share and distributions, are required to be submitted to the SEC.

.31 In addition, tax compliance issues may be extensive, and failure to comply can result in "disproportionate dividends", disqualifying the fund from its status as a registered investment company. Financial statement presentation of information that is fund or class specific may also be complex.

.32 The Investment Company Institute's (ICI's) Accounting Policy Subcommittee has issued a white paper entitled *Multiple Class Accounting and Reporting* (ICI Accounting/Treasurers Members White Paper No. 18-92, March 31, 1992) to help fund accountants and auditors understand the various issues surrounding multiple-class operational and financial reporting issues. Another white paper published by the ICI addresses accounting, tax, and operational issues for mortgage-backed securities.

.33 *"Hub and Spoke" or Master/Feeder Funds.* Hub and spoke or master/feeder funds permit a number of funds (spokes or feeders) with similar investment objectives to invest in a single entity (hub or master). This structure is intended to enable smaller funds to achieve economies of scale and to allow for the segmenting of market while at the same time centralizing assets. The structure allows for the grouping of investors in spokes that in turn invest in a central hub. Such structures permit marketers to develop specific fee structures for particular markets, for example, institutional and retail, while collecting assets into a central pool for investment management purposes.

.34 In master/feeder structures, the investment management and distribution functions are performed by separate investment companies. All investment management functions are conducted by the master fund, whereas distribution, shareholder servicing, and transfer agent functions are conducted by the feeders. Feeder investment companies, each having similar investment objectives but different distribution channels for their shares, invest their assets solely in another investment company, known as the master fund.

.35 The SEC staff currently requires financial statements of the master to be filed with each publicly held feeder's financial statements.

Fund Mergers and Acquisitions

.36 As with most U.S. industries, the trend toward concentration into larger economic units continued for investment companies in 1995. Similar funds are usually combined when investment advisers are acquired by or merge with other investment advisers. Auditors involved in fund combinations should refer to paragraphs 8.27 through 8.31 of *Audits of Investment Companies* for guidance on how to account for such transactions. The SEC staff has issued guidance on how to compute the historical performance of the continuing entity. (See the "Regulatory and Legislative Developments" section of this Audit Risk Alert.)

Attesting to Investment Performance

.37 The AICPA's Investment Companies Committee has prepared a Notice to Practitioners, *Examination Engagements to Report on Investment Performance Statistics Based on Established or Stated Criteria*. The Notice amends the guidance provided in a previously issued Notice to Practitioners, *Engagements to Report on Performance Presentation Standards of the Association for Investment Management and Research*. It provides practical applications of the reporting example included in paragraph 54 of AICPA Statement on Standards for Attestation Engagements No. 1, *Attestation Standards* (AT section 100.54). (To obtain this Notice, dial (201) 938-3787 from a fax machine, follow the voice cues, and select document number 477.)

Elimination of Uncertainty Reporting

.38 The AICPA's Auditing Standards Board (ASB) has issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

.39 The amendment would also expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AU section 508.37), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

.40 The proposal does not affect the provisions of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), which requires that the auditor add an explanatory paragraph to the auditor's report when there is substantial doubt about the entity's ability to continue as a going concern.

.41 *Audits of Investment Companies* indicates that auditors of the financial statements of investment companies may consider it necessary to add an uncertainties explanatory paragraph to their reports when the financial statements contain securities whose values were estimated by the board of directors in the absence of readily ascertainable market values and the range of possible values of those securities is significant. If the proposed SAS is issued in final form, that requirement will be eliminated. Nonetheless, auditors reporting on financial statements that include such securities may wish to emphasize that fact by adding an emphasis-of-a-matter paragraph to their reports. Such paragraphs, however, are optional and are added solely at the auditor's discretion.

.42 The ASB hopes to finalize this SAS late this year and to issue a SAS that would be effective for reports issued on or after June 30, 1996. Comments on the proposed SAS were due on October 20, 1995.

Accounting Issues and Developments

FASB Statement on Derivatives

.43 In October 1994, the FASB issued Statement No. 119 (AC F25). FASB Statement No. 119 (AC F25) requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 (AC F25) and No. 107 (AC F25).

.44 The Statement (AC F25) requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value, with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 (AC F25.115P) encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

.45 FASB Statement No. 119 (AC F25) was effective for financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations, the Statement (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1995.

.46 The FASB Special Report *Illustrations of Financial Instrument Disclosures* contains illustrations of the application of FASB Statements No. 105 (AC F25), No. 107 (AC F25), and No. 119 (AC F25).

.47 In a letter, dated February 3, 1995, to chief financial officers of investment companies, the Chief Accountant of the SEC Division of Investment Management stated that investment companies should designate each derivative covered by FASB Statement No. 119 (AC F25) as either held or issued for trading purposes or for purposes other than trading and should make that designation at the time that the derivative financial instrument is acquired. The letter states that funds have a continuing obligation to regularly evaluate the appropriateness of the original designations, which could lead to changes in a designation and, accordingly, differences in disclosure requirements during the holding period of the instrument.

FASB Interpretation

.48 The FASB issued Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* (AC B10), in December 1994. Accounting Principles Board Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7 (AC B10), states that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), defines *right of setoff* and specifies conditions that must be met to permit offsetting. This Interpretation (AC B10) modifies FASB Interpretation No. 39 (AC B10) to permit offsetting, in the statement of financial position, of payables and receivables that represent repurchase agreements and reverse-repurchase agreements and that meet the conditions of the Interpretation (AC B10).

.49 FASB Interpretation No. 41 (AC B10) was effective for financial statements issued for periods ending after December 15, 1994.

Distribution Costs

.50 The AICPA issued SOP 95-3, *Accounting for Certain Distribution Costs of Investment Companies,* in July 1995. This SOP applies to investment companies that adopt plans that comply with Rule 270.12b-1 of the 1940 Act. It requires—

1. Investment companies with enhanced 12b-1 plans to recognize a liability, with a corresponding charge to expense, for excess costs. Changes in the liability should be recognized in the statement of operations as an expense or a reduction in expense.
2. Reporting of the liability at its present value, calculated using an appropriate current interest rate, if certain conditions are met.
3. Investment companies with board-contingent plans to recognize a liability for excess costs, computed in the same way as for an enhanced 12b-1 plan, when the company's board commits to pay such costs.
4. Certain disclosures for both traditional and enhanced plans.

SOP 95-3 amends *Audits of Investment Companies.* It is effective for annual financial statements for fiscal years beginning after December 15, 1995, and for interim financial statements for periods in such years. The cumulative effect of changes caused by adopting this SOP should be reflected in the calculation of net asset value on the first day of the fiscal year of adoption.

Nonpublic Investment Partnerships

.51 The AICPA also issued SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships,* in May 1995. This SOP applies to financial statements of investment partnerships that are exempt from SEC registration under the 1940 Act (with certain exceptions) prepared in conformity with generally accepted accounting principles (GAAP). It provides guidance on financial statement presentation and disclosure of investments, income, and partners' capital. It requires—

1. That financial statements include a condensed schedule of investments in securities.
2. Presenting a statement of operations in conformity with the requirements for statements of operations of management investment companies in *Audits of Investment Companies.*
3. Presenting management fees in the financial statements and disclosing how they are computed.

SOP 95-2 is effective for financial statements issued for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

Risks and Uncertainties

.52 The AICPA issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties,* in December 1994. This SOP applies to financial statements that are prepared in conformity with GAAP and are applicable to nongovernmental entities. It applies to all entities that issue such statements. It does not apply to condensed or summarized interim financial statements. It requires reporting entities to include in their financial statements disclosures about—

1. The nature of their operations.
2. Use of estimates in the preparation of financial statements.

In addition, if specified disclosure criteria are met, it requires entities to include in their financial statements disclosures about—

1. Certain significant estimates.

2. Current vulnerability due to certain concentrations.

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which the SOP is first applied. Early application is encouraged but not required.

Information Sources

.53 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.54 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.55 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.56 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.57 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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.58 This Audit Risk Alert supersedes *Investment Companies Industry Developments—1994.*

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.59 Practitioners should also be aware of the economic, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 4 (202) 942-7114 (tty)		
Investment Company Institute	Conferences (202) 326-5968 Publications: (202) 326-5872 General Information: (202) 326-8305 1401 H Street, NW Washington, DC 20005			

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AAM Section 8160

Oil and Gas Producers Industry Developments—1995/96

Industry and Economic Developments

.01 Oil and gas production includes those activities relating to the acquisition of mineral interests in properties, exploration and production (E&P), development, and production of crude oil, natural gas, and natural gas liquids (such as butane and propane).

.02 Producers of oil and gas may be classified as independent or integrated companies. The so-called independents are those companies whose activities are typically limited to the exploration, development, and production of oil and gas properties. Integrated companies, on the other hand, are more diverse, with organizations involved not only in exploration, development, and production, but also in the operation of refineries, pipelines, and wholesale and retail outlets.

.03 Surging demand for oil products in the United States resulted in strong prices during 1995. Led by high gasoline consumption during the summer driving season; favorable economic conditions; a steadily rising driver population, along with a de-emphasis on energy conservation, gasoline demand should, by year end, rise to its highest levels since 1978. Demand has also been strong for certain oil-based petrochemical products due to global economic growth and the increased use of synthetic chemical compounds by the textile and other industries. The demand for oil products from Pacific Rim countries has increased as well. And it is expected to continue, given that area's rising prosperity, increased automobile usage, and continued industrialization. In response, many of the largest domestic and foreign oil producers are repositioning their productive assets out of limited growth areas, such as the older, more mature markets of Europe and the United States, into areas of high-demand growth, such as the Pacific Rim.

.04 The abnormally warm winter across much of North America drove down demand for natural gas. Increased drilling in the Gulf of Mexico and rising imports from Canada, along with the warm winter, kept gas inventories abundant. These supply and demand factors resulted in depressed natural gas prices through the first part of 1995. And, since gas prices are typically weakest during the summer months, there was no midyear price rally. The price of natural gas has showed no further declines, however, remaining moderately below prior-year levels. As the heating season approaches, natural gas prices should rise modestly, but the abundance of supplies will likely preclude sustainable increases. Only an unusually cold winter can reduce those supplies to levels at which gas prices may rise to prior-year levels. If, on the other hand, the United States experiences another abnormally warm winter, the supply/demand factor will significantly lower gas prices. See further discussion of oil and natural gas prices under "Price Volatility" in the "Audit Issues" section of this Audit Risk Alert.

.05 Along with product demand and seasonal requirements, production levels have a significant effect on the price of fossil fuels. In considering worldwide production levels, industry analysts always review the annual quotas set by the Organization of Petroleum Exporting Countries (OPEC). Although once the dominant force in oil production, OPEC is no longer the powerhouse it once was. At one time, OPEC was responsible for providing for 60 percent of the world's petroleum consumption—today, its share of the world market is down to less than 40 percent. As such, OPEC now finds itself competing for customers with prolific non-OPEC rivals in Asia, the North Sea, and Latin America, with most new demand for oil being met by sources outside of OPEC control. Still, OPEC plays a significant role in establishing worldwide production levels and, therefore, has a direct impact on oil prices. While OPEC has, in the past, attempted to gain market share by increasing production output this strategy has typically backfired by driving prices down due to excess supplies. OPEC is, therefore, unlikely to increase output for fear of the negative impact on revenues. Most industry analysts expect OPEC to maintain current oil production quotas through year end.

.06 The United States is the world's largest market for petroleum products. Although it is viewed as a mature market, recent expansion has occurred more rapidly than it has in some time. This should be good news for domestic producers except for the fact that the United States is importing more petroleum than ever before. Almost 52 percent of this year's domestic consumption was derived from foreign sources. Analysts predict that by the year 2000 imports will reach 65 percent. This trend to import has persisted over the past ten years; as a result, the domestic petroleum industry has been decimated. Daily domestic crude output has plummeted from more than 9 million barrels in the early 1980s to 6.5 million today. Hundreds of companies have gone bankrupt and more than 400,000 workers have been squeezed out of petroleum-related jobs. "Oil patch" lawmakers, deeply concerned about the premature abandonment of a significant number of wells, are vigorously pursuing tax breaks and regulatory relief for the struggling domestic industry and are adamant about trying to turn the tide on increasing foreign oil imports. While regulatory relief may be a reachable goal (see the "Legislative and Regulatory Issues" section of this Audit Risk Alert), tax breaks in the current budgetary climate are highly unlikely. Accordingly, despite strong oil prices, auditors should be aware that going-concern issues remain relevant in the current year. Auditors should consider their responsibilities pursuant to AICPA Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341). SAS No. 59 (AU section 341) provides guidance to auditors for evaluating whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period not to exceed one year from the date of the financial statements being audited.

.07 Merger and acquisition activity has increased during the current year in both the oil and gas segments of the industry. Most gas producers, feeling the continuing effects of deregulation (see the "Legislative and Regulatory Issues" section of this Audit Risk Alert), are buying their way into the more lucrative distribution business, though some others are diversifying through internal development. Depressed gas prices have driven some firms, with both high debt levels and a large stake in gas, to consider the option to merge. The increase in mergers and acquisitions among oil producers has generally been driven by firms burdened with high debt levels who are unable to develop promising fossil fuel properties. With limited access to outside financing, they have opted to merge with, or to be acquired by, cash-rich competitors. In these circumstances, auditors should consider whether management has appropriately accounted for transactions related to the merger or acquisition activities. Other audit implications of mergers and acquisitions are discussed in the "Accounting Issues and Developments" section of this Audit Risk Alert under "Restructuring Charges".

.08 Oil and gas properties are the most significant assets of producers. The nonregenerative nature of these properties requires producers to engage in exploration activities to replenish their inventory of such wasting assets. However, domestic exploration has declined in part due to the enormous expense of recovering oil and gas from existing, mature reservoirs. In a move that many analysts believe will serve as a model for the industry, as it struggles to maintain a foothold in the nations's maturing oil fields, two major U.S. oil companies announced their intention to establish a jointly owned company to engage in domestic oil and gas exploration. Joint ventures of this type not only provide the financial resources necessary to employ the advanced oil recovery techniques crucial to the continued development of mature properties but also spread the significant risks over several participants. Joint ventures typically create redundancies which result in staff reductions, streamlining operations, and other cost-cutting devices. The audit implications of such restructuring programs are discussed in the "Accounting Issues and Developments" section of this Audit Risk Alert.

Legislative and Regulatory Issues

Continuing Impact of FERC Order 636

.09 The full effects of the radical changes brought about by Federal Energy Regulatory Commission (FERC) Orders 380, 436, 500, and particularly 636, are now being felt by the natural gas industry. With the intent of reversing federally granted monopolistic protection and enhancing competition among natural gas suppliers, the FERC Orders eliminated the advantage enjoyed by gas pipeline companies over other sellers of natural gas.

.10 The advantages at issue are based on a pipeline company's ability to "bundle" gas, that is, its transportation and other related services, into a composite commodity. Given this, a pipeline's operating practices have tended to favor the transportation of its own product to the disadvantage of gas provided by other sellers that also is transported by the pipeline. The open access to transportation service granted by Order 636 has enabled buyers and sellers to go around the pipeline companies and deal directly with each other, thus resulting in a more efficient national market for natural gas. Rather than relying on pipeline companies to buy, store, and transport their gas, customers now have the option to deal with gas marketers that can put together gas supply packages tailored to the customer's specific needs.

.11 The resulting economic circumstances of these regulatory changes mandate that the gas industry emphasize marketing. Most industry analysts believe those companies that do nothing else but produce gas will almost certainly be unprofitable. Thus, as gas producers are pressed to expand their operations into areas such as product marketing, auditors should be alert to the effects these new activities may have on the entity's internal control structure. Auditors should consider the implications on their assessment of control risk when such activities strain existing policies and procedures to the point where effectiveness may be reduced. In such circumstances, auditors should understand the control implications of expansion into new areas of operation, or the internal development of, for example, marketing operations. Documentation of that understanding is required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319). If the assessment of control risk is high, auditors should adjust the scope of their audits accordingly. If that understanding reveals significant deficiencies in the design or operation of the internal control structure, there is increased risk that material errors and irregularities will result in misstatements in the financial statements, and a reportable condition, as defined in SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU section 325), may exist.

Proposed Environmental Legislation

.12 The new Congress has stated its intent to assess future environmental regulations from the perspective of required cost outlay to expected benefit. Without a demonstration that expected future costs are justified by expected future benefits, new regulations are unlikely to be issued. Given the significant costs of compliance, many oil and gas industry groups and trade associations have expressed their support for required analysis of cost-benefit assessments before the adoption of new regulations.

.13 The Job Creation and Wage Enhancement Act (H.R. 9) follows through with the above-stated philosophy by rolling back certain federal regulations. Although the Senate may impose substantial modifications, the House bill is likely to set the tone for future environmental deregulation. The significant aspects of the Act propose—

- The temporary suspension of most new environmental regulation.
- The imposition of elaborate scientific review on proposed rules on health, safety, and environmental protection.
- Compensation for private landowners when environmental regulations reduce property values.

While these proposals provide insight into the possible future of environmental regulation, oil and gas producers currently face significant concerns with regard to remediation liabilities imposed by existing regulations. This issue is discussed further in the "Accounting Issues and Developments" section of this Audit Risk Alert.

Reformulated Gasoline Program

.14 The federal government has in place a reformulated gasoline (RFG) program whose purpose is to ensure the availability of automobile fuel with less harmful environmental effects than conventional gasoline. While the impact of this program on crude oil and natural gas production is likely to be indirect, those integrated producers involved in refining activities are already feeling the effects on their operations. In order to comply with these regulations, these entities are generally required to make additional investments to upgrade their facilities.

.15 The program requires that the new gasoline be made available in certain geographical areas. However, other states and localities are permitted a certain degree of flexibility. They are allowed to "opt in" or "opt out" of the program. Therein lies the problem for refiners. For example, one company had already shipped the new reformulated gasoline to a number of Pennsylvania counties, which then chose not to participate in the program. Another company had modified its refining facilities in Kentucky to accommodate the production of RFG only to find out that the state is likely to back out of the program. Accordingly, integrated companies that have made the plant investments in their refineries necessary to produce reformulated gasoline may incur significant losses. Auditors should consider whether circumstances such as these call into question the recoverability of certain long-lived assets by integrated oil producers. See the "Accounting Issues and Developments" section of this Audit Risk Alert for further discussion of this issue.

Audit Issues

Price Volatility

.16 As with most energy sources, fossil fuel prices generally track normal seasonal patterns. For example, gasoline prices can be expected to rise during peak summer driving months, while heating fuel prices will increase during the winter heating season. However, the prices of natural gas and oil products are difficult to predict with any degree of certainty. Due to the impact of such factors as worldwide production levels, economic growth rates, fluctuations in supply and demand, and unforeseen weather patterns, prices can be extremely volatile. A case in point was the threat, in October, of a massive hurricane in the Gulf of Mexico. In response to dire weather predictions, many major companies in the Gulf area implemented plans to curtail or completely shutter their operations. Analysts initially estimated that the storm would force producers to shut down 6.2 billion cubic feet of natural gas output, which is about 45 percent of total Gulf gas production, and 12 percent of total U.S. gas output. On the basis of these predictions, there was a surge of buying by traders, who viewed the impending weather conditions as a threat to offshore production facilities and coastal refineries. The impact on prices? Significant increases for both natural gas and crude oil. Natural gas scheduled for November delivery jumped $.144 to $1.894 per thousand cubic feet while crude prices increased by $.10 a barrel, settling at $17.64. Subsequent weather forecasts predicted that the hurricane would bypass most offshore rigs. Ultimately, the storm lost strength and was downgraded from a hurricane to a tropical depression. Based on the revised weather report, along with rumors (later proved unfounded) of a one-time United Nations supervised sale of oil by Iraq, prices dropped to near twelve-month lows.

.17 Price volatility presents considerable risks. Declines will produce obvious cash-flow problems. However, dramatic increases such as those described above may cause producers to overextend themselves. Liquidity problems may then arise when prices return to expected, or lower than expected, levels. Therefore, auditors may wish to consider the impact of price volatility on, for example, an oil and gas producer's—

- Debt-service requirements.
- Compliance with restrictive loan covenants.
- Valuations assigned to oil and gas reserves, especially those used as loan collateral.
- Cash flow for drilling commitments and trade payables.
- Ability to collect joint interest billings receivable.

Environmental Issues

.18 In spite of the potential regulatory relief ahead, oil and gas producers face significant environmental compliance issues. Existing environmental remediation liability laws, written at all levels of government, have exposed entities with oil and gas producing activities to an increased vulnerability to environmental claims. Requirements imposed by federal, state, and local regulations that wells be plugged, all facilities and equipment removed, and terrain restored to specified conditions may expose producers to potential litigation. The Oil Pollution Liability and Compensation Act of 1990, the Superfund Amendments and Reauthorization Act, along with various clean air and water acts, may be used to hold oil and gas producers liable for the remediation of environmental contamination. Superfund, for example, legally empowers the U.S. Environmental Protection Agency to seek recovery from current and previous owners or operators of a particular contaminated site or from anyone who generated or transported hazardous substances to such a site.

.19 Auditors should be aware that oil and gas producers may be held liable for cleanup costs despite their lack of intent or knowledge. Auditors of producers that face such claims should carefully consider whether the accounting and disclosure requirements of Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies* (AC C59), have been met. FASB Statement No. 5 (AC C59) requires that an estimated loss be accrued when—

- Information available prior to the issuance of financial statements indicates that it is probable that an asset has been impaired or that a liability has been incurred at the date of the financial statements, and
- The amount of the loss can be reasonably estimated.

.20 The nature and amount of the accrual should be disclosed if it is necessary for the financial statements not to be misleading. Additionally, other disclosures may be necessary when the above conditions are not met and, therefore, no loss has been accrued, or if the exposure to loss exceeds the amount accrued and the loss or additional loss is at least a reasonable possibility. In such circumstances, disclosures should include the nature of the contingency, an estimate of the possible loss or range of loss, or a statement that an estimate of the loss cannot be made.

.21 Auditors should also be aware of the consensus reached by the FASB's Emerging Issues Task Force (EITF) in Issue No. 93-5, *Accounting for Environmental Liabilities*, which states that, among other things, an environmental liability should be evaluated independently from any potential recovery and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization. Additional accounting guidance in this area is included in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (AC C59), FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal*, and EITF Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination*. See further discussion of this matter under the "Accounting Issues and Developments" section of this Audit Risk Alert.

.22 Auditors of publicly held oil and gas producers should be aware of the Securities and Exchange Commission's (SEC's) Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies*. The SAB provides the SEC staff's interpretation of current accounting literature related to the following:

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities
- The recognition of liabilities for costs apportioned to other potential responsible parties
- The uncertainties in estimating the extent of environmental liabilities
- The appropriate discount rate for environmental liabilities, if discounting is appropriate
- Accounting for exit costs

- Financial statement disclosures of exit costs and other items and disclosure of certain information outside the basic financial statements

Investments in Derivatives

.23 In recent years there has been a growing use of innovative financial instruments, commonly referred to as derivatives, that often are very complex and can involve a substantial risk of loss. Oil and gas producers may hedge or speculate with energy futures or options on such futures. Normally, subsequent production rather than existing inventory is hedged. As interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments obtain their value have increased in volatility, a number of entities have incurred significant losses as a result of their use. The use of derivatives almost always increases audit risk. Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditors' approach to achieving related audit objectives may differ because certain derivatives are not generally recognized in the financial statements.

.24 It is essential that auditors understand both the economics of derivatives used by entities whose financial statements they audit and the nature and business purpose of the entities' derivatives activities. In addition, auditors should carefully evaluate their clients' accounting for any such instruments, especially those carried at other than market value. To the extent the derivatives qualify as financial instruments as defined in FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), the disclosure requirements set forth in those Statements (AC F25) must be met. When derivatives are accounted for as hedges of on-balance-sheet assets or liabilities or of anticipated transactions, auditors should carefully review the appropriateness of the use of hedge accounting, particularly considering whether the criteria set forth in applicable accounting literature are met.

.25 The SEC staff has indicated in public speeches and letters of comment to registrants during the past year that publicly held companies should disclose the nature and purpose of certain commodity-based derivatives activities, the nature and terms of certain commodity-based derivatives used, and the accounting methods used even when such derivatives do not meet the definition of financial instruments set forth in the FASB Statements (AC F25) cited above.

.26 Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1995/96* [AAM section 8010]. Also, see "Disclosures About Derivatives" in the "Accounting Issues and Developments" section of this Audit Risk Alert. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations.

Related-Party Transactions

.27 In the oil and gas production industry, related-party transactions are often extensive and may result in possible conflicts of interest among investors, operators, and general partners. Though always an area of significant audit risk, related-party concerns are particularly important in the current year given the rise in joint ventures brought about by regulatory forces affecting gas producers and economic necessity in the case of some oil producers.

.28 FASB Statement No. 57, *Related Party Disclosures* (AC R36), sets forth the requirements for related-party disclosures. Certain accounting pronouncements prescribe the accounting treatment if related parties are involved; however, established accounting principles ordinarily do not require transactions with related parties to be accounted for on a basis different from that which would be appropriate if the parties were not related. Auditors should view related-party transactions within the framework of existing pronouncements, placing emphasis on the adequacy of disclosure.

.29 SAS No. 45, *Omnibus Statement on Auditing Standards—1983,* "Related Parties" (AU section 334), provides guidance on procedures auditors should consider if they are performing an audit of financial statements in accordance with generally accepted auditing standards to identify related-party relationships and transactions. Auditors should satisfy themselves concerning the required financial statement accounting and disclosure.

Estimated Reserves

.30 The reliability of reserve estimates is a key consideration in many aspects of accounting for oil and gas producing activities. This area could be a source of significant audit risk in the current year as domestic producers apply advanced, unproven recovery techniques to mature reservoirs. Reserve estimates have a direct impact on the calculation of depreciation, depletion, and amortization as well as on ceiling and impairment tests. In addition, some companies with bank debt and other forms of long-term borrowing may be subject to various debt covenants that are based on the value of oil and gas reserves. Such covenants may stipulate, for example, that if the value of the reserves falls below a certain level, the entire debt or a part thereof may be callable in the current year. Auditors should review debt covenants for such matters and consider the effect of reserve valuations and debt restrictions. Auditors should be alert to matters subject to "events of default" and, if necessary, examine written waivers from lending institutions.

.31 In assessing the reliability of reserve estimates, auditors should consider whether qualified and reputable petroleum engineers have been involved in determining reserve estimates. If engineers were involved in the determination of the reserve estimates, the auditor should follow the guidance in SAS No. 73, *Using the Work of a Specialist* (AU section 336).

.32 Accordingly, auditors who use the work of a petroleum engineer in auditing the financial statements of an oil or gas producer should evaluate the professional qualifications of the specialist in determining that the specialist possesses the necessary skill or knowledge in the particular field. In making that evaluation, auditors should consider factors such as the following:

- The professional certification, license, or other recognition of the competence of the engineer in the field of petroleum engineering (The Society of Petroleum Engineers of the American Institute of Mining Engineers has established Standards Pertaining to the Estimating and Auditing of Oil and Gas Reserve Information. Those standards, which are included as appendix B to the AICPA Audit and Accounting Guide *Audits of Entities With Oil and Gas Producing Activities,* describe professional qualifications that should be met by reserve estimators and reserve auditors.)
- The reputation and standing of the engineer in the views of peers and others familiar with the specialist's capability or performance
- The engineer's experience in the type of work under consideration

.33 Auditors who use the work of petroleum engineers in auditing the financial statements of oil and gas producers should also obtain an understanding of the nature of the work performed by the engineers. That understanding should cover the objectives and scope of the engineer's work; the engineer's relationship to the client; the methods or assumptions used; a comparison of the methods or assumptions used with those used in the preceding period; the appropriateness of using the engineer's work for the intended purpose; and the form and content of the engineer's findings that will enable the auditor to evaluate the appropriateness and reasonableness of the methods and assumptions used and their application.

.34 FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities* (AC Oi5), sets forth requirements for a comprehensive set of disclosures for oil and gas producing activities. The Statement (AC Oi5) also requires publicly traded enterprises with significant oil and gas producing activities to disclose prescribed supplementary information that includes data about their reserves. SAS No. 52, *Omnibus Statement on Auditing Standards—1987,* "Required Supplementary Information" (AU section 558), provides guidance to auditors regarding the procedures they should apply to required supplementary information and describes circumstances that require reporting on such information.

Adequacy of Disclosure

.35 SAS No. 32, *Adequacy of Disclosure in Financial Statements* (AU section 431), sets forth the auditor's responsibility to ensure that audited financial statements include disclosures required by generally accepted accounting principles. The SEC staff has noted several instances in which financial statement disclosures have been inadequate. For example—

- *Standardized Measure of Discounted Future Net Cash Flows.* FASB Statement No. 69 (AC Oi5) requires the disclosure of both future net cash flows and the standardized measure of discounted future cash flows in the aggregate and for each geographic area for which reserve quantities are disclosed. In the financial statements of publicly held entities, the SEC staff has noted presentations of the required supplementary information on the standardized measure of discounted future cash flows that omit the line item "future net cash flows". Such presentations fail to comply with the specific disclosure requirements of Statement No. 69, paragraph 30(d) (AC Oi5.180). Illustration 5 in appendix A to Statement No. 69 (AC Oi5) provides an example of the disclosures required to comply with paragraph 30 of that Statement (AC Oi5.180).

- *Volumetric Production Payments.* FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies,* paragraph 47(a) (AC Oi5.138), for companies following the successful efforts method of accounting, and Rule 4-10(h)(5)(i) of SEC Regulation S-X, for companies following the full cost method, require the seller to account for volumetric production payments received as unearned revenue to be recognized as the oil and gas is delivered. These rules also require that the related reserve estimates and production data be reported as those of the purchaser of the production payment and not of the seller in the disclosures required by FASB Statement No. 69 (AC Oi5). Auditors should carefully review reserve disclosures to ensure that sellers of volumetric production are properly excluding the related reserves from the disclosures required by FASB Statement No. 69 (AC Oi5).

Accounting Issues and Developments

Impairment of Long-Lived Assets

.36 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). FASB Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

.37 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by

Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.38 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.39 The Statement (paragraph 25 [AC Oi5.141]) also amends FASB Statement No. 19 (AC Oi5) by adding a new paragraph dealing with impairment test for proved properties and capitalized exploration and development cost after paragraph 62 (AC Oi5.141). The paragraph reads as follows:

> The provisions of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* are applicable to the costs of an enterprise's wells and related equipment and facilities and the costs of the related proved properties. The impairment provisions relating to unproved properties referred to in paragraphs 12, 27-29, 31(b), 33, 40, 47(g), and 47(h) of this Statement remain applicable to unproved properties.

.40 Given the capital-intensive nature of oil and gas production activities, auditors should be alert to those events or changes in circumstances that indicate an impairment of an asset may have occurred. For example, auditors should consider the possible impairment of—

- Undeveloped properties—resulting from declining leasehold values.
- Producing properties—as a result of the reduced value of the related reserves.
- Lease and well equipment inventory—due to excess supply.

.41 Auditors of integrated oil producers should consider the possible impairment of—

- Plant investments necessary to produce reformulated gasoline for refineries located in areas that have opted out of the RFG program.
- Single-hulled tankers and barges required to be phased out over a fifteen-year period pursuant to the Oil Pollution and Liability Compensation Act of 1990.

.42 As oil and gas producers adopt technologically advanced recovery techniques for mature properties, traditional long-lived equipment may be rendered obsolete. Additionally, environmental regulations may impose restrictions on the use of a long-lived asset used in exploration, development, and production, thus significantly reducing its ability to generate future cash flows. In these instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.43 In considering an oil and gas production entity's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AU section 342).

.44 In the past, the SEC staff has, as a matter of administrative policy, required publicly held entities that use the successful efforts method of accounting, to recognize an impairment loss on oil and gas properties when the total capitalized costs of such properties exceed undiscounted after tax net revenues on a worldwide basis. Such an impairment policy represented only a minimum test for impairment; successful efforts entities could elect to apply a more "stringent" test for impairment. The SEC staff has indicated in public speeches during the past several months that upon the adoption of FASB Statement No. 121 (AC I08), publicly held entities using the successful efforts method of accounting will be required to comply with the provisions of the new impairment standards rather than follow the previous minimum standard.

Risks and Uncertainties

.45 In December 1994, the AICPA's Accounting Standards Executive Committee issued Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires nongovernmental entities to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires organizations to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.46 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to changes in the near term. Examples of similar estimates that may be included in the financial statements of oil and gas producers include, but are not limited to the following:

- Estimates of oil and gas reserve quantities
- Standardized measure of discounted future net cash flows relating to proved oil and gas reserve quantities

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of oil and gas producers in accordance with paragraph 21 of the SOP include the following:

- Revenue from a particular oil or gas based product
- Exploration, development, and production of properties in a particular geographic area
- International exploration activities

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

.47 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

Restructuring Charges

.48 Oil and gas producers have seen an increased rate of mergers, acquisitions, and related activities. These entities typically seek to gain access to new markets through acquisition or to concentrate on their core business by divesting themselves of unrelated divisions. Greater cost efficiencies and economies of scale are being sought through such vertical and horizontal integrations. For example, during the current year:

- Two major U.S. oil companies announced their intention to establish a jointly owned company to engage in oil and gas exploration and production.
- Declining U.S. oil production has prompted domestic producers to seek overseas opportunities. As part of that reallocation of assets, many producers have been downsizing their domestic operations and selling off marginal production properties.

- In a billion dollar sale, one major oil producer shed its plastics division to concentrate on its core operations—oil, gas, and petrochemicals. (Authoritative guidance on accounting for the disposal of a business segment is set forth in APB Opinion No. 30 [AC I13].)

The restructuring that often accompanies these activities typically creates redundancies that raise the specter of staff reductions and related cost-cutting measures as duplicate functions are eliminated and existing areas streamlined. Auditors should consider the impact of such activities on the entity's operations and internal control structure; the reserves relating to current restructuring plans; and the appropriate period for reporting the costs associated with restructurings.

.49 In considering restructuring liabilities and costs, auditors should be aware of EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, for authoritative guidance on the appropriate accounting for restructurings. EITF Issue No. 94-3 also provides guidance on (1) the types of costs that should be accrued, (2) the timing of recognition of restructuring charges, and (3) prescriptions for disclosures that should be included in the financial statements.

.50 For publicly held entities, SEC SAB No. 67 (Topic 5P), *Income Statement Presentation of Restructuring Charges*, requires that restructuring charges be reported as a component of income from continuing operations.

Disclosures About Derivatives

.51 As previously discussed, oil and gas producers may employ derivative financial instruments as risk management tools. Derivatives are complex financial instruments whose values are affected by the volatility of interest rates, foreign currency indices, and commodity and other prices.

.52 In October 1994, the FASB issued Statement No. 119 (AC F25) which requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 (AC F25) and No. 107 (AC F25).

.53 FASB Statement No. 119 (AC F25) requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 (AC F25.115P) encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

.54 FASB Statement No. 119 (AC F25) was effective for financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations, the Statement (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1995.

.55 The FASB Special Report *Illustrations of Financial Instrument Disclosures* contains illustrations of the application of FASB Statements No. 105 (AC F25), No. 107 (AC F25), and No. 119 (AC F25).

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

.56 Environmental compliance costs may be significant for oil and gas producers. Federal, state, and local regulations require that depleted well sites be plugged, facilities and equipment removed, and the terrain restored to specified conditions. As such, auditors should note that in June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities*. The exposure draft provides that:

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 (AC C59) are met: the exposure draft includes benchmarks to aid in determining when those criteria are met.

- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent the employees are expected to devote time to the remediation effort.

- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.

- Measurement of the liability should be based on enacted laws and existing regulations, policies, and remediation technology.

- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and clean up laws and the need to consider various individual state and other non-U.S. government requirements.

Disclosures—Publicly Held Companies

.57 *Management's Discussion and Analysis.* SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550), requires that auditors read such information and consider whether it and the manner of its presentation are materially consistent with information appearing in the financial statements. As auditors of oil and gas producers that are required to file reports with the SEC read the Management's Discussion and Analysis (MD&A) sections of SEC filings, they might consider whether the MD&A includes discussions of—

- The impact of recently issued accounting standards that are not effective until some future date. If the adoption of a standard is expected to have a significant effect on the oil and gas producer's financial position or results of operations, the MD&A disclosure should (1) notify that a standard has been issued which the oil and gas producer will be required to adopt in the future and (2) assess the significance of the impact the adoption of the standard should have on the company's financial statements (unless this cannot be reasonably estimated, in which case a statement to that effect should be made).

- The effects of hedging on liquidity and results of operations.

- Known trends, demands, commitments, events, or uncertainties that are reasonably likely to have a material effect on the oil and gas producer's results of operations or financial condition.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

.58 The AICPA Audit and Accounting Guide *Audits of Entities With Oil and Gas Producing Activities* is available through the AICPA loose-leaf subscription service. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the Guides as they appear in the service are printed annually.

Information Sources

.59 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.60 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.61 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.62 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.63 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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.64 This Audit Risk Alert supersedes *Oil and Gas Producers Industry Developments—1994.*

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.65 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department (800) 862-4272	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep 748.	
Financial Accounting Standards Board (FASB)	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10 Action Alert Telephone Line (203) 847-0700, ext 444 Copies of FASB publications referred to in this document may be obtained directly from the FASB by calling the FASB Order Department.			*Action Alert Telephone Line* (203) 847-0700 (ext 444)
U.S. Securities and Exchange Commission (SEC)	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext 4 (202) 942-7114 (tty)		*Information Line* (202) 942-8088 (202) 942-7114 (tty)
Institute of Petroleum Accounting	University of North Texas P.O. Box 13677 Denton, Texas 76203-6677	*General Information* (817) 565-3170 Fax (817) 369-8839		
American Petroleum Institute	1220 L Street NW Washington, DC 20005 Publications and Materials (202) 682-8000	*General Information* (202) 783-9000		
Gas Research Institute	8600 W Bryn Mawr Chicago, IL 60631	*General Information* (312) 399-8100		

AAM Section 8170
Securities Industry Developments—1995/96

Industry and Economic Developments

.01 The securities industry appears to be on the upswing in 1995, after experiencing significant declines in 1994 revenues and earnings from the records set in 1993. Contributing to the upswing are—

- Increased fixed-income activity in the wake of a favorable interest-rate environment.
- Record levels of average daily volume on major exchanges.
- Strong underwriting activity as markets maintain record high levels.
- Continuing strength in merger and acquisition related work.

Securities analysts expect that brokerage firms will continue to generate strong profits for the balance of the year, especially if interest rates do not increase.

Industry Trends

.02 The securities industry continues to be affected in a variety of ways by recent economic trends and developments. Some of the more pervasive trends that are likely to affect the operations of securities firms, and thereby influence audit risk, include the following.

.03 *Expansion of the Derivatives Products Market.* The securities industry continues to play a major role in the market for derivative financial instruments—in terms of the types of products offered, the number of transactions, and the number of participants in the market. Many firms have established divisions or subsidiaries solely for the purpose of conducting business in derivatives. The innovative and complex nature of derivative products along with the rapid expansion of the market and limited authoritative accounting literature related to these entities and products may significantly increase audit risk.

.04 Inadequate internal controls over transactions that involve complex financial instruments, coupled with highly sophisticated trading strategies, can significantly heighten audit risk. Recent instances of disastrous consequences from this shortcoming are exemplified by the collapse of Barings PLC. In addition, broker-dealers who sell complex financial instruments may be subject to customers' claims for compensation for losses on such instruments, such as for the financial difficulties experienced by the government of Orange County, California. As they assess audit risk, auditors of financial statements of broker-dealers should consider the auditing ramifications of these and other developments significant to the industry. Regulators and major participants in the derivatives markets are taking the initiative to improve controls over these products. (See the "Regulatory and Legislative Developments", "Audit Issues and Developments", and "Accounting Issues and Developments" sections of this Audit Risk Alert, as well as *Audit Risk Alert—1995/96* [AAM section 8010], for further discussions of derivatives.)

.05 *Heightened Competition From Banks and Other Financial Services Entities.* Banks, insurance companies, and other providers of financial services continue to present formidable competition to securities firms. Heightened competition is spurring consolidation activities in the industry. To maintain their home-field advantage and gain a foothold in lucrative emerging foreign markets, many firms are rounding out product lines through acquisitions.

.06 *Market Globalization.* In the face of worldwide economic and ideological transformations and technological advances, as well as changes in the European Economic Community, the move toward globalization of the securities industry continues at break-neck speed. Many broker-dealers view gaining access to new markets as one of their top priorities for future growth. As a result, auditors may need to consider the ramifications of globalization on financial statements of broker-dealers. (See the "Audit Issues and Developments" section of this Audit Risk Alert.)

Regulatory and Legislative Developments

.07 Regulation of broker-dealers is discussed in chapter 1 of the AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities.* The following discussion is intended to help auditors stay abreast of developments that affect the regulation of broker-dealers.

.08 AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), requires that, in planning their audits, auditors consider matters affecting the industry in which an entity operates, including, among other things, government regulations. Auditors consider such regulations in light of their potential impact on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AU section 317), distinguishes between two types of laws and regulations:

1. Those that have a direct and material effect on the determination of financial statement amounts
2. Those that relate more to an entity's operating aspects than to its financial and accounting aspects and therefore have only an indirect effect on the financial statements

Although auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that directly and materially affect financial statement amounts, an audit performed in accordance with generally accepted auditing standards does not include procedures specifically designed to detect illegal acts that would have only indirectly affected financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

.09 The securities industry is subject to extensive regulations by a number of federal and state authorities. As a result, auditors of broker-dealers should be familiar with applicable rules and regulations of government agencies and other regulatory bodies, including the Securities and Exchange Commission (SEC) and industry member regulatory bodies (such as the National Association of Securities Dealers) and national securities exchanges (such as the New York Stock Exchange).

.10 Auditors of broker-dealers that are also commodities brokers should consider rules and regulations of the Commodity Futures Trading Commission (CFTC). The CFTC was created by Congress in 1974 and is the federal agency with regulatory and oversight responsibility for the trading of commodity futures and options contracts on the U.S. futures exchanges. Since 1982, the CFTC has also regulated operations on futures contracts and options on physical commodities trading on commodity markets.

.11 A summary of some of the recent regulatory developments that may affect the audits of broker-dealers follows.

Changed Settlement Date

.12 On June 7, 1995, Rule 15c6-1 of the Securities and Exchange Act of 1934, establishing three business days after the trade date (T+3) instead of five business days as the standard settlement time frame for most broker-dealer transactions, became effective. The rule covers transactions in all securities other than exempted securities, government securities, municipal securities, commercial paper, bankers' acceptances, or commercial bills. The rule contains a specific exemption for sales of unlisted limited-partnership interests and contains alternative settlement time frames for certain firm commitment offerings of new issues.

FOCUS Report Revision

.13 The Financial and Operational Combined Uniform Single (FOCUS) report is the uniform regulatory report required to be filed with regulators by broker-dealers. Some parts of the report are to be filed monthly, some quarterly, and some annually. Audited financial statements must be filed with the report annually. The staffs of the SEC and the CFTC, in cooperation with the Capital Committee of the Securities Industry Association, are revising the report. The CFTC permits futures commission merchants (FCMs) who are also registered broker-dealers to file the FOCUS report instead of the currently required CFTC Form 1-FR. After the revised FOCUS report has been approved for use, the CFTC intends to allow FCMs, whether or not they are broker-dealers, to file CFTC reports using the new FOCUS report. The revised report is expected to prohibit broker-dealers from including subordinated debt in a combined total with equity on the balance sheet. However, no change is anticipated that would prohibit including qualifying subordinated debt in regulatory net capital. Auditors should be alert to the issuance of final regulations specifying the revised reporting requirements.

Other SEC Concerns

.14 The SEC's Division of Market Regulation has noted, in various public forums, the matters in the following sections that frequently incur comments on materials filed with the SEC or that have been identified by the SEC's field inspection process. If auditors become aware during the course of audits that such transactions have not been reported in the financial statements as recommended, they should consider the effect on the amounts presented in the financial statements of such deviations and whether, in accordance with SAS No. 54 (AU section 317), the audit committee or others with equivalent authority or responsibility are adequately informed about the matter.

.15 *Derivatives and Other High-Risk Investments.* The joint Statement of the SEC, the CFTC and the Securities and Investments Board emphasized the importance of management controls over derivatives and the need for improved accounting and disclosure rules for derivatives. It listed the following concepts that management controls should include:

1. Policies about derivative activities should be promulgated by the board of directors and should be reviewed as business and market circumstances change.
2. Execution of these policies should be supported by valuation procedures and techniques, risk management and information systems designed to ensure the adequacy of both management information and external reporting.
3. Responsibility for implementing the policies should be clearly delineated and the board of directors should define appropriate levels of and delegated authority for those responsible for implementing board policies for supervising over-the-counter (OTC) derivatives activities.
4. Information systems should be designed to achieve full compliance with the policies and principles, assist in the active management of derivatives activities, and provide an adequate flow of relevant information about the derivatives activities not only of the firm but also of its related entities on a worldwide basis.
5. Appropriate expertise should be maintained at all levels of a firm.
6. Internal controls should include units, which are independent of trading personnel and report directly to senior management, dedicated to the evaluation of credit, market, and legal risks.
7. Appropriate use should be made of risk-reduction techniques, such as master agreements and credit enhancements, including collateralization.

CFTC Regulations

.16 *Risk Assessment Rules.* The CFTC has approved Regulations 1.14 and 1.15, which entail, respectively, certain recordkeeping and reporting requirements for FCMs that are part of a holding-company system. The requirements relate to risk assessment information covering the financial activities of the FCM's affiliates. The rules are designed to enhance the CFTC's financial surveillance program by providing the CFTC with increased access to material information concerning the activities of the affiliates of an FCM that may expose the FCM to financial or operational risks. The rules were effective on December 31, 1994, with initial filings for firms with a December 31 year-end due May 15, 1995.

.17 *Revised Disclosure Framework.* The CFTC has adopted substantial revisions to the disclosure framework applicable to commodity pool operators (CPOs) and commodity trading advisors (CTAs). The revisions are intended to achieve greater simplicity, focus, and clarity in performance history; streamline other required disclosures; improve the presentation and understandability of disclosures to investors; and create a more concise and readable format for disclosure documents. The rules are effective for filings made after August 24, 1995. CPOs and CTAs sometimes request that auditors report on their performance statistics. Auditors performing such engagements should follow the guidance in the AICPA Notice to Practitioners *Examination Engagements to Report on Investment Performance Statistics Based on Established or Stated Criteria.* The Notice amends the guidance provided in a previously issued Notice to Practitioners, *Engagements to Report on Performance Presentation Standards of the Association for Investment Management and Research.* It provides practical applications of the reporting example included in paragraph 54 of AICPA Statement on Standards for Attestation Engagements No. 1, *Attestation Standards* (AT section 100.54). (To obtain this Notice to Practitioners, dial (201) 938-3787 from a fax machine, follow the voice cues, and select document number 477.)

Audit Issues and Developments

Derivatives Activities

.18 Recent years have seen a growing use of the innovative financial instruments commonly referred to as derivatives. They are often very complex and can involve a substantial risk of loss. Broker-dealers both create and sell derivative financial products and use such instruments as risk management tools (hedges) or as speculative investment vehicles. As interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments obtain their value have increased in volatility, a number of entities have incurred significant losses as a result of their use. The use of derivatives almost always increases audit risk. Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditors' approach to achieving related audit objectives may differ because certain derivatives are not generally recognized in the financial statements.

.19 Broker-dealers that sell derivative financial instruments are increasingly at risk for their sales practices and the acceptability of the methodology used to value derivatives at any point in time when requested to do so by their customers. In several cases, customers who have suffered large derivative-related losses have sued, alleging fraud and deception in sales practices or valuation. Determining the fair value of a derivative financial instrument related to a customized transaction can involve complex calculations. These calculations often require various quantitative assumptions and complex modeling, and are further complicated by subjective value adjustments, such as the credit risk associated with the specified counterparty.

.20 It is essential that auditors understand both the economics of derivatives used by the entities whose financial statements they audit and the nature and business purpose of the entities' derivatives activities. In addition, auditors should evaluate their client's accounting for any such instruments, especially those carried at other than market value. To the extent the derivatives qualify as financial instruments as defined in Financial Accounting Standards Board (FASB) Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), and FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), the disclosure requirements set forth in those Statements (AC F25) must be met. When derivatives are accounted for as hedges of on-balance-sheet assets or liabilities or of anticipated transactions, auditors should review the appropriateness of the use of hedge accounting, particularly considering whether the criteria set forth in appropriate accounting literature are present.

.21 The SEC staff has indicated that publicly held companies should disclose the nature and purpose of certain commodity-based derivatives activities, the nature and terms of certain commodity-based derivatives used, and the accounting methods used even when such derivatives do not meet the definition of financial instruments set forth in the FASB Statements (AC F25) cited above.

.22 Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1995/96* [AAM section 8010]. Also, see "FASB Statement on Derivatives" in the "Accounting Issues and Developments" section of this Audit Risk Alert. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations.

Valuation of Securities

.23 The valuation of investment securities continues to be a prime concern for auditors of broker-dealers. Investments generally represent the most significant asset in a broker-dealer's statement of condition.

.24 Chapter 4 of *Audits of Brokers and Dealers in Securities* describes the estimation of fair values of securities in good faith by management. In auditing securities' valuations determined by management, auditors should review the information considered by management in determining the value of the securities, ascertain that the procedures followed were reasonable, and read relevant minutes. In some instances, auditors may consider using the work of a specialist in auditing the valuation of such securities. SAS No. 73, *Using the Work of a Specialist* (AU section 336), provides guidance for when auditors decide to consider the work of any specialist used. Auditing the valuation of such securities is an area that requires a high degree of judgment and scrutiny to ensure that the carrying amounts approximate fair value.

Globalization

.25 With the continuing trend to globalization of securities markets, auditors should be alert to factors that affect financial statements of broker-dealers effecting transactions in foreign securities. The following effects on broker-dealers' financial statements should be considered:

- There are custody issues related to the receipt and delivery of securities, the collections and payments of dividends and interest, information gathering, and processing with regard to corporate actions. Foreign custody agents must qualify under SEC Rule 17f-4, which governs the eligibility of depositories.

- Custody requirements vary by country. Settlement cycles, as well as holiday schedules, are usually different. Seldom, other than in the United States, does the exchange of shares for money take place simultaneously. In some clearing environments, the actual delivery of shares takes place more than twenty-four hours before payment. Therefore, counterparty risk and the process for choosing counterparties are important factors.

- The means of settling transactions in different countries can be dissimilar. Depending on the marketplace, book shares, physical shares (both registered and bearer), issuers' receipts, or transfer agent receipts may be the norm for transferal of ownership.

- Trading in offshore markets may involve the use of corresponding foreign exchange (FX) transactions to convert into the local currency of the foreign market. Such an FX transaction is another contract with its own risks and liabilities.

- Each country has its own unique rules relating to certain exception-type transactions. The issues here may be whether short sales are allowed in the trading environment, if a stock loan is a business in that market, and what the regulatory issues relating to contract closeouts are.

- Tax and regulatory issues within a foreign market are another of the considerations to review. Issues relating to withholding of taxes, principal and income repatriation, and proper registrations are important within that market. The U.S. rules as they relate to a U.S. broker-dealer transacting business in the international marketplace are also a variable that affects business.

Service Auditors' Reports

.26 Broker-dealers frequently use the services of fund custodians, transfer agents, and other service organizations that affect assertions in a broker-dealer's financial statements. In obtaining an understanding of a broker-dealer's internal control structure and assessing control risk, auditors should consider the functions or processing performed by such service organizations. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324), provides guidance to auditors of entities that use service organizations and may be applicable to audits of broker-dealers.

.27 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), requires an auditor to obtain a sufficient understanding of an entity's internal control structure to plan the audit. When a broker-dealer uses a service organization, control structure policies and procedures at the service organization that affect the functions or processing performed by the service organization may have a significant effect on assertions in the broker-dealer's financial statements. For this reason, planning the audit of a broker-dealer may require that the auditor gain an understanding of the control structure policies and procedures performed by a service organization. When a broker-dealer relies on a service organization's control structure policies and procedures over the processing of transactions that are material to the broker-dealer's financial statements, these policies and procedures should be considered by the auditor. One method of obtaining information about these policies and procedures is to obtain a service auditor's report as described in SAS No. 70 (AU section 324).

.28 The AICPA's Auditing Standards Division will issue an Auditing Procedure Study titled *Implementing SAS No. 70,* Reports on the Processing of Transactions by Service Organizations, by the end of 1995.

Elimination of Uncertainty Reporting

.29 The AICPA's Auditing Standards Board (ASB) has issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

.30 The amendment would also expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AU section 508), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

.31 The proposal does not affect the provisions of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), which requires that the auditor add an explanatory paragraph to the auditor's report when there is substantial doubt about the entity's ability to continue as a going concern.

.32 *Audits of Brokers and Dealers in Securities* indicates that auditors of the financial statements of broker-dealers may consider it necessary to add an uncertainty explanatory paragraph to their reports when the financial statements contain securities whose values were estimated by the board of directors in the absence of readily ascertainable market values and the range of possible values of those securities is significant. If the proposed SAS is issued in final form, that requirement will be eliminated. Nonetheless, auditors reporting on financial statements that include such securities may wish to emphasize that fact by adding an emphasis-of-a-matter paragraph to their reports. Such paragraphs, however, are optional and are added solely at the auditor's discretion.

.33 The ASB hopes to finalize this SAS late this year and to issue an SAS that would be effective for reports issued on or after June 30, 1996. Comments on the proposed SAS were due on October 20, 1995.

Accounting Issues and Developments

Impairment of Long-Lived Assets

.34 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). FASB Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

.35 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.36 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.37 Auditors of broker-dealers should be aware that the current industry climate of restructurings, mergers, and realignments have increased the likelihood that events or changes in circumstances that indicate that assets have been impaired may have occurred. For example, a merger may result in the reduction of services provided by a particular entity within the combined organization and significantly reduce its ability to generate future cash flows. In this instance, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.38 In considering a broker-dealer's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AU section 342).

FASB Statement on Derivatives

.39 In October 1994, the FASB issued Statement No. 119 (AC F25). FASB Statement No. 119 (AC F25) requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 (AC F25) and No. 107 (AC F25).

.40 The Statement (AC F25) requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value, with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 (AC F25.115P) encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

.41 FASB Statement No. 119 (AC F25) was effective for financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations, the Statement (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1995.

.42 The FASB Special Report, *Illustrations of Financial Instrument Disclosures,* contains illustrations of the application of FASB Statements No. 105 (AC F25), No. 107 (AC F25), and No. 119 (AC F25).

FASB Interpretation—Offsetting

.43 The FASB issued Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* (AC B10), in December 1994. APB Opinion No. 10, *Omnibus Opinion—1966,* paragraph 7 (AC B10.101-103), states that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), defines *right of setoff* and specifies conditions that must be met to permit offsetting. This Interpretation modifies Interpretation No. 39 (AC B10) to permit offsetting in the statement of financial position of payables and receivables that represent repurchase agreements and reverse repurchase agreements and that meet the conditions of the Interpretation (AC B10).

.44 This Interpretation (AC B10) is effective for financial statements issued for periods ending after December 15, 1994.

Audit and Accounting Guide

.45 In 1996, the AICPA expects to issue an Audit and Accounting Guide *Brokers and Dealers in Securities,* which will supersede the current Audit and Accounting Guide *Audits of Brokers and Dealers in Securities.* The new Guide will discuss those aspects of accounting and auditing unique to brokers and dealers in securities. It also incorporates new accounting and financial reporting requirements issued by the FASB and the AICPA's Accounting Standards Executive Committee, as well as new auditing standards issued by the ASB since issuance of the superseded guide.

.46 The new Guide is expected to provide for two changes in financial reporting: (1) it will no longer permit combining of subordinated debt with stockholders' equity and (2) it will require that delayed delivery transactions be reported in the statement of condition on the settlement (delivery) date instead of on the trade date. The changes are tentatively effective for annual financial statements issued for fiscal years ending after June 15, 1996.

Information Sources

.47 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.48 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.49 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.50 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.51 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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.52 This Audit Risk Alert supersedes *Securities Industry Developments—1994.*

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.53 Practitioners should also be aware of the economic, industry, regulatory, and professional developments as described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext 3) and the AICPA Meetings and Travel Division (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext 10			Action Alert Telephone Line (203) 847-0700 (ext. 444)
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, (ext 3) (202) 942-7114 (tty)		Information Line (202) 942-8088 (202) 942-7114 (tty)
Commodity Futures Trading Commission	Three Lafayette Center 1155 21st Street NW Washington, DC 20581 (202) 418-5459 (Office of Chief Accountant Div. of Trading & Markets)	(202) 418-5528		
Securities Industry Association	120 Broadway New York, NY 10271-0080 (212) 608-1500	(212) 608-1604		
New York Stock Exchange, Inc.	Eleven Wall Street New York, NY 10005 (212) 656-3000	(212) 656-2126		
National Association of Securities Dealers, Inc.	1735 K Street NW Washington, DC 20006-1500 (202) 728-8000			

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AAM Section 8180

Not-for-Profit Organizations Industry Developments—1996

Industry and Economic Developments

.01 The United States is in a slow-growth economy. The effects of growth felt by the not-for-profit sector continue to lag behind those felt by the overall economy. Although consumer spending is expected to pick up, many individuals continue to have financial concerns and are skeptical about the efficiency of not-for-profit organizations, thereby reducing their levels of charitable giving. In addition, furloughs of federal workers have reduced giving by federal employees, a major source of private giving in many localities. Interest rates remained relatively unchanged, resulting in not-for-profit organizations receiving consistent levels of return on their interest-earning investments. Significant increases in equity markets have resulted in higher returns on equity investments, resulting in many organizations earning significant returns on their total investment portfolios. However, funding that not-for-profit organizations receive from private foundations has remained relatively stagnant. Also, reductions in funding from federal, state, and local governments have slowed dramatically for some organizations, with funds continuing to go to not-for-profit organizations that have maintained positive public images and are operationally effective and efficient. In particular, the National Endowment for the Arts has reduced its funding, affecting cultural organizations. Also, the shift toward federal block grants to states has reduced the funding for some organizations. Exhibit 1 summarizes the changes in key economic factors from last year.

Exhibit 1

Economic Factor	*Change from Last Year*
Private Contributions	Slightly Decreased
Interest Rates	Steady
Equity Markets	Significant Increases
Funding from Foundations	Steady
Government Funding	Decreased; significant decreases for some organizations

.02 The use of gifts, such as annuities, charitable remainder trusts and unit-trusts, pooled income funds, and lead trusts that provide donors with tax deductions while retaining beneficial interests in property, has increased. Not-for-profit organizations that receive those gifts are faced with the challenge of maintaining the investment assets at sufficient levels to support the required payments to donors and beneficiaries. Also, generally accepted accounting principles (GAAP), particularly revenue recognition practices, concerning how those gifts should be accounted for are inconsistent, and auditors should consider whether organizations' accounting for those gifts are appropriate and consistently applied.

.03 The media continue to focus attention on issues relating to not-for-profit organizations, including the following:

- Reasonableness of compensation
- Fringe benefits
- Perquisites afforded to the senior management personnel of some organizations

- The perception that expenditures for program services are a low portion of total expenditures
- Fraud
- Worthless investments and receivables
- The amounts of assets held by not-for-profit organizations
- The portion of revenue earned from fees for goods or services

The adverse publicity concerning such issues continues to make many donors less willing to continue contributing at the levels they maintained in the past. Furthermore, questions raised about the personal inurement of executives continue to threaten the tax-exempt status of the organizations they serve.

.04 Changes in funding as well as increased scrutiny continue to exert pressure on not-for-profit organizations to maximize investment returns and to present financial statements that make their operations appear as efficient as possible. Auditors should consider the effect that such pressures may have on audit risk, particularly those associated with areas such as (1) allocation of costs between program services and support services and (2) high-risk investments, such as derivatives.

.05 Like many organizations, some not-for-profit organizations are restructuring and reengineering their operations to become more efficient. Auditors should consider the effects of such restructuring and reengineering on their consideration of internal controls, as well as considering whether such charges are reported in conformity with GAAP.

Regulatory and Legislative Developments

Federal Issues

.06 *Lobbying.* In addition to reductions in government funding granted to not-for-profit organizations, the federal government is focusing increased attention on lobbying activities of not-for-profit organizations. Restrictions on lobbying activities could affect the ability of or manner in which certain organizations accomplish their missions. Recent Internal Revenue Service (IRS) regulations concerning lobbying are discussed in paragraph .15 of this Audit Risk Alert.

.07 *Business-related activities.* Some businesses believe that tax-exempt not-for-profit organizations have unfair competitive advantages over taxable entities and have asked the U.S. Congress to pass laws to eliminate those perceived advantages. Such laws could adversely affect some not-for-profit organizations, although their passage does not appear imminent.

State and Local Issues

.08 State and local laws concerning not-for-profit organizations continue to change. Some states have enacted or are revising existing laws concerning registration or licensing requirements, reporting requirements, solicitation disclosure requirements, or limitations on fund-raising expenses. Also, some states have increased efforts to have not-for-profit organizations pay property taxes, or make other payments in lieu of such taxes. The American Association of Fund-Raising Counsel, Inc. (AAFRC) publishes its *Annual Survey of State Laws Regulating Charitable Solicitations* (available for $24). Copies of this publication can be obtained by writing to the AAFRC, Suite 820, at 25 West 43d Street, New York, NY 10036, or by calling (212) 354-5799.

IRS Activities

.09 Auditors should be aware of applicable tax laws and regulations and their potential impact on not-for-profit organizations and their financial statements. An organization's failure to maintain its tax-exempt status could have serious tax consequences and affect both its financial statements and related disclosures, and it could possibly require modification of the auditor's report. Failure to comply with tax laws and regulations could be an illegal act that may have either a direct and material effect on the determination of financial statement amounts (for example, the result of an incorrect accrual for taxes on unrelated business income) or a material indirect effect on the financial statements that would require disclosures (for example, the result of a potential loss of tax-exempt status). AICPA Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AU section 317), discusses the nature and extent of the consideration the auditor should give to the possibility of illegal acts and provides guidance on the auditor's responsibilities when a possible illegal act is detected.

.10 *Coordinated audit program.* The IRS Coordinated Examination Program (CEP) now has 86 entities under review, including approximately 40 health care organizations, 18 colleges and universities, and 28 miscellaneous exempt organizations including, media evangelists, and electric cooperatives. As a result of coordinated examination audits, some organizations have paid significant taxes, penalties, and interest in order to close out their examinations. Also, organizations that are not in compliance face the possibility of having their exempt status revoked.

.11 During the course of the CEP audits, the IRS found extensive noncompliance in the tax sheltered annuity area. Consequently, the IRS has developed an audit program specifically for the audit of 403(b) tax sheltered annuity plans. The IRS is currently in the process of training agents and has already selected a few organizations for 403(b) audits.

.12 In conjunction with this program, the IRS also initiated a Tax Sheltered Annuity Voluntary Compliance (TVC) Program (Revenue Procedure 95-24) that allows employers to voluntarily approach the IRS regarding certain eligible 403(b) program deficiencies and receive a significantly reduced assessment. The TVC program is scheduled to apply from May 1, 1995, through October 31, 1996. Penalty assessments under the program are generally less than 40 percent of the possible assessments.

.13 *Bond compliance program.* The IRS is also undertaking a bond compliance program. The program is designed to review bond issuances for compliance with the private use tests, arbitrage requirements, and other requirements related to bond issues. Because the IRS recently changed the division responsible for enforcement in this area, this initiative has been developing slowly, though the number of audits under way is steadily increasing.

.14 *Unrelated business income.* The IRS is focusing particularly significant attention on methods of allocating expenses incurred in connection with activities generating unrelated business income. For dual-use facilities or personnel, expenses such as salaries, depreciation and overhead must be allocated between exempt and nonexempt activities on a reasonable basis. The portion that approximately and primarily relates to the unrelated business activity is allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by sections 162 (business expenses) and 167 (depreciation) of the Internal Revenue Code. In particular, the IRS has been considering the documentation supporting the allocation methods in evaluating the propriety of amounts allocated to unrelated business activities.

.15 *Lobbying.* The IRS has issued final regulations that define "influencing legislation" and related terms in connection with its rules concerning allocation of costs for determining lobbying expenditures. "Influencing legislation" means an attempt to influence any legislation through a lobbying activity, and includes all related activities, such as research, preparation, planning, and coordination. A *lobbying communication* pertains to a specific legislation and reflects a view on that legislation, even if that view does not explicitly support or oppose the legislation.

.16 *Private foundations compliance program.* The IRS is in the process of developing a private foundations compliance program. The IRS intends to initiate a sample-based audit program rather than an issue-based program. The IRS is particularly concerned that some private foundations are abusing a series of disaster relief notices that gave private foundations participating in various disaster relief efforts temporary exemptions from compliance with self-dealing rules.

.17 *Employment taxes related to student wages.* The employment tax rules provide limited exclusions from the definitions of employment and wages, including exclusions for students. The IRS is challenging whether educational institutions are properly applying rules providing that students wages are exempt from FICA taxes. The applicability of the exclusion depends entirely on the nature of the employing organization and the status of the employee as a student enrolled and regularly attending classes. The IRS is focusing particularly significant attention on the status of summer students, because many of them continue to work for the institution but do not attend summer classes, or maintain a reduced class schedule. Organizations that are not withholding FICA taxes for their summer students may be liable for such employment taxes as well as assessed penalties and interest.

Revisions to the Single Audit Act

.18 It appears that 1996 may be the year for the overhauling of single audit policy. In February 1996, legislation was introduced in the U.S. Senate to amend the Single Audit Act of 1984 (S.1579). A comparable bill has also been introduced in the U.S. House of Representatives (HR.3184). The proposed revisions would include not-for-profit organizations in the scope of the act, raise the dollar threshold for single audit coverage to $300,000 from $25,000, implement a risk-based approach to selecting major programs, and reduce the audit report due date to nine months. It is uncertain at this time how quickly the proposed legislation will move through Congress.

.19 At the same time, the U.S. Office of Management and Budget (OMB) is moving forward on a project to combine the audit requirements under OMB Circulars A-128, *Audits of State and Local Governments,* and A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* As the first step in this project, the OMB issued proposed revisions to OMB Circular A-133 in March 1995. A revised OMB Circular A-133 was finalized on April 22, 1996, and will be effective for audits of fiscal years ending on or after June 30, 1997. It is expected that as soon as the Single Audit Act is amended (see the preceding paragraph), the OMB will publish a notice in the *Federal Register* of its intent to rescind OMB Circular A-128 and further revise OMB Circular A-133 to be applicable to state and local governments, colleges and universities, and not-for-profit organizations.

OMB Circular A-133

.20 *Revisions.* OMB Circular A-133 establishes audit requirements that apply to not-for-profit organizations that receive federal awards. The revisions include the following:

- The threshold for an audit under Circular A-133 would be raised to $300,000 from $25,000.
- Auditors would determine "major programs," as defined in Circular A-133, on the basis of a risk assessment, considering prior audit experience, oversight performed by federal agencies and others, and the inherent risk of the program, rather than solely on the basis of federal expenditures, as currently required.
- The required level of testing of the internal control structure over major programs would be clarified as being based on auditors' planning for a low assessed level of control risk.
- Minimum requirements for the Schedule of Federal Awards would be provided.
- Guidance would be included concerning (1) reporting audit findings concerning federal awards in a single schedule of findings and questioned costs which includes a summary of the auditor's results; (2) thresholds for determining which audit findings should be included in the audit report; (3) descriptions of what information auditors should include in an audit finding; and (4) required follow-up on audit findings, including providing a corrective action plan for current audit findings and a summary schedule of prior audit findings.

- The definition of *non-profit organization* would be revised to include non-profit hospitals.
- Guidance would be included concerning the assignment of cognizant agencies.
- Restrictions would be imposed on auditor selection whereby auditors who also prepare the indirect cost proposal or cost allocation plan are prohibited from being selected as the auditor if the indirect costs recovered in the prior year are greater than $1 million in total.
- The due date would be shortened for submitting reports required by the Circular from thirteen months to nine months after the end of the recipients fiscal year. (The provision for a cognizant or oversight agency to grant an extension would be retained.) Also, the report submission process would be streamlined.

A copy of the Circular may be obtained from the April 30, 1996, *Federal Register* notice (61 FR 19134); OMB fax information line, (202) 395-9063, document number 1133; OMB home page on the internet or by calling or writing the Office of Administration, Publications Office (see the table of *Information Sources* at the end of this section).

OMB Circulars A-21 and A-122

.21 OMB Circulars A-21, *Cost Principles for Educational Institutions* and A-122, *Cost Principles for Nonprofit Organizations*, establish guidelines concerning costs incurred in connection with federal contracts, including the allowability and reporting of such costs. In July 1995, the OMB published final revisions to OMB Circulars A-21 and A-122. The revisions increase the equipment cost threshold for capitalization from $500 to $5,000. The revisions are effective as of June 29, 1995.

.22 In May 1996, the OMB issued revisions to OMB Circular A-21, to incorporate certain Standards issued by the Cost Accounting Standards Board (CASB) and to extend the applicability of the CASB disclosure statement to all sponsored agreements (negotiated federal contract or subcontract awards in excess of $25 million) subject to OMB Circular A-21. The revisions are effective for fiscal years beginning after May 8, 1996.

.23 *OMB Circular A-122.* In October 1995, the OMB published final revisions to OMB Circular A-122. The revisions apply to not-for-profit organizations other than colleges and universities, because interest and other financing costs are already allowable for colleges and universities under OMB Circular A-21, which is discussed in paragraph .21 of this Audit Risk Alert. The revisions provide that interest on borrowed capital or temporary use of endowment funds is an unallowable cost of federal contracts. However, interest on debt to acquire or replace capital assets is allowable provided that the following conditions are met:

- For acquisitions over $10 million for which the federal government's reimbursement is expected to be equal to or greater than 40 percent, the organization must justify the need for the facility in the conduct of federally-sponsored activities.
- For facilities costing over $500,000, the organization must prepare a lease/purchase analysis in accordance with the provisions of OMB Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations*, which shows that a financed purchase or capital lease is less costly to the organization than other leasing alternatives, on a net present value basis.

The revision was effective on September 29, 1995.

.24 In October 1995, OMB published proposed revisions to OMB Circular A-122. The proposed revisions would revise the definition of equipment, make certain additional costs unallowable, modify the multiple allocation based method for computing indirect cost rates, and place a 26 percent ceiling on the administrative portion of indirect costs for organizations with federal funding over $10 million. The proposed changes would provide consistency among OMB Circulars for not-for-profit organizations, state and local governments, and educational institutions.

.25 The period for commenting on the proposal has expired.

SFA Guide

.26 In June 1995, the Department of Education issued a revised audit guide, *Compliance Audits (Attestation Engagements) of the Federal Student Financial Assistance Programs at Participating Institutions* (the SFA Guide). The SFA Guide replaces the March 30, 1990, version of the *Student Financial Aid Audit Guide* and Non-Federal Technical Bulletin 92-1 issued in September 1992. The revised SFA Guide is effective for audits of award years ending on or after June 30, 1995.

.27 The SFA Guide must be used by all recipients of SFA funds, except for public and not-for-profit colleges and universities that obtain an audit in accordance with OMB Circular A-128, *Audits of State and Local Governments* or OMB Circular A-133. However, auditors of recipients of SFA funds that are exempt from following the revised SFA Guide should consult it to identify revised compliance requirements. The SFA Guide provides the following:

- The audit should be performed in accordance with the requirements of *Government Auditing Standards* issued by the Comptroller General of the U.S. (Also referred to as the "Yellow Book" or GAS) (1994 Revision)
- The compliance audit should be performed in accordance with AICPA Statement on Standards for Attestation Engagements No. 3, *Compliance Attestation* (AT section 500), in addition to the Yellow Book requirements.
- Audited financial statements and compliance attestation reports are due four and six months after the end of the fiscal year, respectively.
- The SFA Guide should be used if a program audit is elected in accordance with the provisions of OMB Circular A-133.
- Prescribed methodology concerning sample sizes is to be used to test management's assertions concerning student eligibility, disbursements, and refunds.

PCIE Statistics

.28 The President's Council on Integrity and Efficiency (PCIE) issues statistics concerning the results of the Federal Inspector's General (IGs) reviews of audits of federal activities performed by independent public accountants. The statistics based on reviews for the six months ended March 31, 1995, indicate that IGs continue to find deficiencies that cause them to reject audit reports, though some improvement has been noted. Specifically, 17 percent of the OMB Circular A-133 audit reports submitted for federal review required major changes or were deemed significantly inadequate, as compared with 26 percent for the same period of the prior year.

.29 Some of the more common deficiencies cited by reviewers include—

- Incomplete auditor's reports, meaning that reports on the internal control structure or compliance with applicable laws and regulations were missing, or did not include all the required information, such as support for findings or the auditee's comments on the status of prior findings.
- Noncompliance with GAS, which includes failure to adequately test internal controls or compliance with applicable laws and regulations, inadequate documentation of substantive testing of significant compliance/provisions of laws and regulations, and failure to report all findings.
- Inadequate working papers, which includes failure to include adequate documentation to support the auditor's opinion.
- Lack of or incomplete financial statements.

Audit Issues and Developments

Internal Control

.30 Changes in financial accounting standards, changes in tax laws concerning reporting requirements, increased attention to requirements to properly bill overhead costs to government agencies, restructuring, and expanded contractual audit requirements are resulting in the need for significant changes in the accounting systems and internal control of not-for-profit organizations. Auditors should ensure that they have a sufficient understanding of the organization's internal control in order to plan and perform the audit. (As discussed in paragraph .39 of this Audit Risk Alert, in December 1995, the AICPA's Auditing Standards Board (ASB) issued SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AU section 319), which discusses the auditor's consideration of internal control in a financial statement audit.)

Unusually High Returns

.31 Some not-for-profit organizations provide resources as either investments or contributions to other organizations with the expectation that they will receive returns that significantly exceed market rates or contributions that significantly exceed the resources they have provided. (Those organizations generally report the amounts they have provided as either investments or contributions receivable.) In meeting the second standard of fieldwork (AU section 319), which requires the auditor to obtain a sufficient understanding of the entity's internal control to plan the audit, the auditor should obtain an understanding of the organization's investment policies and policies for making contributions and consider such transactions in relation to those policies. Also, such transactions may indicate that there is a significant risk of material misstatement in the financial statements and auditors should therefore be skeptical of amounts reported in connection with such transactions. (In 1995, such transactions resulted in some not-for-profit organizations losing significant amounts when the returns or contributions that they expected did not materialize.) SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU section 316), discusses the auditor's responsibility for the detection of errors, including unintentional misstatements of amounts in financial statements, and irregularities. The Statement (AU section 316) provides that the auditor should maintain an attitude of professional skepticism in planning and performing the audit. If the auditor concludes that there is a significant risk of material misstatement in the financial statements, the auditor requires more or different evidence to support material transactions than would be the case in the absence of such risk. For example, if the auditor concludes that there is a significant risk that a particular investment or contribution receivable may not be realized at its recorded amount, the auditor may confirm the transaction in connection with the financial statement assertion of existence. In addition, the auditor may request and evaluate audited financial statements and credit reports of the investee or donee in connection with the financial statement assertion of valuation.

Derivatives

.32 As discussed in paragraph .58 of this Audit Risk Alert, in recent years, not-for-profit organizations have become increasingly involved in the use of derivative financial instruments both as speculative investment vehicles and as risk management tools. (Auditors should look through the form of investments to determine whether they are investments in derivatives. For example, some organizations have invested in investment funds, such as *The Common Fund*, that have incurred losses due to unhedged investments in derivatives.) Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditor's approach to achieving related audit objectives may differ because the notional or contractual amounts of certain derivatives—such as futures contracts, forward contracts, swaps, options, and other contracts with similar characteristics—generally are not recognized in the financial statements. Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1995/96* [AAM section 8010]. As discussed in paragraphs .59 through .61 of this

Audit Risk Alert, in October 1994, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), which provides guidance concerning financial statement disclosures about derivatives.

Going Concern

.33 In today's economy, there are an increasing number of organizations that may be unable to continue as a going concern. In some cases, management's plan for the organization to continue as a going concern may rely on mergers with other organizations. Auditors should consider whether plans for mergers or plans for other significant changes are red flags that there may be concerns about the organization's ability to continue as a going concern. The auditor's decision not to modify the auditor's report for a going concern uncertainty depends on receiving adequate evidence regarding the organization's ability to continue as a going concern. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), provides guidance concerning the auditor's consideration of an entity's ability to continue as a going concern.

Split-Interest Agreements

.34 Some organizations enter into split-interest agreements in which the organization accepts a contribution and is obligated to make periodic stipulated payments to the donor or a third-party beneficiary. The amount of those periodic payments is often determined in part by an interest rate. Recently, there have been lawsuits alleging price fixing among organizations participating in such agreements. Participating in price fixing could be an illegal act that may have a direct and material effect on the determination of financial statement amounts (for example, the liability for amounts payable under split-interest agreements and punitive damages or settlements resulting from any related lawsuits). SAS No. 54 (AU section 317) discusses the nature and extent of the consideration the auditor should give to the possibility of illegal acts and provides guidance on the auditor's responsibilities when a possible illegal act is detected.

Auditing Pronouncements

.35 As summarized in Exhibit 2, five new SASs, which are discussed below, have been issued recently.

Exhibit 2

Pronouncement	Pronouncements Affected	Key Provisions
SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622)	SAS No. 35	Prohibits negative assurance. Provides guidance concerning the conditions for performing agreed-upon procedures engagements; the nature, timing, and extent of the procedures; the responsibilities of practitioners and specified users; and reporting on agreed-upon procedures.
SAS No. 76, *Amendments to SAS No. 72,* Letters for Underwriters and Certain Other Requesting Parties (AU section 634)	SAS No. 72	Specifies the form of letter to be provided by the accountant in circumstances in which a comfort letter is requested but the requesting party has not provided a representation letter.
SAS No. 77, *Amendments to SAS No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, *and No. 62,* Special Reports (AU sections 311, 341, and 623)	SAS Nos. 22, 59, and 62	Clarifies that a written audit program should be prepared. Precludes the use of conditional language in a going concern report.
SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AU section 319)	SAS No. 55	Recognizes the COSO definition of internal control.
SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements (AU section 508)	SAS No. 58	Eliminates the requirement to add an uncertainties paragraph to the auditor's report (does not affect SAS No. 59 [AU section 341]).

.36 *SAS No. 75.* In September 1995, the ASB issued SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622), which provides guidance to an accountant concerning performance and reporting in all engagements to apply agreed-upon procedures to specified elements, accounts, or items of a financial statement, except for in certain circumstances, as discussed in the SAS (AU section 622). The Statement (AU section 622) is effective for reports on engagements to apply agreed-upon procedures dated after April 30, 1996, with earlier application encouraged.

.37 *SAS No. 76.* In September 1995, the ASB issued SAS No. 76, *Amendments to SAS No. 72,* Letters for Underwriters and Certain Other Requesting Parties (AU section 634). The SAS (AU section 634) provides reporting guidance and an example of a letter, actually a form of agreed-upon procedures report, that the accountant can provide in response to a request to provide a comfort letter in circumstances in which the party requesting the letter is not willing to provide the accountant with the representations required in paragraphs 6 and 7 of SAS No. 72 (AU section 634.06 and .07). The Statement (AU section 634) is effective for letters issued pursuant to paragraph 9 of SAS No. 72 (AU section 634.09) after April 30, 1996.

.38 *SAS No. 77.* In November 1995, the ASB issued SAS No. 77, *Amendments to SAS No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, *and No. 62,* Special Reports (AU sections 311, 341, and 623), which, among other things, clarifies that a written audit program should be prepared in every audit and precludes the use of conditional language in the auditor's explanatory paragraph to indicate that there is substantial doubt about the entity's ability to continue as a going concern. SAS No. 77 (AU sections 311, 341, and 623) is effective for engagements beginning after December 15, 1995.

.39 *SAS No. 78.* In December 1995, the ASB issued SAS No. 78 (AU section 319), which revises the definition and description of internal control contained in the Statements on Auditing Standards to recognize the definition and description contained in *Internal Control—Integrated Framework* (the COSO Report), published by the Committee of Sponsoring Organizations of the Treadway Commission, formed to address the Report of the National Commission on Fraudulent Financial Reporting. This Statement (AU section 319) is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

.40 *SAS No. 79.* In December 1995, the ASB issued SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements (AU section 508), which eliminates the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report. SAS No. 79 (AU section 508) also clarifies and reorganizes the guidance in SAS No. 58 (AU section 508) concerning emphasis paragraphs, matters involving uncertainties, and disclaimers of opinion. This SAS (AU section 508) does not affect SAS No. 59 (AU section 341) nor preclude the auditor from adding a paragraph to the auditor's report to emphasize a matter disclosed in the financial statements. This Statement (AU section 508) is effective for reports issued or reissued on or after February 29, 1996, with earlier application permitted. Auditors are permitted to delete the uncertainties paragraph in their audit reports for year-end audits.

.41 *SOP 92-9.* In December 1995, a new edition of Statement of Position (SOP) 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards,* was released. This edition incorporates conforming changes resulting from the issuance of the Yellow Book and SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AU section 801). This SOP provides guidance on the auditor's responsibility when conducting an audit in accordance with the Yellow Book and OMB Circular A-133.

Accounting Issues and Developments

Joint Costs

.42 In 1987, the AICPA issued SOP 87-2, *Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal.* SOP 87-2 provides guidance on reporting the costs of informational materials that include solicitations for financial support, and requires such costs to be reported as fund-raising expenses if it cannot be demonstrated that a bona fide program or a management and general function has been conducted in conjunction with the appeal for funds. If such activities other than appeals for funds can be demonstrated, such costs should be allocated between fund-raising and the related program or management and general function. Certain financial statement disclosures concerning such allocations are also required.

.43 Because of pressure to portray fund-raising expenses within certain percentages of revenue and expenses, there continues to be an increased risk that the cost of mailing materials or conducting other communications with the public may not be properly allocated between program expenses and fund-raising or management and general expenses in accordance with SOP 87-2.

.44 Some state attorneys general continue to criticize the manner in which some organizations allocate joint costs. They believe some organizations have been too liberal in their allocation of costs to program expenses, especially those costs incurred to educate the public.

.45 Not-for-profit organizations and auditors should carefully review the requirements of the SOP and consider the sufficiency of evidence that exists to support any allocations of such joint costs.

.46 An AICPA exposure draft of a proposed SOP on this subject is discussed in paragraph .84 of this Audit Risk Alert.

Restructuring and Reengineering

.47 Like many organizations, some not-for-profit organizations are restructuring and reengineering their operations to become more effective and efficient. Some organizations are recording restructuring and reengineering charges in the face of workforce reductions, facility closings, and the discontinuance of certain operations and programs. Auditors should consider the consensus reached by the Emerging Issues Task Force (EITF) of the FASB in its discussion of Issue No. 94-3, *Liability Recognition for Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, which provides guidance on whether certain costs (such as employee severance and termination costs) should be accrued and classified as part of restructuring charges, or whether such costs would be more appropriately considered a recurring operational cost of the organization. EITF Issue No. 94-3 provides guidance concerning the appropriate timing of recognition of restructuring charges and prescribes disclosures that should be included in the financial statements.

Expense Allocations

.48 Some expenses are allocated to more than one function. Examples include salaries of persons who perform more than one kind of service and the rental of a building used for various programs and supporting activities. Auditors should be mindful that a change in the allocation method is a change in accounting principle under Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes* (AC A06 and A35), unless the facts and circumstances related to the basis for the allocation have changed. (Paragraph 7 of APB Opinion No. 20 [AC A06.105] states that "the term *accounting principle* includes 'not only accounting changes and practices but also methods of applying them.'" [footnote omitted])

Accounting Pronouncements and Projects

.49 Recent key FASB pronouncements affecting not-for-profit organizations, which are discussed below, and their effective dates are summarized in Exhibit 3.

Exhibit 3

Pronouncement	Effective Date
FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made* (AC C67)	Annual financial statements issued for fiscal years beginning after December 15, 1994, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the Statement is effective for fiscal years beginning after December 15, 1995. Earlier application is encouraged.
FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations* (AC C25)	Same as Statement No. 116 (AC C67).
FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25)	Financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations, the Statement is effective for financial statements issued for fiscal years ending after December 15, 1995.
FASB Statement No. 121, *Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08)	Financial statements issued for fiscal years beginning after December 15, 1995.
FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations* (AC No5)	Financial statements issued for fiscal years beginning after December 15, 1995.

.50 *FASB Not-for-Profit Organizations Project.* The FASB is continuing its consideration of the specialized accounting principles and practices included in four AICPA Audit and Accounting Guides pertinent to not-for-profit organizations. The FASB added this project to its agenda in March 1986, initially to address accounting for contributions and the recognition of depreciation by not-for-profit organizations. The portion of the project addressing depreciation was completed in September 1988 and resulted in FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations* (AC D40). The portion of the project addressing contributions was completed in June 1993 and resulted in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made* (AC C67). (Statement No. 116 [AC C67] is effective for annual financial statements issued for fiscal years beginning after December 15, 1994, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the Statement [AC C67] is effective for fiscal years beginning after December 15, 1995. Earlier application is encouraged. This Statement [AC C67] may be applied either retroactively or by recognizing the cumulative effect of the change in the year of the change. The provisions for recognition of expirations of restrictions may be applied prospectively.) The portion of the project addressing financial statement display was completed in June 1993 and resulted in FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations* (AC C25). (Statement No. 117 [AC C25] is effective for annual financial statements issued for fiscal years beginning after December 15, 1994, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the Statement [AC C25] is effective for fiscal years beginning after December 15, 1995. Earlier application is encouraged.) The portion of the project addressing investments was completed in November 1995 and resulted in FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations* (AC No5), which is discussed in paragraph .52 of this Audit Risk Alert.

.51 *Definition of a Not-for-Profit Organization*—The Glossary of FASB Statement No. 116 defines not-for-profit organizations as follows:

> An entity that possesses the following characteristics that distinguish it from a business enterprise: *(a)* contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, *(b)* operating purposes other than to provide goods or services at a profit, and *(c)* absence of ownership interests like those of business enterprises. Not-for-profit organizations have those characteristics in varying degrees (Concepts Statement 4, paragraph 6). Organizations that clearly fall outside this definition include all investor-owned enterprises and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans (Concepts Statement 4, paragraph 7).

That definition has resulted in some confusion in practice. The Audit and Accounting Guide *Not-for-Profit Organizations* (the New Guide), which is expected to be issued in July 1996 and which is discussed in paragraphs .77 through .83 of this Audit Risk Alert, will provide that the term "not-for-profit organizations" encompasses all entities defined as not-for-profit organizations by FASB Statement No. 116 (AC C67), including the kinds of organizations that are covered by the Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations* and *Audits of Colleges and Universities*, the Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*, SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, which will be superseded by the New Guide. (As discussed in paragraph .77 of this Audit Risk Alert, the New Guide has been approved for issuance by the AICPA Accounting Standards Executive Committee (AcSEC) and cleared by the FASB and is expected to be issued in July 1996.) Auditors should consider whether the organization is a not-for-profit organization, because that will determine which accounting principles the organization should follow. For example, for-profit entities should report investments in conformity with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), whereas not-for-profit organizations should report investments in conformity with FASB Statement No. 124 (AC No5), which is discussed in paragraph .52 of this Audit Risk Alert.

.52 *Investments.* As discussed in paragraph .50, in November 1995, the FASB issued FASB Statement No. 124 (AC No5). Statement No. 124 (AC No5) requires the following:

- Investments in equity securities with readily determinable fair values and all investments in debt securities should be reported at fair value with gains and losses included in a statement of activities.
- Certain disclosures about all investments held by not-for-profit organizations and the return on those investments.
- In the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund should reduce temporarily restricted net assets to the extent that donor-imposed restrictions on net appreciation of the fund have not been met before the loss occurs. Any remaining loss should reduce unrestricted net assets.

The Statement (AC No5) is effective for annual financial statements issued for fiscal years beginning after December 15, 1995, with earlier application encouraged.

.53 *Impairment of Long-Lived Assets.* In March 1995, FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

.54 Some assets of not-for-profit organizations cannot be directly related to identifiable cash flows that are largely independent of cash flows from other assets. FASB Statement No. 121 (AC I08) provides that for purposes of estimating expected future cash flows, "assets shall be grouped at the lowest level for which there are identifiable cash flows that are largely independent of cash flows of other groups of assets." In limited circumstances, the comparison of the estimated cash flows with the carrying amount of the assets "will be applicable only at the entity level because the asset being tested for recoverability does not have identifiable cash flows that are largely independent of other asset groupings....If the asset is expected to provide service potential, an impairment loss shall be recognized if the sum of the expected future cash flows (undiscounted and without interest charges) for the entity is less than the carrying amounts of the entity's assets covered by this Statement." Further, in determining the appropriate cash flows to compare with the carrying amount of an asset, not-for-profit organizations that rely in part on contributions to maintain their assets may need to consider those contributions.

.55 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value. The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. (Earlier application is encouraged.) Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.56 Auditors of not-for-profit organizations should be aware that the current industry climate of restructurings, mergers, and realignments has increased the likelihood that events or changes in circumstances that indicate that assets have been impaired may have occurred. For example, a merger may result in the reduction of services provided by a particular organization within the combined organization and significantly reduce its ability to generate future cash flows. Additionally, a not-for-profit organization may lose a significant source of funding and lose its ability to continue its programs. In these instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.57 In considering a not-for-profit organization's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AU section 342).

.58 *Derivatives.* In recent years, not-for-profit organizations have become increasingly involved in the use of derivative financial instruments both as speculative investment vehicles and as risk management tools.

.59 In October 1994, the FASB issued Statement No. 119 (AC F25). FASB Statement No. 119 (AC F25) requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB

Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), and FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25).

.60 The Statement (AC F25) requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 (AC F25.115P) encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

.61 FASB Statement No. 119 (AC F25) was effective for financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations, the Statement (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1995.

.62 The FASB Special Report, *Illustrations of Financial Instrument Disclosures*, contains illustrations of the application of FASB Statement Nos. 105 (AC F25), 107 (AC F25), and 119 (AC F25).

.63 *Agency Transactions.* In December 1995, the FASB released an exposure draft of a proposed Interpretation, *Transfers of Assets in Which a Not-for-Profit Organization Acts as an Agent, Trustee, or Intermediary (An Interpretation of FASB Statement No. 116)*. The exposure draft would clarify the use of the terms *agent, trustee, or intermediary* in paragraph 4 of FASB Statement No. 116 (AC C67.103). The exposure draft would provide that an organization is presumed to be acting as an agent or trustee if (1) a resource provider specifies a third-party beneficiary or beneficiaries and does not explicitly grant the recipient organization the unilateral power to redirect the use of assets provided away from the specified beneficiary or beneficiaries, (2) the recipient organization exists to raise, hold, or invest assets for another organization, or (3) the recipient organization is directed by the resource provider to invest assets provided in perpetuity and return the income from those assets to the resource provider or its affiliates. The proposed Interpretation would be effective upon issuance.

.64 The period for commenting on the proposal has expired.

.65 Auditors should consider the wording used in solicitations or gift agreements to determine whether resources received by not-for-profit organizations are received in agency transactions. This issue is particularly pertinent for audits of community foundations, federated fund raisers, and fund raising foundations. Auditors should consider discussing these matters with clients as soon as possible, to avoid misunderstandings between clients and auditors concerning accounting for such transactions.

.66 *Consolidations.* In October 1995, the FASB released an exposure draft of a proposed Statement, *Consolidated Financial Statements: Policy and Procedures*. The exposure draft would apply to not-for-profit organizations and would require a controlling organization to consolidate all entities that it controls unless control is temporary at the time the entity becomes a subsidiary. For purposes of this requirement, control of an entity is power to use or direct the use of the individual assets of another entity in essentially the same ways as the controlling entity can use its own assets. The exposure draft includes presumptions of effective control and indicators of effective control.

.67 As discussed in paragraphs .75 and .76 of this Audit Risk Alert, not-for-profit organizations are required to follow SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*. If the FASB Statement resulting from the exposure draft were issued in substantially the same form as the exposure draft, SOP 94-3 would be superseded to the extent that it is inconsistent with the FASB Statement resulting from the exposure draft.

.68 The exposure draft would require consolidation in all circumstances in which SOP 94-3 requires consolidation. Also, the exposure draft requires consolidation in circumstances in which SOP 94-3 permits but does not require consolidation. (SOP 94-3 does not include the presumptions of effective control. However, paragraph 12 of the SOP permits consolidation with certain types of control if coupled with an economic interest. Therefore, the circumstances in the exposure draft that result in effective control, and therefore consolidation, could result in consolidation being permitted, but not required, under SOP 94-3.)

.69 The proposed Statement would be effective for financial statements for fiscal years beginning after December 31, 1996. The period for commenting on the proposal has expired.

AcSEC Projects

.70 In December 1994, AcSEC issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires not-for-profit organizations to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires organizations to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.71 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of similar estimates that may be included in financial statements of not-for-profit organizations include, but are not limited to, the following:

- Specialized equipment subject to rapid technological obsolescence, for example, a computer used in a learning center
- Capitalized computer software costs
- Valuation allowances for loans
- Valuation allowances for promises to give
- Environmental remediation-related obligations
- Contingent liabilities for obligations of other entities; for example, another not-for-profit organization
- Amounts reported for long-term obligations such as amounts reported for pensions and postemployment benefits
- Estimated net proceeds recoverable, the provisions for expected losses to be incurred, or both, on disposition of a business or assets
- Amounts reported for long-term contracts
- Estimated liabilities for assessments for taxes on unrelated business income
- Estimated liabilities or contingent liabilities resulting from audits of grants

.72 Examples of concentrations that may meet the criteria that require disclosure in the financial statements of not-for-profit organizations in accordance with paragraph 21 of the SOP include the following:

- Volume of business transacted with a particular contributor, grantor, customer, supplier, or lender
- Revenue from particular products, services, or fund-raising events
- Available sources of supply of material, labor, or services, or of licenses or other rights used in the entity's operations
- Market or geographic area in which an organization conducts its operations

.73 The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

.74 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

.75 In 1994 AcSEC issued SOP 94-3, which amends and makes uniform the guidance concerning reporting related entities in the AICPA Industry Audit Guides *Audits of Colleges and Universities* and *Audits of Voluntary Health and Welfare Organizations* and in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations.* The SOP provides that the decision about whether to consolidate the financial statements of a reporting not-for-profit organization and those of one or several other entities (either not-for-profit organizations or business entities) should be based on the relationship of the entities to each other. That relationship also governs the disclosures that the reporting organization is required to make. The guidance in the SOP focuses on investments in majority-owned for-profit subsidiaries and financially interrelated not-for-profit organizations. The SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets, and less then $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 15, 1995, with earlier application permitted. For organizations that adopt FASB Statement No. 117 (AC No5) before its effective date, earlier application of the SOP is encouraged.

.76 Auditors should consider whether there are entities that should be included in the consolidated financial statements of the reporting not-for-profit organization and whether the disclosures about other entities required by SOP 94-3 should be made. Auditors should read the bylaws and articles of incorporation of all related entities, paying particular attention to provisions concerning appointing the governing board, to determine how, if at all, those related entities should be reported in the financial statements of the reporting entity. If auditors are unable to examine the bylaws and articles of incorporation of related parties, they should consider whether there is a limitation on the scope of the audit sufficient to preclude an unqualified opinion. SAS No. 58 (AU section 508) discusses reporting in circumstances in which there is a scope limitation. Alternatively, depending on the facts and circumstances and the audit risk, auditors may determine that they can obtain adequate audit evidence concerning the relationship of the entities based on alternative procedures, such as information obtained from management and legal counsel. Auditors should consider obtaining written documentation of such audit evidence and should consider including such matters in the management representation letter.

.77 *AICPA Guide Project.* In April 1995, the AICPA Not-for-Profit Organizations Committee released an exposure draft of a proposed Audit and Accounting Guide *Not-for-Profit Organizations*. The New Guide has been approved for issuance by AcSEC and cleared by the FASB and is expected to be issued in July 1996. (The discussion of the New Guide in this Audit Risk Alert is based on the conclusions that are expected to be included in the New Guide when it is issued in final form.) The New Guide will incorporate certain provisions of FASB Statement Nos. 116 (AC C67) and 117 (AC No5) and will be directed at not-for-profit organizations in general, and not at specific kinds of such organizations, such as voluntary health and welfare organizations or private colleges and universities.

.78 The New Guide will supersede the following AICPA Audit and Accounting Guides:

- Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*
- Industry Audit Guide *Audits of Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*

.79 It also will supersede the following AICPA SOPs:

- SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*

- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*
- SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*
- Also, it will supersede SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*, for organizations that are included in the scope of the New Guide.

.80 The New Guide will provide the following, among other matters:

- If the financial statements include prior year's financial information that does not include sufficient detail to constitute a presentation in conformity with GAAP because it does not include the minimum information required by FASB Statement No. 117 (AC No5) and the New Guide (for example, if the statement of activities does not present revenues, expenses, gains, and losses by net asset class), the nature of the prior-year information should be described by the use of appropriate titles on the face of the financial statements and in a note to the financial statements. The use of appropriate titles includes a phrase such as "with summarized financial information for the year ended 19PY," following the title of the statement or column headings that indicate the summarized nature of the information. Labeling the prior-year summarized financial information "for comparative purposes only" without further disclosure in the notes to the financial statements would not constitute the use of an appropriate title.

  If such summarized comparative information that does not include the minimum information required by GAAP is presented, certain disclosures about the nature of the information presented are required. If the required disclosures about the nature of that information are omitted or are incomplete, the auditor ordinarily should add a paragraph to his or her report calling the omitted or incomplete disclosure to the readers' attention. To reduce the likelihood that a reader might misinterpret such a paragraph to be a qualified opinion on the current period financial statements, the paragraph should follow the opinion paragraph and should not be referred to in either the scope or opinion paragraphs of the auditor's report.

- Solicitations for donations that clearly include wording such as "information to be used for budget purposes only" or that clearly and explicitly allow resource providers the ability to rescind their indications that they will give are intentions to give rather than promises to give and should not be reported as contributions.
- Not-for-profit organizations may receive contributions of the use of electric, telephone, and other utilities and of facilities (such as a building or office space) in which the donor retains legal title to the facilities. Organizations receiving such contributions should recognize contribution revenue in the period in which the promise is received and expenses in the period the utilities, facilities, or long-lived assets are used. (Whether such contributions should be reported is unaffected by whether the not-for-profit organization could afford to purchase the utilities or facilities at their fair value.) If the transaction is an unconditional promise to give for a specified number of periods, the promise should be reported as contributions receivable and as restricted support that increases temporarily restricted net assets.
- If a contribution is transferred to the ultimate recipient through an agent acting as an intermediary, the ultimate recipient should report the contribution when sufficient verifiable evidence that the agent has received the promise to give or contribution becomes available.
- Unconditional promises to give cash should be measured at fair value, based on the present value of their estimated future cash flows.
- Contributions receivable are not accounts receivable that are required to be confirmed in accordance with SAS No. 67, *The Confirmation Process* (AU section 330). Though contributions receivable are not

required to be confirmed, the auditor may nevertheless decide to request confirmation of contributions receivable. If the auditor confirms promises to give, he or she should follow the guidance in SAS No. 67 (AU section 330) concerning the confirmation process.

- For split-interest agreements, if the not-for-profit organization is the trustee, it should recognize the assets held under the trust at fair value and a liability for the present value of the expected future cash payments to be made to other beneficiaries. Contribution revenue should be reported for the present value of the cash flows expected to be received by the organization. If the not-for-profit organization is not the trustee, it would be required to recognize contribution revenue and an asset representing its right to receive future cash flows.

- Contributions of perpetual trusts held by third parties should be reported as permanently restricted support.

- Contributions of inventory should be reported in the period received and should be measured at fair value. Estimates of fair value may be obtained from published catalogs, vendors, independent appraisals, estimated selling prices, and other sources. If methods such as estimates, averages, or computational approximations, such as average value per pound or subsequent sales, can reduce the cost of measuring the fair value of inventory, use of those methods is appropriate, provided the methods are applied consistently, and the results of applying those methods are reasonably expected not to be materially different from the results of a detailed measurement of the fair value of contributed inventory. If the gifts have no value, as might be the case for certain clothing and furniture that cannot be sold or used either internally or for program purposes by the not-for-profit organization, the item received should not be recognized.

- If collection items are not capitalized, the auditor should perform procedures to understand the organization's controls over recording accessions (including contributions) and deaccessions of collection items, controlling the collections, and periodically physically inspecting them. Those auditing procedures are performed, in part, to provide evidence supporting the disclosures required by paragraph 27 of FASB Statement No. 116 (AC C67.124). They are also part of the auditor's work in obtaining an understanding of the organization's controls over collection items and contributions of such items. The objective of performing those procedures when the collection is not recognized is not to obtain evidence to corroborate a recorded amount, since no amount has been recorded. Instead, the objective is to help the auditor understand the organization's control environment, which is a component of its internal control.

- FASB Statement No. 124 (AC No5), which is discussed in paragraph .52 of this Audit Risk Alert, does not address measurement issues concerning investments other than investments in equity securities with readily determinable fair value and all investments in debt securities. Investments not covered by FASB Statement No. 124 (AC No5) are referred to in the New Guide as *other investments*. Other investments include, among others, investments in real estate, mortgage notes, venture capital funds, partnership interests, oil and gas interests, and equity securities that do not have a readily determinable fair value. The various AICPA Industry Audit Guides, Audit and Accounting Guides, and SOPs that will be superseded by the New Guide include guidance concerning other investments. The New Guide retains the measurement guidance for accounting for other investments included in the AICPA publications that will be superseded by the New Guide, until such time as the FASB or AcSEC issues more definitive guidance, except as stated in the next sentence. To the extent that the guidance in the AICPA publications that will be superseded by the New Guide requires all investments to be measured using the same measurement attribute, only other investments, rather than all investments, will be required to be measured using the same measurement attribute. For example, if an AICPA publication that will be superseded by the New Guide permits investments to be carried at either cost or fair value, provided that the same attribute is used for all investments, and if equity securities with a readily determinable fair value are carried at fair value in conformity with the guidance in FASB Statement No. 124 (AC No5), other investments are permitted to be carried at either cost or fair value, provided that the same attribute is used for all other investments.

- FASB Statement No. 124 (AC No5) provides that net appreciation on donor-restricted endowment funds should be reported as changes in unrestricted net assets unless the appreciation is temporarily or permanently restricted by explicit donor-imposed stipulations or by law. Laws concerning net appreciation of donor-restricted endowment funds may vary from jurisdiction to jurisdiction. For example, some jurisdictions follow trust law, some follow the Uniform Management of Institutional Funds Act (UMIFA), some follow modifications of UMIFA, and some follow interpretations of those laws issued by state attorneys general. Generally, in jurisdictions following trust law, net appreciation is not spendable and therefore should be added to permanently restricted net assets. Accordingly, unless the donor has explicitly restricted the net appreciation on an endowment fund, net appreciation subject to such limitations should be reported as a change in unrestricted net assets.

  Also, it has generally been interpreted that, absent donor restrictions, net appreciation is spendable under UMIFA and therefore should be added to unrestricted net assets. (Legal limitations that require the governing board to act to appropriate net appreciation under a statutorily prescribed standard of ordinary business care and prudence do not extend donor restrictions to the net appreciation.) Auditors should obtain an understanding about these issues and the laws concerning net appreciation on donor-restricted endowments applicable to the reporting organization. Also, auditors should obtain representations from management about any interpretations made by the organization's governing board concerning whether laws limit the amount of net appreciation of donor-restricted endowments that may be spent. However, for organizations operating in jurisdictions in which there may be questions concerning interpretations of the applicable laws or where there are conflicting interpretations by various legal counsel, auditors should request the organization to obtain a specific opinion from legal counsel concerning interpretation of the legal requirements. SAS No. 73, *Using the Work of a Specialist* (AU section 336), provides guidance concerning circumstances in which the auditor relies on the representations or work of an attorney for other than litigation, claims, and assessments as addressed in SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU section 337).

- Property and equipment used in exchange transactions (other than lease transactions), such as federal contracts, in which the resource provider retains legal title during the term of the arrangement should be capitalized by the not-for-profit organization only if it is probable that the organization will be permitted to keep the assets when the arrangement terminates. The terms of such arrangements should be disclosed in notes to the financial statements.

- Revenues from exchange transactions should generally be reported gross of any related expenses, rather than net of related expenses. If the organization regularly provides discounts (such as financial aid for students that is not reported as an expense, reduced fees for services, or free services) to certain recipients of its goods or services, revenues should be reported net of those discounts. (Net revenue may be reported as a single line item in a statement of activities, or the gross revenue is permitted to be reported less the related discount, provided that the discount is displayed immediately beneath the revenue.)

- Some not-for-profit organizations provide reductions in amounts charged for goods or services, such as financial aid provided by colleges and universities. Reductions in amounts charged for goods or services provided by a not-for-profit organization should be recognized as expenses if such reductions are given in exchange for goods or services provided to the organization, such as part of a compensation package. Amounts recognized as expenses for such reductions should be reported in the same functional classification in which the cost of the goods or services provided to the organization are reported. If reductions in amounts charged for goods or services provided by a not-for-profit organization are given other than in exchange for services provided to the organization, such amounts should be reported as—

  — Expenses if the organization incurs incremental expense in providing such goods or services

  — Discounts if the organization incurs no incremental expense in providing such goods or services

- Fund-raising costs, including costs incurred in one period that may result in contributions that will be received in future periods, should be expensed as incurred.
- The costs of soliciting contributed services, such as volunteers, regardless of whether those services are recognized as contributions in conformity with the provisions of paragraph 9 of FASB Statement No. 116 (AC C67.109), should be reported as fund-raising.
- The financial statements should disclose the total fund-raising expenses.
- The financial statements should provide information about program expenses. If the components of total program expenses are not evident from the details provided on the face of the statement of activities, for example, if cost of sales is not identified as either program or supporting services, the notes to the financial statements should disclose total program expenses and should provide information about why total program expense disclosed in the notes does not articulate with the statement of activities. The financial statements should also provide a description of the nature of the organization's activities, including a description of each of its major classes of programs, either on the statement of activities (for example, using column headings) or in the notes to the financial statements.
- Occupying and maintaining a building is not a separate supporting service. Interest costs, including interest on a building's mortgage, should be allocated to specific programs or supporting services to the extent possible; interest costs that cannot be allocated should be reported as part of the management and general function.
- Auditors should not report separately on operations if the statement of activities includes an intermediate measure of operations.

.81 In addition, the New Guide will include the following:

- A definition of a governmental entity
- Indicators to distinguish exchange transactions from contributions
- Indicators to distinguish contribution and exchange portions of membership dues.

.82 The provisions of the New Guide will be effective for financial statements for periods ending on or after December 31, 1996.

.83 The period for commenting on the exposure draft has expired and the New Guide is expected to be issued in July 1996.

.84 *Accounting for the Costs of Joint Activities.* In September 1993, the AICPA Not-for-Profit Organizations Committee released an exposure draft of a proposed SOP that would clarify and revise SOP 87-2. The proposed SOP would be applied by not-for-profit organizations and state and local governmental entities in determining fund-raising costs. It would require entities to report the costs of all materials and activities that include a fund-raising appeal as fund-raising costs, including costs that are otherwise clearly identifiable with program or management and general functions, unless a bona fide program or management and general function has been conducted in conjunction with the appeal for funds. If a bona fide program or management and general function has been conducted in conjunction with an appeal for funds, the joint costs of those activities would be allocated. Costs that are clearly identifiable with fund-raising, program, or management and general functions would be charged to that cost objective. The period for commenting on the exposure draft has expired and the committee is considering the comments received. In addition, the committee is conducting a field test of the proposed SOP.

GASB Projects

.85 *GASB Governmental Not-for-Profit Project.* In August 1995, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting*

Principles by Governmental Entities. This project was added to the GASB's technical agenda because of questions concerning whether certain governmental entities could apply not-for-profit accounting and financial reporting principles, especially FASB Statement Nos. 116 (AC C67) and 117 (AC No5).

.86 GASB Statement No. 29 provides that governmental entities that have been applying not-for-profit accounting and financial reporting principles by following AICPA SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations,* or Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations,* should apply the governmental model or the AICPA not-for-profit model. The AICPA not-for-profit model consists of the accounting and financial reporting principles contained in SOP 78-10 or *Audits of Voluntary Health and Welfare Organizations*—except for the provisions relating to the joint costs of informational materials and activities that include a fund-raising appeal—as modified by all applicable FASB pronouncements issued through November 30, 1989, and as modified by most applicable GASB pronouncements.

.87 The Statement also provides that proprietary activities that apply the provisions of paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting,* should apply only those FASB Statements and Interpretations issued after November 30, 1989 that are developed for business enterprises. They should not apply FASB Statements and Interpretations whose provisions are limited to not-for-profit organizations or address issues concerning primarily such organizations (such as FASB Statement Nos. 116 [AC C67] and 117 [AC No5]).

.88 The provisions of the Statement are generally effective for financial statements for periods beginning after December 15, 1994; the modifications of the AICPA Not-for-Profit model for certain GASB pronouncements is effective for entities that previously have not applied those pronouncements for periods beginning after December 15, 1995, with earlier application encouraged.

.89 Auditors should consider whether the organization is a governmental entity, because that will determine which accounting principles the organization should follow. The New Guide, which is discussed in paragraphs .77 through .83 of this Audit Risk Alert, will provide guidance concerning the definition of a government.

.90 *GASB Reporting Entity Project.* In December 1994, the GASB issued an exposure draft of a proposed Statement, *The Financial Reporting Entity—Affiliated Organizations,* that would establish standards to determine whether an organization should be classified as an affiliated organization and, if so, would establish criteria to determine whether that affiliated organization is a component unit of a primary government's financial reporting entity. The proposed Statement also would establish financial reporting guidance for those organizations that are governmental entities. It would apply to financial reporting by primary governments and other stand-alone governments, and to the separately issued financial statements of governmental component units as defined in GASB Statement No. 14. The GASB is expected to issue a final Statement in early 1997.

Nonauthoritative AICPA Audit and Accounting Literature

.91 *Continuing Professional Education Courses.* The AICPA Government Accounting and Auditing Certificate of Educational Achievement Program consists of the following series of continuing professional education (CPE) courses:

- Governmental Accounting and Financial Reporting: Issues and Implications (GAA1)
- Financial Audits of Governmental Entities (GAA2)
- Nonprofit Accounting: Issues and Implications (NAA1)
- Issues and Implications of *Government Auditing Standards* (GNP4)

On successful completion of the program, the participant is awarded a certificate.

.92 In addition, the AICPA offers group-study and self-study courses. Group-study courses include the following:

- Accounting and Reporting for Certain Nonprofit Organizations
- Advanced Auditing of HUD-assisted Projects
- Audit Requirements of OMB Circular A-133
- Audits of HUD-assisted Projects
- Compliance Auditing
- Cost Principles for Nonprofit Organizations Under OMB Circular A-133
- Implementing SFAS Nos. 116 and 117 in Financial Statements of Nonprofit Organizations
- Nonprofit Auditing and Accounting Update
- Performing Cost Efficient Audits of Nonprofit Organizations
- Tackling Tough Tax Topics in Nonprofit Organizations
- Yellow Book: Government Auditing Standards

.93 Self-study courses include the following:

- Accounting for Nonprofits: Contributions and Financial Statements
- Accounting and Auditing for Certain Nonprofit Organizations
- Nonprofit Auditing and Accounting Update
- Audit Requirements of OMB Circular A-133
- Communicating Material Noncompliance and Material Internal Control Weaknesses
- Compliance Auditing
- HUD Audits: A Comprehensive Guide
- Understanding Federal Audit Policies and Procedures
- Working with the Revised Yellow Book on *Government Auditing Standards*

.94 For more information about AICPA CPE courses, call the AICPA information hotline at (800) 862-4272.

.95 *Not-for-Profit Organizations Checklists.* The AICPA's Accounting and Auditing Publications staff has developed various publications that may be of interest to readers of this Audit Risk Alert. For example, an annual publication entitled Checklists and Illustrative Financial Statements for Not-for-Profit Organizations, is a nonauthoritative practice aid designed to help those preparing reports and financial statements of not-for-profit organizations.

.96 *Technical Practice Aids. Technical Practice Aids* is an AICPA Publication that includes questions received by the AICPA's Technical Information Service on various subjects and the service's response to those questions. Sections 6960 and 7300 of *Technical Practice Aids* include questions and answers specifically pertaining to not-for-profit organizations. *Technical Practice Aids* is available both as a subscription service and in hardback form.

.97 *Industry Conference.* The AICPA will hold its fourth annual Not-for-Profit Organizations Industry Conference on June 17 and 18, 1996 in Washington D.C. The conference is designed for both practitioners and financial executives, and to provide technical information for those decision makers. For further information, call the AICPA CPE Division Hotline at (800) TO-AICPA.

Information Sources

.98 Further information on matters addressed in this Audit Risk Alert is available through various publications and services listed in the table at the end of this document. Many nongovernment and some government publications and services involve a charge or membership requirement.

.99 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.100 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.101 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.102 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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.103 This Audit Risk Alert supersedes *Not-for-Profit Organizations Industry Developments—1995.*

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.104 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA CPE programs is available through the AICPA CPE Division (extension 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account, call (800) 524-3388 and ask for the AICPA package or rep. 748.
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		
U.S. Office of Management and Budget	Office of Administration Publications Office Room 2200 New Executive Office Building Washington, D.C. 20503 (202) 395-7332		OMB has a home page on the World Wide Web. The address is http://www.whitehouse.gov/wh/EDP/OMB: An alternate address is http://www.sbaonline.sba.gov/Ignet For information concerning publications, standards, and exposure drafts released for comments by Inspectors General: Gopher//Gopher.Financenet.gov:70/1
National Association of College and University Business Offices	One Dupont Circle Suite 500 Washington, D.C. 20036 (202) 861-2500 (202) 861-2583 (f)		*Electronic Bulletin Board Service*. Modem access: (202) 861-8400. Internet access: telnet to bbs.nacubo.nche.edu. IP address: 198.76.77.2 (Can also be accessed through the Ignet.)

Information Sources *(cont'd)*

Organization	General Information	Fax Services	Electronic Bulletin Board Services
National Health Council	1730 M Street, NW Suite 500 Washington, D.C 20036 (202) 785-3910 (202) 785-5923 (f)		
Other			The *Rutgers Bulletin Board* on the World Wide Web includes various accounting related databases. The address for the home page is http://www.rutgers.edu/accounting/raw.html. The address for information concerning the FASB is http://www.rutgers.edu/accounting/raw.html/fasb/faf.htm
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250 (f)		*U.S. Government Printing Office's The Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account. User assistance line: (202) 512-1530 (202) 512-1387 (d) Telnet via internet: federal.bbs.gpo.gov 3001 (Can also be accessed through the Ignet.)

AAM Section 8190

FDIC Improvement Act Implementation Issues

Introduction

.01 This document alerts CPAs to how the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 (FDICIA) and its implementing regulations and guidelines affect the engagements they perform. This section of the Audit Risk Alert synthesizes the requirements. Appendix A (paragraph .52) presents, verbatim, the regulations and guidelines that implement the law. Commentary prepared by the staff of the American Institute of Certified Public Accountants (AICPA) is included to focus on practical matters that the independent accountant should consider when taking action to comply with the requirements. The agreed-upon procedures that must be performed by the independent accountant, as presented in Appendix B (paragraph .53), are also reprinted verbatim with AICPA staff commentary. Both appendixes should be read in their entirety.

.02 Independent accountants serving covered institutions will be required—for the first time—to attest to managements' assertions about internal controls over financial reporting and compliance with laws and regulations. Independent accountants should become familiar with the new reporting requirements, particularly those that address the independent accountant's qualifications, exposure to enforcement actions, required communications with client institutions, and interaction with the audit committee. The effects of a number of the law's provisions on a client institution's ability to remain a going concern should also be considered.

.03 This document is not intended to provide comprehensive guidance on implementing the requirements of the law, regulations, and guidelines. This document does, however, focus on several practical matters concerning implementation that the independent accountant should consider in complying with the requirements. In a number of these areas, guidance has not yet been developed and the independent accountant will need to exercise judgment about how to proceed. For example, independent accountants will need to make judgments on practical matters such as the following:

- Performing agreed-upon procedures on internal auditors' workpapers
- Determining sample sizes for agreed-upon procedures
- Defining financial reporting controls
- Reporting on "safeguarding" objectives in the report on management's assertion about financial reporting controls

This Audit Risk Alert should not be substituted for a complete reading of the applicable sections of the law, regulations, and guidelines where appropriate.

The Law

.04 Early in 1991, Congress was informed that the FDIC's Bank Insurance Fund (BIF) would need more money because a record number of banks had failed, and that regulators needed timely information about the financial condition of banks. Legislative proposals coupling additional money for the BIF with an enhanced financial reporting system for federally insured depository institutions became the basis for a number of reforms embodied in the FDICIA. These measures reflect policymakers' emphasis on regulatory solutions to concerns about the depository institutions industry.

.05 Although related legislative proposals that would have expanded bank powers (by permitting interstate activities and new products and services) were ultimately dropped, the reach of the final provisions—which emphasize least-cost resolutions and improved supervision and examinations—surpasses even that of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

.06 Signed into law in December 1991, FDICIA spawned a rule making process that, when completed, will alter every major area of existing regulation of banks and thrifts. As discussed below, the effect of FDICIA on practice in the industry and on the current regulatory environment requires heightened awareness among practitioners.

.07 The federal banking regulatory agencies have been carrying out the massive effort necessary to develop regulations to implement the law, including audit provisions that directly affect CPAs. Many provisions of the FDICIA are amendments or additions to the Federal Deposit Insurance Act (FDI Act). Major provisions affecting practitioners who provide services to depository institutions are summarized below. Readers should refer to the law, implementing regulations, and guidelines for a complete discussion of these and other requirements.

The Implementing Regulations

Reporting Requirements—Section 36

.08 New Section 36 of the FDI Act (added by Section 112 of the FDICIA) creates new reporting requirements including, for the first time, reports by managements and independent accountants on internal controls over financial reporting and compliance with certain laws and regulations. It also establishes minimum qualifications for independent accountants serving the affected institutions. The Section 36 provisions, as summarized below, apply to each FDIC-insured depository institution having total assets of $500 million or greater at the beginning of its fiscal year. The reporting requirements are effective for fiscal years ending December 31, 1993, and thereafter. Despite the asset threshold, Section 36 does not override any non-FDICIA requirements for audited financial statements or other requirements that an institution exempt from Section 36 must otherwise satisfy.[1]

.09 To implement Section 36, the FDIC has issued both a final regulation[2] and accompanying guidelines and interpretations (guidelines), which became effective July 2, 1993. The general requirements are summarized below; however, the side-by-side analysis of the detailed regulation and guidelines presented in Appendix A (paragraph .52) should be read as an integral part of this Audit Risk Alert.

.10 *Annual Report.* Management is required to prepare, annually, a report that includes the following: [3]

- Financial statements prepared in conformity with generally accepted accounting principles (GAAP)
- A written assertion about the effectiveness at year-end of the institution's internal controls over financial reporting
- A written assertion about the institution's compliance during the year with (a) federal laws and regulations relative to insider loans, and (b) federal and state laws and regulations relative to dividend restrictions

Management must also include a statement about its responsibilities for the financial statements, financial reporting controls, and compliance with laws and regulations.

.11 Management must engage an independent accountant to provide the following reports annually:

- An audit report on the GAAP-basis financial statements

[1] In FDIC Financial Institution Letter (FIL-43-93), the FDIC noted that, in adopting the final rule implementing Section 36, the Board of Directors of the FDIC reiterated its belief that "every depository institution, regardless of size or charter, should voluntarily have an annual audit of its financial statements by an independent public accountant and establish an independent audit committee."

[2] The regulation and guidelines implementing FDI Act Section 36 (which have been reproduced in Appendix A [paragraph .52]) are codified in Section 12 of the Code of Federal Regulations (CFR) Part 363. The regulation was published in the *Federal Register* on June 2, 1993, and in FDIC FIL-41-93.

[3] The reporting requirements may be satisfied for certain subsidiaries through reporting by their holding companies. These exemptions are discussed in Section 363.1 of the rule and in guidelines 2-4.

- An examination-level attestation report on management's assertion about financial reporting controls

An agreed-upon procedures-level attestation report on management's assertion about compliance with insider loan and dividend restriction laws and regulations is also required, but is not included in the institution's annual report and, therefore, is not publicly available.

.12 The financial statement audit is to be performed in accordance with generally accepted auditing standards (GAAS). The examination of management's assertion about financial reporting controls and the agreed-upon procedures report on management's compliance assertion are to be performed in accordance with the AICPA's Statements on Standards for Attestation Engagements (SSAE).[4]

.13 The audited financial statements and other reports of management and the independent accountant must be filed with the FDIC and other regulatory agencies within the ninety days following the institution's fiscal year-end. Management must also file any management letter, qualification, or other report within fifteen days following receipt from the independent accountant.

.14 All of management's reports will be made publicly available. The independent accountant's report on the financial statements and attestation report on financial reporting controls will also be made publicly available. The independent accountant's agreed-upon procedures report and any management letter, while filed with the FDIC, will not be included in the annual report and, therefore, will not be publicly available.

.15 *Qualifications of Independent Accountants.* Acceptance of an engagement to report under Section 36 is conditioned on the independent accountant being enrolled in a practice-monitoring program. Membership in the AICPA Division for Firms' SEC Practice Section or Private Companies Practice Section, or enrollment in the AICPA's Quality Review Program will satisfy this requirement.

.16 Another condition of the engagement is that the independent accountant agree to provide regulators with access to workpapers related to the three engagement reports. Although this condition is not explicitly expressed in the law or regulations, the implementing guidelines also call for providing copies of workpapers to regulators. Independent accountants should read the July/August 1993 *Notice to Practitioners* (included as Appendix C (paragraph .54) to this Audit Risk Alert), which provides guidance on complying with requests for access to, and copies of, workpapers when required to do so by contract, law, or regulation.

.17 The accountant must meet the independence requirements and interpretations of the AICPA and the Securities and Exchange Commission (SEC) and its staff.

.18 The implementing regulation requires both management and independent accountants to provide certain notifications of changes in an institution's independent accountants within specified time periods. An independent accountant must also file a peer review report within fifteen days of acceptance of the report.

.19 *Enforcement Actions Against Accountants.* Section 36 of the FDI Act also provides for enforcement actions against accountants with respect to the Section 36 requirements. However, the regulatory agencies have not yet proposed or published rules or guidelines to implement this statutory requirement.[5]

.20 *Communication With Auditors.* Each subject institution must provide its independent accountant with copies of the institution's most recent reports of condition and examination; any supervisory memorandum of understanding or written agreement with any federal or state regulatory agency; and a report of any action initiated or taken by federal or state banking regulators.

[4] SSAE No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AT section 400), was issued in June 1993. On April 7, 1993, the AICPA's Auditing Standards Board issued an exposure draft of a proposed SSAE, *Compliance Attestation,* which, when finalized, will provide additional guidance on compliance attestation engagements. A final statement is expected to be issued by year-end 1993.

[5] Section 36(g)(4) of the FDI Act states that the FDIC or the appropriate federal banking agency may "remove, suspend, or bar an independent public accountant, upon a showing of good cause, from performing audit services" required by Section 36. The federal banking agencies are expected to jointly issue rules to implement this provision.

.21 *Audit Committees.* Each subject institution must have an independent audit committee made up entirely of outside directors independent of management. One of the audit committee's required duties is to review with management and the independent accountant the reports required under Section 36. A list of other suggested duties is included in the guidelines, some of which relate to the independent accountant. Audit committees of institutions having $3 billion or more in assets must include members with banking or related financial management expertise, have access to their own outside counsel, and not include any large customers of the institution.

Accounting Reforms—Section 37

.22 FDI Act Section 37 was added by FDICIA Section 121 to establish accounting objectives, standards, and requirements for regulatory financial reporting, that is, the Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income (Call Reports) and Thrift Financial Reports (TFRs). Among other provisions, Section 37—

- Requires regulatory financial reporting to be uniform and consistent with GAAP, unless more stringent principles are considered necessary to reflect capital accurately, facilitate effective supervision, or permit prompt corrective action.
- Instructs the regulatory agencies to develop both a method for supplemental disclosures of market values of assets and liabilities (to the extent feasible and practicable) and regulations to ensure adequate reporting of off-balance-sheet transactions (including reporting of contingent assets and liabilities).
- Promotes uniformity of capital and accounting standards among the federal regulatory agencies.

.23 On April 13, 1993, the FFIEC requested comment on a proposed approach to unaudited supplemental fair value disclosures that would use concepts and principles set forth in the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25). No other proposals have been made toward implementation of the Section 37 provisions.

Prompt Corrective Action—Section 38

.24 FDICIA makes capital an essential indicator to be used by regulators in monitoring the financial health of insured depository institutions. Regulatory intervention is focused primarily on an institution's capital levels relative to regulatory standards. Through FDI Act Section 38, FDICIA added a uniform framework for prompt corrective regulatory action to the existing capital adequacy guidelines set forth by each agency for safety and soundness purposes.[6]

.25 The independent accountant considers regulatory capital from the perspective that noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. The AICPA's Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), provides guidance in this area.

.26 Capital regulations are complex and their application by management requires a thorough understanding of specific requirements and the potential impact of noncompliance. Accordingly, relevant regulations and regulatory guidance should be referred to by the independent accountant as necessary when considering regulatory capital matters.

.27 Effective December 19, 1992, Section 38 provides for supervisory action at certain institutions based on their capital levels. Each institution falls into one of five regulatory capital categories based primarily on three capital measures: Tier 1 leverage, total risk-based, and Tier 1 risk-based capital. These capital ratios are defined in

[6] The final rules implementing prompt corrective action were published in the September 29, 1992, *Federal Register;* in the FDIC's FIL-70-92; and in the Office of the Comptroller of the Currency's (OCC's) Banking Bulletin 92-52 and Banking Circular 268.

the same manner for Section 38 purposes as under the respective agencies' capital adequacy guidelines and regulations. For savings institutions, Tier 1 leverage capital is comparable to core capital, as defined.

.28 Regulations also specify a minimum requirement for tangible equity, which is defined as Tier 1 capital plus cumulative perpetual preferred stock, net of all intangibles except limited amounts of purchased mortgage servicing rights (PMSRs). In calculating the tangible equity ratio, intangibles (except for qualifying PMSRs) should also be deducted from the total assets included in the ratio denominator.

.29 An institution may be reclassified between certain capital categories if its condition or an activity is deemed by regulators to be "unsafe or unsound." A change in an institution's capital category initiates certain mandatory—and possibly additional discretionary—action by regulators.

.30 Under Section 38, an institution is considered—

- *Well capitalized* if its capital level significantly exceeds the required minimum level for each relevant capital category.
- *Adequately capitalized* if its capital level meets the minimum levels.
- *Undercapitalized* if its capital level fails to meet the minimum levels.
- *Significantly undercapitalized* if its capital level is significantly below the minimum levels.
- *Critically undercapitalized* if it has a ratio of tangible equity to total assets, as defined, of 2 percent or less, or otherwise fails to meet the critical capital level, as defined.

.31 The minimum levels are defined as shown in the following table:

Capital Category	*Total Risk-Based (Ratio)*	*Tier 1 Risk-Based (Ratio)*	*Tier 1 Leverage (Ratio)*
Well capitalized	≥ 10%	≥ 6%	≥ 5%
Adequately capitalized	≥ 8	≥ 4	≥ 4*
Undercapitalized	< 8	< 4	< 4*
Significantly undercapitalized	< 6	< 3	< 3

* 3.0 percent for 1-rated institutions under the regulatory CAMEL, MACRO, or related rating system.

.32 As noted in the preceding, critically undercapitalized institutions are those having a ratio of tangible equity to total assets of 2 percent or less.

.33 An institution will not be considered well capitalized if it is under a cease-and-desist order, formal agreement, capital directive, or prompt-corrective-action capital directive.

.34 Actions that may be taken under the prompt corrective action provisions range from the restriction or prohibition of certain activities, such as the payment of dividends, to the appointment of a receiver or conservator.

.35 Regulators will also require undercapitalized institutions to submit a plan for restoring the institution's capital to an acceptable level. For example, each undercapitalized institution is required to submit a plan that specifies the following:

- Steps the institution will take to become adequately capitalized
- Targeted capital levels for each year of the plan
- How the institution will comply with other restrictions or requirements put into effect
- The types and levels of activities in which the institution will engage

.36 Savings institutions that are complying with capital plans approved by the Office of Thrift Supervision (OTS) prior to December 19, 1991, are not required to file new plans and are not immediately subject to certain sanctions.

.37 Noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. The implementation of the prompt corrective action provisions warrants similar attention by auditors when considering an institution's ability to remain a going concern.

Internal Control Standards—Section 39

.38 New Section 39 of the FDI Act (as added by Section 132 of the FDICIA) requires the federal banking agencies to prescribe safety and soundness standards for management and operation of insured depository institutions, including standards for internal controls. Implementing regulations will apply to all federally insured institutions and must be finalized by August 1, 1993, to become effective no later than December 31, 1993.

.39 In July 1992, the federal banking agencies jointly published an advance notice of proposed rule making for Section 39 (*Federal Register,* July 15, 1992). In April 1993, the Board of Governors of the Federal Reserve System (FRB) approved a staff proposal for implementation of Section 39. Because the federal banking agencies plan to simultaneously issue their proposals for comment, the FRB proposal was not immediately published for comment. However, the joint proposal is expected to track the FRB's draft.

.40 Among other matters, the FRB draft proposal would require state member banks to have internal controls and information systems that provide for the following:

(a) An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to prescribed policies

(b) Effective risk assessment

(c) Timely and accurate financial, operational, and regulatory reports

(d) Adequate procedures to safeguard and manage assets

(e) Compliance with applicable laws and regulations

.41 The Section 39 internal control requirements (as proposed in the FRB draft) would exceed the scope of the Section 36 management and independent accountant reports, which are limited to internal controls over financial reporting. Management is not required to make an assertion, nor is the independent accountant required to examine or report on any such management assertion, about the broader internal controls and information systems contemplated by Section 39.

.42 The Section 39 proposal also prescribes standards for operations, management, internal audit, asset quality, earnings, stock valuation, and employee compensation. If an institution fails to meet any of the prescribed standards, it must submit and implement a plan to achieve compliance. Failure to submit or implement the plan could lead to supervisory action.

Effects on Institutions' Liquidity

.43 Several provisions of FDICIA may affect the liquidity of an institution. Specifically, FDICIA places new restrictions on the following:

- Acceptance of brokered deposits by certain institutions[7]

[7] See FDICIA Section 301 and FDIC FIL-3-92.

- Availability of borrowings through the discount window[8]
- Exposure to the institution posed by transactions with correspondent banks and related limitations on interbank liabilities[9]

Accordingly, the independent accountant should consider whether the effect on the institution's liquidity, when considered with other factors, could indicate substantial doubt about an entity's ability to continue as a going concern.

Qualified-Thrift-Lender Test—Subtitle G

.44 To be considered a savings institution, an entity must hold a specific portion of its assets in eligible housing-related assets. On July 1, 1991, the required minimum percentage of qualified investments was 70 percent. Subtitle G of the FDICIA modified the qualified-thrift-lender (QTL) test to require that minimum qualified thrift investments equal or exceed 65 percent of assets, as defined, on a monthly average basis in nine out of every twelve months. Subtitle G also expands the definition of qualified thrift investments to include stock of any Federal Home Loan Bank, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association. The amounts of certain assets includable in the numerator and deductible in the denominator of the QTL ratio were also modified (see *Federal Register,* September 2, 1992).

.45 Noncompliance with the QTL requirement subjects an institution and its holding company, if any, to certain restrictions, among other regulatory actions. An institution that fails the OTS QTL test may also fail the separate Internal Revenue Service (IRS) QTL test.

Information Sources

.46 Copies of the FDICIA (stock number 869-015-00242-6) are available from the Government Printing Office (GPO). Call (202) 783-3238, or send an order via fax to (202) 512-2250 (VISA or MasterCard charges only; include expiration date). The price is $4.50.

.47 FDIC policy is communicated in Financial Institution Letters, News Releases, Regional Director Memoranda, updates to the Division of Supervision Manual of Examination Policies, and instructions for FFIEC Consolidated Reports of Condition and Income (Call Reports). For information about ordering these issuances, call FDIC Corporate Communications at (202) 898-6996.

.48 OCC supervisory policies and guidance are issued as Advisory Letters, Banking and Examining Bulletins and Circulars, Memoranda, News Releases, updates to the OCC Policies and Procedures Manual, the Bank Accounting Advisory Series, instructions for FFIEC Call Reports, and other issuances. For information on ordering copies of OCC issuances, call OCC Publications Control at (202) 874-4884.

.49 Information about FRB publications is available through FRB Publications Services at (202) 452-3245.

.50 OTS supervisory policies and guidance are issued in the form of Thrift Bulletins, Regulatory Bulletins, Transmittals, and in guidance provided to examiners through a multivolume set of agency handbooks. For information on ordering OTS publications, call the OTS Controller's Division at (202) 906-6427.

.51 The *Federal Register* contains notices about the actions of federal government agencies. It may be purchased from the GPO by calling (202) 783-3238 or by writing to New Orders, Superintendent of Documents, PO Box 371954, Pittsburgh, PA 15250-7954. Most public libraries also have copies of the *Federal Register.*

[The next page is 8409.]

[8] See FDICIA Section 142.

[9] See FDICIA Section 308 and OCC Banking Bulletin 93-3.

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Appendix A

Audit and Reporting Requirements

Reprinted below are 12 CFR Part 363—Annual Independent Audits and Reporting Requirements (left column) and Appendix A to Part 363—Guidelines and Interpretations (center column). The regulation and appendix were published in the June 2, 1993 *Federal Register*. The right column is the AICPA staff's commentary on the regulation and guidelines.

Regulation	*Guidelines*	*Commentary*
§ 363.1 SCOPE		
(a) Applicability. This part applies with respect to fiscal years of insured depository institutions which begin after December 31, 1992 This part does not apply with respect to any fiscal year of any insured depository institution, the total assets of which, at the beginning of such fiscal year, are less than $500 million.	1. Measuring Total Assets. To determine whether this part applies, an institution should use total assets as reported on its most recent Report of Condition (Call Report) or Thrift Financial Report (TFR), the date of which coincides with the end of its preceding fiscal year. If its fiscal year ends on a date other than the end of a calendar quarter, it should use its Call Report or TFR for the quarter end immediately preceding the end of its fiscal year. 2. Insured Branches of Foreign Banks Unlike other institutions, insured branches of foreign banks are not separately incorporated or capitalized. To determine whether this part applies, an insured branch should measure claims on non-related parties reported on its Report of Assets and Liabilities of U.S Branches and Agencies of Foreign Banks (form FFIEC 002)	● The requirements for independent accountants apply only to accountants serving the subject institutions. If an institution does not fall within the scope of § 363, neither the institution nor its independent accountant is subject to the rule or guidelines.
(b) Compliance by subsidiaries of holding companies. The audited financial statements requirement of § 363.2(a) may be satisfied for an insured depository institution that is a subsidiary of a holding company by audited financial statements of the consolidated holding company. The other requirements of this part for an insured depository institution that is a subsidiary of a holding company may be satisfied by the holding company if: *(1) The services and functions comparable to those required of the insured depository institution by this part are provided at the holding company level; and* *(2) Either the insured depository institution has total assets as of the beginning of such fiscal year of·* *(i) less than $5 billion; or*	3. Compliance by Holding Company Subsidiaries. Audited consolidated financial statements and other reports or notices required by this part which are submitted by a holding company for any subsidiary institution, should be accompanied by a cover letter identifying all subsidiary institutions to which they pertain. An institution filing holding company consolidated financial statements as permitted by § 363.1(b) also may report on changes in its independent public accountant on a holding company basis An institution that does not meet the criteria in section 36(i) must satisfy the remaining provisions of the statute and this part on an individual institution basis, and maintain its own audit committee. Multi-tiered holding companies may satisfy all requirements of this part at any level	

Regulation

(ii) more than $5 billion, but less than $9 billion, and a composite CAMEL (or MACRO, or equivalent) rating of 1 or 2.

Guidelines

4. Comparable Services and Functions. Services and functions will be considered "comparable" to those required by this part if the holding company:

(a) Prepares reports used by the subsidiary institution to meet the requirements of this part;

(b) Has an audit committee that meets the requirements of the part appropriate to its largest subsidiary institution; and

(c) Prepares and submits the management assessments of the effectiveness of the internal control structure and procedures for financial reporting ("internal controls"), and compliance with the Designated Laws defined in Guideline 12 that are based on information concerning the activities and operations of all subsidiary institutions within the scope of this part.

Commentary

- The guidelines use *internal controls* throughout to refer internal controls over financial reporting Management and independent accountant reports required by the rule relate only to financial reporting controls—including *safeguarding of assets* as discussed in Guideline 9. These controls do *not* extend to compliance with applicable federal, state, and local laws and regulations *(compliance controls)* or controls over effectiveness and efficiency of operations *(operational controls).*
- See the related commentary on Guideline 8. Further guidance is needed on how the independent accountant would report (under SSAE No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* [AT section 400]) when management applies Guideline 4(c) by making an assertion about the financial reporting controls of more than one of its subsidiary institutions within the scope of 12 Code of Federal Regulations (CFR) 363 *(a covered subsidiary).*
- In applying Guideline 4(c) to performance of the compliance attestation procedures, if the independent accountant performs procedures listed in Section I of Appendix B (paragraph .53) of this Audit Risk Alert, he or she could use sample sizes calculated on a consolidated basis for the holding company and all covered subsidiaries of that holding company. Sample sizes for covered subsidiaries that are not being reported on following Guideline 4(c) should not be calculated on a conHsolidated basis.

§ 363.2 ANNUAL REPORTING REQUIREMENTS

Regulation

(a) Audited financial statements. Each insured depository institution shall prepare annual financial statements in accordance with generally accepted accounting principles which shall be audited by an independent public accountant.

Guidelines

5. Annual Financial Statements. Each institution should prepare comparative annual consolidated financial statements (balance sheets, statements of income, changes in equity capital, and cash flows, with accompanying footnote disclosures) in accordance with generally accepted accounting principles (GAAP) for each of its two most recent fiscal years. Statements for the earlier year may be presented on an unaudited basis if the institution was not subject to this part for that year and audited statements were not prepared.

Regulation	Guidelines	Commentary
	6. Holding Company Statements. Subsidiary institutions may file copies of their holding company's audited financial statements filed with the Securities and Exchange Commission (SEC) or prepared for their FR Y-6 Annual Report under the Bank Holding Company Act of 1956.	
	7. Insured Branches of Foreign Banks. An insured branch of a foreign bank should satisfy the financial statements requirement by filing one of the following for the two preceding fiscal years: (a) Audited balance sheets, disclosing information about financial instruments with off-balance-sheet risk; (b) Schedules RAL and L of Form FFIEC 002, prepared and audited on the basis of the instructions for its preparation; or (c) With written approval of the appropriate federal banking agency, consolidated financial statements of the parent bank.	● The guidelines permit insured branches of foreign banks to satisfy the requirement with (a) a balance sheet prepared in conformity with United States GAAP; (b) a schedule prepared on another comprehensive basis of accounting defined in the Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports on Condition and Income (Call Reports) or Thrift Financial Reports (TFRs) instructions; or (c) the parent bank's consolidated financial statements, which may be prepared on a basis other than United States generally accepted accounting principles (GAAP).
(b) Management report. Each insured depository institution annually shall prepare, as of the end of the institution's most recent fiscal year, a management report signed by its chief executive officer and chief accounting or chief financial officer which contains: *(1) A statement of management's responsibilities for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with laws and regulations relating to safety and soundness which are designated by the FDIC and the appropriate federal banking agency; and* *(2) Assessments by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year and the institution's compliance with such laws and regulations during such fiscal year.*	8. Management Report. Management should perform its own investigation and review of the effectiveness of internal controls and compliance with Designated Laws defined in guideline 12. Management also should maintain records of its determinations and assessments until the next federal safety and soundness examination, or such later date as specified by the FDIC or appropriate federal banking agency Management should provide in its assessment of the effectiveness of internal controls and compliance with the Designated Laws, or supplementally, sufficient information to enable the accountant to report on its assertions. The management report of an insured branch of a foreign bank should be signed by the branch's managing official if the branch does not have a chief executive or financial officer	● The Statement on Standards for Attestation Engagements (SSAE) No. 2 (AT section 400) states "an entity's internal control structure over financial reporting includes those policies and procedures that pertain to an entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in either annual financial statements or interim financial statements, or both" (paragraph 2 [AT section 400.02]). Accordingly, management's assertion and the independent accountant's report should relate to the assertions embodied in the annual financial statements required by 12 CFR § 363.2(a). The federal banking agencies have not issued guidance about whether Call Reports or TFRs fall within the scope of management's assertion and the independent accountant's report. Call Reports and TFRs are not included in the annual report required by 12 CFR § 363.4(1). However, the FDIC staff has stated that management's assertion will be expected to address call reporting. ● Guideline 8 supports the concept in the exposure draft of the proposed SSAE, *Compliance Attestation,* issued by the AICPA's Auditing Standards Board on April 7, 1993, that management's assertion be specific enough to be capable of evaluation.

Regulation	Guidelines	Commentary
		● There are projects underway at various banking industry associations to provide guidance on management reporting.
	9. Safeguarding of Assets The FDIC believes "safeguarding of assets," as the term relates to internal controls policies and procedures regarding financial reporting, and which has precedent in accounting literature, should be addressed in the management report and the independent public accountant's attestation discussed in guideline 18 It also believes that testing the existence of and compliance with internal controls on the management of assets, including loan underwriting and documentation, represents a reasonable implementation of section 36. Management should therefore address such internal controls as part of its management report, and the accountant should test compliance with them. Recognizing the lack of objective criteria against which the accountant may judge safeguarding of assets, however, the FDIC does not require the accountant to attest to the adequacy of safeguards, but only to determine whether safeguarding policies exist, and whether management has implemented them.[1]	● SSAE No. 2 (AT section 400) addresses "safeguarding of assets" as required by Guideline 9.* Management's assertion about, and the independent accountant's tests of, financial reporting controls will consider "safeguarding of assets" policies and procedures accordingly The independent accountant's tests of controls over financial reporting of loans, for example, should include tests of whether the institution is executing transactions in accordance with management's policies for loan underwriting and loan documentation Such procedures might include, for example, comparing approvals for loan transactions to management's written policy to ascertain whether the loan was apHproved by an officer or committee consistent with the authority limits specified for that officer or committee in the policy. Therefore, such policies and procedures are implicit in management's assertion and the independent accountant's opinion. However, management's assertion and the independent accountant's opinion could explicitly refer to safeguarding of assets, to emphasize that the scope of management's assertion and the attestation report is consistent with, and limited to, safeguarding of assets in the context discussed in paragraph 27 of SSAE No. 2 (AT section 400.27). Further guidance on such report language is needed.

[1] It is management's responsibility to establish underwriting policies and to make credit decisions. The auditor's role is to test compliance with management's policies.

* Specifically, paragraph 27 of SSAE No. 2 (AT section 400.27) states:

> In the context of an entity's internal control structure, safeguarding of assets refers only to protection against loss from errors and irregularities in the processing of transactions and the handling of related assets. It does not include, for example, loss of assets arising from management's operating decisions, such as selling a product that proves to be unprofitable, incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory, authorizing what proves to be unproductive research or ineffective advertising, or accepting some level of merchandise pilferage by customers as part of operating a retail business.

See also Appendix D of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319.69).

Regulation	*Guidelines*	*Commentary*
		If the scope of management's assertion with respect to safeguarding of assets goes beyond the context discussed in paragraph 27 of SSAE No. 2 (AT section 400.27), management should explicitly describe the scope of its assertion and further guidance would be needed for reporting by the independent accountant.
	10. Standards for Internal Controls. Each institution should determine its own standards for establishing, maintaining and assessing the effectiveness of its internal controls.[2]	● SSAE No. 2 (AT section 400.27) establishes conditions for the acceptance of engagements to examine and attest to management assertions about financial reporting controls. One condition is that management evaluate the effectiveness of the institution's financial reporting controls using reasonable criteria for effective internal control structures established by a recognized body. Criteria issued by the AICPA, regulatory agencies, or other bodies that comprise experts who follow due procedures, including procedures for the broad distribution of proposed criteria for public comment, usually should be considered reasonable criteria for this purpose. For example, the report *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission provides reasonable criteria. The Auditing Standards Board has a project under way to conform SAS No. 55 (AU section 319) to the COSO report. SAS No. 30, *Reporting on Internal Accounting Control,* has been superseded by SSAE No. 2 (AT section 400).

[2] In considering what information is needed on safeguarding of assets and standards for internal controls, management may review guidelines provided by its primary federal regulator; the Federal Financial Institutions Examination Council's "Supervisory Policy Statement on Securities Activities"; the FDIC's "Statement of Policy Providing Guidance on External Auditing Procedures for State Nonmember Banks" (Jan. 16, 1990), "Statement of Policy Regarding Independent External Auditing Programs of State Nonmember Banks" (Nov. 16, 1988), and Division of Supervision Manual of Examination Policies; the Federal Reserve Board's Commercial Bank Examination Manual and other relevant regulations; the Office of Thrift Supervision's Thrift Activities Handbook; the Comptroller of the Currency's Handbook for National Bank Examiners; standards published by professional accounting organizations, such as the American Institute of Certified Public Accountant's (AICPA) Statement on Auditing Standards No. 30, "Reporting on Internal Accounting Control"; and other internal control standards published by the AICPA, other accounting or auditing professional associations, and financial institution trade associations.

Regulation	*Guidelines*	*Commentary*
	11. Service Organizations Although service organizations should be considered in determining if internal controls are adequate, an institution's independent public accountant, its management, and its audit committee should exercise independent judgment concerning that determination. On-site reviews of service organizations may not be necessary to prepare the reports required by the Rule, and the FDIC does not intend that the Rule establish any such requirement.	● SAS No 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324),which provides guidance to independent accountants of a service organization on issuing a report on certain aspects of the service organization's internal control structure that can be used by other independent accountants, also provides guidance on how other independent accountants should use such reports. Further, paragraphs 84-87 of SSAE No. 2 (AT section 400.84—.87) discuss the relationship of the practitioner's examination of an entity's internal control structure to the opinion obtained in an audit of financial statements.
	12. Compliance with Laws and Regulations. The designated laws and regulations are the federal laws and regulations concerning loans to insiders and the federal and state laws and regulations concerning dividend restrictions, which are more specifically identified in Section I of the Agreed Upon Procedures referred to in guideline 19	

Regulation	Guidelines	Commentary

§ 363.3 INDEPENDENT PUBLIC ACCOUNTANT

(a) Annual audit of financial statements. Each insured depository institution shall engage an independent public accountant to audit and report on its annual financial statements in accordance with generally accepted auditing standards and section 37 of the Federal Deposit Insurance Act (12 U.S.C. 1831n). The scope of the audit engagement shall be sufficient to permit such accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles.

13. General Qualifications. To provide audit and attest services to insured depository institutions, an independent public accountant should be registered or licensed to practice as a public accountant, and be in good standing, under the laws of the state or other political subdivision of the United States in which the home office of the institution (or the insured branch of a foreign bank) is located. As required by section 36(g)(3)(A)(i), the accountant must agree to provide copies of any workpapers, policies, and procedures relating to services performed under this part.

● If the independent public accountant is a firm, the firm and the signing partner should meet qualification criteria.

● Practitioners should consult the AICPA Auditing Standards Division's *Notice to Practitioners* (reproduced as Appendix C (paragraph .54) to this document) for further guidance on complying with requests for access to workpapers.

With respect to requests for access, the independent accountant should consider asking that the regulators' request be in writing (as discussed in the *Notice to Practitioners*) and specify the documents sought and the reason for requesting access. The independent accountant should also consider asking that the request be signed by the highest official responsible for examinations at a state banking regulatory agency or the regional office of a federal regulatory agency. Further, the independent accountant should consider asking that the request acknowledge that the agency requesting access will keep any information obtained from the documents confidential. Agencies with access should be permitted to disclose such information if it is to be used as evidence in a formal proceeding brought by, or on behalf of, the agency against the client or the independent accountant, but only after the independent accountant and the client have received reasonable notice of the proposed disclosure and the opportunity to apply for an effective protective order.

14. Independence. The independent public accountant also should be in compliance with the AICPA's *Code of Professional Conduct* and meet the independence requirements and interpretations of the SEC and its staff.

● Under Guideline 14, independent accountants not currently subject to the Securities and Exchange Commission's (SEC's) independence requirements must meet those requirements.

15. Peer Reviews. As required by section 36(g) (3)(A)(ii), the independent public accountant must have received, or be enrolled in, a peer review that meets acceptable guidelines. The following peer review guidelines are acceptable:

(a) The external peer review should be conducted by an organization independent of the accountant or firm being reviewed, as frequently as is consistent with professional accounting practices;

(b) The peer review should be gener-

● Guideline 15 acknowledges that certain firms—for example, those that have been recently formed—may be enrolled in a practice monitoring program but may not have yet received a review. It also recognizes that certain firms may not have previously performed audits of depository institution financial statements.

● Current practice, as referred to by Guideline 15(a), requires a review once every three years.

● Guidance on making workpapers available to the FDIC in a form consistent with the SEC's agreement, as

Regulation	Guidelines	Commentary
	ally consistent with AICPA standards;[3] and (c) The review should include, if available, at least one audit of an insured depository institution or consolidated financial holding company. Peer review working papers are to be retained for 120 days after the peer review report is filed with the FDIC, and be made available to the FDIC upon request, in a form consistent with the SEC's agreement with the accounting profession.	referred to by Guideline 15(c), is available from the AICPA's Quality Review Division to independent accountants who receive such a request from the FDIC. ● Based on footnote 3 to Guideline 15, membership in the AICPA's Division for CPA Firms' SEC Practice Section or Private Companies Practice Section or enrollment in the AICPA Quality Review Program should satisfy the requirement.
	16. <u>Filing Peer Review Reports.</u> Within 15 days of receiving notification that the peer review has been accepted, or before commencing any audit under this part, whichever is earlier, two copies of the peer review report, accompanied by any letter of comments and letter of response, should be filed by the independent public accountant with the FDIC, Registration and Disclosure Section, 550 17th Street, NW, Washington, DC 20429, where they will be available for public inspection. Accountants may elect to file an annual list of their insured depository institution and holding company (identifying any subsidiary institutions subject to this part) audit clients in lieu of copies of peer review reports for each institution they have been engaged to audit. The FDIC has determined that such client lists are exempt from public disclosure. All corrective action required under any qualified peer review report should have been taken prior to commencing services under this part.	● Consistent with Guideline 15, a firm that is enrolled in a practice monitoring program, but has not yet received a report, would not be required to file a report before commencing an engagement under the rule. Independent accountants who are not currently undergoing a review in 1993 may wish to consider filing their most recent report with the FDIC now.

[3] These would include Standards for Performing and Reporting on Peer Reviews, codified in the *SEC Practice Section Reference Manual;* Standards for Performing and Reporting on Quality Reviews (QR section 100); or Standards for Performing and Reporting on Peer Reviews, of the AICPA's Private Companies Practice Section.

Regulation	*Guidelines*	*Commentary*
	17. Information to Independent Public Accountant. Attention is directed to section 36(h) which requires institutions to provide specified information to their accountants. An institution also should provide its accountant with copies of any notice that the institution's capital category is being changed or reclassified under section 38 of the correspondence from the FDI Act, and any appropriate federal banking agency concerning compliance with this part	● Section 36(h) referred to by Guideline 17 requires an institution to generally provide its independent accountant with copies of the following: —The institution's most recent Call Report (or TFR) and report of examination —Any supervisory memorandum of understanding and any written agreement between the institution and any federal or state banking agency —A report of any action initiated or taken by federal or state banking agencies —A report of any assessment of any civil money penalty under any other provision of law with respect to the institution or any institution-affiliated party.
(b) Additional reports. Such independent public accountant shall examine, attest to, and report separately on, the assertions of management concerning the institution's internal control structure and procedures for financial reporting. The accountant shall apply procedures agreed upon by the FDIC objectively to determine compliance by an insured depository institution with designated laws and regulations. The attestations shall be made in accordance with generally accepted standards for attestation engagements.	18. Attestation Reports. The independent public accountant should provide the institution with an internal controls attestation report, a compliance with Designated Laws attestation report, and any management letter, at the conclusion of the audit as required by section 36(c)(1). If a holding company subsidiary relies on its holding company management report, the accountant may attest to and report on the management's assertions in one report, without reporting separately on each subsidiary covered by this part. One attestation report for compliance with the Designated Laws also may be filed, if all exceptions are listed and the respective institutions to which the exceptions apply are identified. The FDIC has determined that management letters and the Designated Laws attestation report are exempt from public disclosure.	● Practitioners should consult SSAE No. 2 (AT section 400), and the final SSAE on compliance attestation that is expected to be issued by the AICPA by year-end 1993, for guidance on reporting that involves multiple locations. ● The independent accountant's compliance attestation report and any management letter will not be publicly available.

Regulation	Guidelines	Commentary
	19 <u>Procedures for Determining Compliance with Designated Laws</u> In order to permit the independent public accountant to determine the extent of compliance with the Designated Laws defined in guideline 12 and the related assessment by management, the procedures set forth in schedule A (the Agreed Upon Procedures) to these Guidelines should be applied The accountant should require all management representations to be in writing, and take appropriate steps to determine that any sampling is reasonably representative. Attestation reports generally should identify all findings from application of the Agreed Upon Procedures which establish any items of non-compliance, note any absence of written policies, and disclose the reasons why any Agreed Upon Procedures were not performed.	● Although Guideline 19 refers to a determination about compliance with laws and regulations, the independent accountant will make no such determination. Rather, the independent accountant will report procedures performed and findings. The FDIC and other regulatory agencies will have to consider the procedures and findings in making their own determination about compliance. ● The AICPA's SSAEs provide guidance on reporting findings, and scope limitations
	20 <u>Reviews with Audit Committee and Management</u> The independent public accountant should meet with the institution's audit committee to review the accountant's reports required by this part before they are filed. It also may be appropriate for the accountant to review its findings with the institution's board of directors and management	
(c) <u>Notice by accountant of termination of services.</u> An independent public accountant performing an audit under this part who ceases to be the accountant for an insured depository institution shall notify the FDIC and the appropriate federal banking agency in writing of such termination within 15 days after the occurrence of such event, and set forth in reasonable detail the reasons for such termination.	21. <u>Notice of Termination.</u> The notice required by § 363.3(c) should state whether the independent accountant agrees with the assertions contained in any notice filed by the institution under § 363.4(d), and whether the institution's notice discloses all relevant reasons	

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22. Reliance on Internal Auditors. Nothing in this part or this appendix is intended to preclude the ability of the independent public accountant to rely on the work of an institution's internal auditor.

- The extent to which the independent accountant may consider the work of internal auditors in a financial statement audit is addressed in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AU section 322). SSAE No. 2 (AT section 400) refers the accountant to SAS No. 65 (AU section 322) when addressing the competence and objectivity of internal auditors; the nature, timing, and extent of work to be performed; and other related matters in an examination-level attestation engagement (such as a report on the examination of management's assertion about financial reporting controls). With respect to the compliance attestation engagement, the Auditing Standards Board, at its December 1992 meeting, concluded that the external auditor may not use the internal auditor for direct assistance in an agreed-upon procedures engagement to satisfy the FDICIA requirement. As discussed in appendix B (paragraph 53), guidance is needed for reporting on procedures performed on internal auditors' workpapers.

§ 363.4 FILING AND NOTICE REQUIREMENTS

(a) Annual reporting. Within 90 days after the end of its fiscal year, each insured depository institution shall file with each of the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor, two copies of:

(1) An annual report containing audited annual financial statements, the independent public accountant's report thereon, management's statements and assessments, and the independent public accountant's attestation report concerning the institution's internal control structure and procedures for financial reporting as required by § 363.2(a) and 363.3(a), and 363.3(b) respectively; and

(2) the accountant's attestation concerning compliance with laws and regulations pursuant to § 363.3(b).

23. Place for Filing. Except for peer review reports filed pursuant to Guideline 16, all reports and notices required by, and other communications or requests made pursuant to, this part should be filed as follows:

(a) FDIC: Regional Director (Supervision) of the FDIC Regional Office in which the institution is headquartered;

(b) Office of the Comptroller of the Currency (OCC): appropriate OCC Supervisory Office;

(c) Federal Reserve: appropriate Federal Reserve Bank;

(d) Office of Thrift Supervision (OTS): appropriate OTS District Office; and

(e) State bank supervisor: the filing office of the appropriate state bank supervisor.

Regulation	*Guidelines*	*Commentary*
	24 Relief from Filing Deadlines Although the FDIC believes that the deadlines for filings and other notices established by section 36 and this part are reasonable, it recognizes some institutions occasionally may be confronted with extraordinary circumstances beyond their reasonable control that may justify extensions of a deadline In that event, upon written application from an insured depository institution, setting forth the reasons for any requested extension, the FDIC or appropriate federal banking agency may, for good cause shown, extend the deadline for a period not to exceed 30 days.	
(b) Public availability. The foregoing annual report in paragraph (a) of this section shall be available for public inspection.	25 Public availability Each institution's annual report should be available for public inspection at its main branch offices no later than 15 days after it is filed with the FDIC Alternatively, an institution may elect to mail one copy of its annual report to any person who requests it. The annual report should remain available to the public until the annual report for the next year is available. An institution may use its annual report under this part to meet the annual disclosure statement required by 12 CFR 350.3, if the institution satisfies all other requirements of 12 CFR part 350	● The publicly available annual report contains the independent accountant's audit report on financial statements and attestation report on management's assertion about financial reporting controls. The independent accountant's agreed-upon procedures report is not to be included in the annual report and is not publicly available.
(c) Independent accountant's reports Each insured depository institution shall file with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor, a copy of any management letter, qualification, or other report issued by its independent public accountant with respect to such institution and the services provided by such accountant pursuant to this part within 15 days after receipt	26. Independent Public Accountant's Report Section 36(h)(2)(A) requires that, within 15 days of receipt by an institution of any management letter or other report, such letter or other report shall be filed with the FDIC, any appropriate federal banking agency and any appropriate state bank supervisor. Institutions and their accountants are encouraged to coordinate preparation and delivery of audit and attestation reports and filing the annual report, to avoid duplicate filings.	● Note that management must file, within fifteen days of receipt, reports of the independent accountant, even if they will be filed later with the annual report discussed in Guidelines 23 and 25. For example, if management receives a letter communicating internal control structure matters noted in the interim fieldwork for a subject finanDHcial statement audit, that report should be filed when received. SAS No. 1, *Codification of Auditing Standards and Procedures* (AU section 530), provides guidance on dating of the independent auditor's report on financial statements. When providing final reports, practitioners may wish to include a transmittal letter, which will help document when the report was sent to the institution. ● The law, implementing regulations, and guidelines do not eliminate the independent accountant's responsibility under generally accepted auditing standards (GAAS) for communicating internal control structure related matters noted in a financial statement audit.

Regulation	Guidelines	*Commentary*
		● "Other report" refers to the reports required by 12 CFR § 363.
(d) Notice of engagement or change of accountants. Each insured depository institution shall provide, within 15 days after the occurrence of any such event, written notice to the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor of the engagement of an independent public accountant, or the resignation or dismissal of the independent public accountant previously engaged. The notice shall include a statement of the reasons for any such event in reasonable detail.	27. Notices Concerning Accountants. Institutions should review and satisfy themselves as to compliance with the required qualifications set forth in guidelines 13-15 before engaging an independent public accountant. With respect to any selection, change or termination of an accountant, institutions should be familiar with the notice requirements in guideline 21, and should send a copy of any notice under § 363.4(d) to the accountant when it is filed with the FDIC. An institution which files reports with its appropriate federal banking agency under, or is a subsidiary of a holding company which files reports with the SEC pursuant to, the Securities Exchange Act of 1934 may use its current report (e.g. SEC Form 8-K) concerning a change in accountant to satisfy the similar notice requirements of this part.	● The current report filed with regulators (that is, Form F-3 for the FDIC and SEC Form 8-K for others) includes the independent accountant's response to management's disclosures. However, it may not include all matters required to be reported under 12 CFR § 363.3(c) and Guideline 21.
§ 363.5 AUDIT COMMITTEES *(a) Composition and duties. Each insured depository institution shall establish an independent audit committee of its board of directors, the members of which shall be outside directors who are independent of management of the institution, and the duties of which shall include reviewing with management and the independent public accountant the basis for the reports issued under this part.*	28. Composition. The board of directors of each institution should determine if outside directors meet the requirements of section 36 and this part. At least annually, it should determine whether all existing and potential audit committee members are "independent of management of the institution." If the institution has total assets in excess of $3 billion, the board also should determine whether members of the committee satisfy the additional requirements of this part. Because an insured branch of a foreign bank does not have a separate board of directors, the FDIC will not apply the audit committee requirements to such branch However, any such branch is encouraged to make a reasonable good faith effort to see that similar duties are performed by persons whose experience is generally consistent with the Rule's requirements for an institution the size of the insured branch. 29. "Independent of Management" Considerations. In determining whether an outside director is independent of management, the board should consider all relevant information. This would include considering whether the director: (a) Is or has been an officer or employee of the institution or its affiliates;	

Regulation	Guidelines	Commentary

(b) Serves or served as a consultant, advisor, promoter, underwriter, legal counsel, or trustee of or to the institution or its affiliates;

(c) Is a relative of an officer or other employee of the institution or its affiliates;

(d) Holds or controls a direct or indirect financial interest in the institution or its affiliates; and

(e) Has outstanding extension of credit from the institution or its affiliates.

30. Lack of Independence. An outside director should not be considered independent of management if such director is, or has been within the preceding year, an officer or employee of the institution or any affiliate, or owns or controls, or has owned or controlled with the preceding year, assets representing 10 percent or more of any outstanding class of voting securities of the institution.

31. Holding Company Audit Committees. Members of an independent audit committee of a holding company may serve as the audit committee of any subsidiary institution if they are otherwise independent of management of the subsidiary. This would not, however, permit officers or employees of the holding company to serve on the audit committee of its subsidiary institutions. The audit committee of the holding company may perform all the duties of the audit committee of a subsidiary institution, even though such holding company directors are not directors of the institution.

32. Duties. The audit committee should perform all duties determined by the institution's board of directors. The duties should be appropriate to the size of the institution and the complexity of its operations, and include reviewing with management and the independent public accountant the basis for the reports issued under § 363.2(b). Appropriate additional duties could include:

(a) Reviewing with management and the independent public accountant the scope of services required by the audit, significant accounting policies, and audit conclusions regarding significant accounting estimates;

Regulation	Guidelines	Commentary
	(b) Reviewing with management and the accountant their assessments of the adequacy of internal controls, and the resolution of identified material weaknesses and reportable conditions in internal controls, including the prevention or detection of management override or compromise of the internal control system;	
	(c) Reviewing with management and the accountant the institution's compliance with laws and regulations;	
	(d) Discussing with management the selection and termination of the accountant and any significant disagreements between the accountant and management; and	
	(e) Overseeing the internal audit function. It is recommended that audit committees maintain minutes and other relevant records of their meetings and decisions.	
(b) Committees of large institutions. The audit committee of any insured depository institution that has total assets of more than $3 billion, measured as of the beginning of each fiscal year, shall include members with banking or related financial management expertise, have access to its own outside counsel, and not include any large customers of the institution.	33. Banking or Related Financial Management Expertise. At least two members of the audit committee of a large institution shall have "banking or related financial management expertise" as required by section 36(g)(1)(C)(i). This determination is to be made by the board of directors of the insured depository institution. A person will be considered to have such required expertise if the person has significant executive, professional, educational, or regulatory experience in financial, auditing, accounting, or banking matters as determined by the board of directors. Significant experience as an officer or member of the board of directors or audit committee of a financial services company would satisfy these criteria.	
	34. Large Customers. Any individual or entity (including a controlling person of any such entity) which, in the determination of the board of directors, has such significant direct or indirect credit or other relationships with the institution, the termination of which likely would materially and adversely affect the institution's financial condition or results of operations, should be considered a "large customer" for purposes of § 363.5(b).	

Regulation	*Guidelines*	*Commentary*

35 Access to Counsel. The audit committee should be able to retain counsel at its discretion without prior permission of the institution's board of directors or its management. Section 36 does not preclude advice from the institution's internal counsel or regular outside counsel It also does not require retaining or consulting counsel, but if the committee elects to do either, it also may elect to consider issues affecting the counsel's independence. Such issues would include whether to retain or consult only counsel not concurrently representing the institution or any affiliate, and whether to place limitations on any counsel representing the institution concerning matters in which such counsel previously participated personally and substantially as outside counsel to the committee.

36. Forming and Restructuring Audit Committees. Audit committees should be formed within four months of the effective date of this part. Some institutions may have to restructure existing audit committees to comply with this part. No regulatory action will be taken if institutions restructure their audit committees by the earlier of their next annual meeting of stockholders, or one year from the effective date of this part.

37. Modifications of Guidelines. The FDIC Board of Directors has delegated to the Director of the FDIC's Division of Supervision authority to make and publish in the *Federal Register* minor technical amendments to the Guidelines (including the attached Agreed Upon Procedures in schedule A to this appendix), in consultation with the other appropriate federal banking agencies, to reflect the implementation of this part. It is not anticipated any such modification would be effective until affected institutions have been given reasonable advance notice of the modification Any material modification or amendment will be subject to review and approval of the FDIC Board of Directors

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Appendix B

Agreed-Upon Procedures

Reprinted in the following are the agreed-upon procedures to be performed by the independent accountant in relation to management's assertion about compliance with dividend restriction and insider loan laws and regulations.[1] The resulting report will not be publicly available (see guideline 18 in appendix A [paragraph .52]). The AICPA staff commentary on the procedures is provided in the fully italicized paragraphs.

Section I—Procedures for Individual Institutions

The following information should be obtained, and the indicated procedures should be performed, by the institution's independent public accountant in accordance with generally accepted standards for attestation engagements, or by the institution's internal auditor if the procedures set forth in section II of this schedule are to be performed by the accountant.

Commentary: On April 7, 1993, the Auditing Standards Board published an exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE), Compliance Attestation. *That statement would provide additional guidance on such agreed-upon procedures level attestation engagements. Comments on the exposure draft were due by June 30, 1993. A final statement is expected to be issued by year-end 1993.*

Commentary: The following sample sizes have not been objected to by the FDIC, the OCC, or the OTS for purposes of applying those procedures that require sampling:

Population Number (N)	*Sample size*
100 or greater	60
50 to 100	25
0 to 50	N or 20, whichever is smaller

A. Loans to Insiders

1. *Designated Laws.* The following laws and regulations (Designated Insider Laws) should be read:

(a) The laws codified at 12 U.S.C. 375, 375a, 375b, 376, 1468(b), 1828(j)(2), 1828(j)(3)(B), 1817(k), and 1972; and

(b) The regulations set forth at 12 CFR 23.5, part 31, 211.3(b)(4), part 215, 337.3, 349.3, 563.43, and 935.2.

2. *Information and Procedures.* Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

a. *General Information.* Obtain management's assessment of compliance with the Designated Insider Laws; all minutes (including minutes drafted, but not approved) of the meetings of the board and its committees; reports of examinations, supervisory agreements, and enforcement actions issued by the institution's primary federal and state regulators, if applicable; all public documents filed under the Securities and Exchange Act of 1934 with the FDIC, SEC, Federal Reserve Board, OCC, or OTS and annual reports filed by insiders identifying their related interest as required by 12 CFR 215.7.

Procedure:

(i) Read the foregoing information.

[1] Reprinted from Appendix A to 12 CFR Part 363. See *Federal Register,* June 2, 1993.

(ii) Trace and agree each disclosed insider loan and other extension of credit to see that it is included on the list of Insider Transactions.

b. *Calculations.* Obtain management's calculation of the greater of 5 percent of the institution's year-end capital and unimpaired surplus or $25,000.

Procedure: Recalculate for mathematical accuracy, and trace amounts used in management's calculations to the institution's year-end Call Report or TFR.

c. *Policies and Procedures.* Obtain the institution's written policies and procedures concerning its compliance with the Designated Insider Laws, including any written "Code of Ethics" or "Conflict of Interest" policy statements. If the institution has no written policies and procedures, obtain a narrative from management that describes the methods for complying with such laws, and includes provisions similar to those listed below.

Procedure: Ascertain that the policies and procedures include, or incorporate by reference, provisions consistent with the Designated Insider Laws for:

(i) Defining terms;

(ii) Prohibiting and restricting loans to insiders (i.e., directors, executive officers, and principal shareholders and their related interests);

(iii) Maintaining records of loans to insiders;

(iv) Requiring reports and disclosures by the institution and by executive officers, directors, and principal shareholders;

(v) Disseminating policy information;

(vi) Revising policies to reflect subsequent changes in the law;

(vii) Educating employees about the legal requirements and management's related policies and procedures;

(viii) Prior approval of the board of directors or its committees, as appropriate; and

(ix) Reporting insider loans to regulatory agencies on the institution's Call Report or TFR.

d. *Insider Transactions.* Obtain a list of loans or other extensions of credit to insiders (including their related interests) during the fiscal year and management's written representations regarding—

(i) The completeness of the list, and

(ii) Whether the terms of insider transactions are comparable to those that would have been available to unaffiliated third parties.

Procedure: Select a sample of the insider transactions from the list. For each transaction in the sample selected:

(1) Ascertain that each executive officer and principal shareholder (or related interest) has reported annually to the board of directors, on or before January 31 of the following year, any indebtedness to correspondent banks, and that such report states:

(a) The maximum amount of indebtedness during the previous calendar year;

(b) The amount of indebtedness outstanding 10 days prior to report filing; and

(c) A description of the loan terms and conditions, including the rate or range of interest rates, original amount and date, maturity date, payment terms, security, and any unusual terms or conditions.

(2)(a) Trace and agree amounts outstanding by insiders to the schedule aggregating indebtedness of all insiders on the institution's year-end Call Report or TFR;

(b) Obtain from management documentation that indicates whether the specific extensions of credit, at the option of the institution, will become due and payable at any time that the insider is indebted to any other insured institution in an aggregate amount greater than the amount specified for a category of credit in 12 CFR 215.5(c);

(c) Obtain from management a copy of the institution's written notification to the insider to ascertain whether the insider has been informed of the reporting requirements relative to insider transactions and has acknowledged such requirements;

(d) If the credit exceeds the lesser of the calculation obtained in paragraph 2b. or $500,000, read the minutes of the meetings of the board of directors and determine whether the minutes indicate that the credit was approved in advance by the board and the insider abstained from participating directly or indirectly in voting on the transactions; and

(e) Obtain management's calculated legal lending limit for the credit and ascertain whether the amount of the credit exceeds such limit.

(3) For executive officers, directors, and principal shareholders of the institution included in the sample, obtain a written history of the insider's overdrafts for the year and obtain management's representation whether that history is complete. In addition,

(a) Inquire whether cash items for the individual are being held by the institution to prevent an overdraft, and

(b) Trace and agree subsequent payment by the insider of the insider's overdrafts to records of the account at the institution.

(4) For overdrafts of executive officers and directors included in the sample that are being paid by the institution for the executive officer and director on an account at the institution:

(a) Trace and agree to a written, pre-authorized, interest-bearing extension of credit plan that specifies a method of repayment; or,

(b) Trace and agree to a written, pre-authorized transfer of funds from another account of the insider at the institution; or,

(c) For aggregate amounts of $1,000 or less, obtain a written representation from management that:

(i) It believes the overdraft was inadvertent,

(ii) The account was overdrawn in each case for less than 5 business days, and

(iii) The institution charged the executive officer and director the same fee that it would charge any other customer in similar circumstances.

(5) For extensions of credit to an executive officer selected, ascertain that each credit was:

(a) Preceded by a submission of a financial statement;

(b) Promptly reported to the board of directors; and

(c) Made subject to the condition, as specified in the note or other evidence of indebtedness, that the extension of credit will become, at the option of the institution, due and payable at any time that the executive officer is indebted to other insured institutions in an aggregate amount greater than the executive officer would be able to borrow from the institution.

(6) Based on the types of transactions in the sample selected, select a sample of similar transactions with persons who are not insiders of the institution or its affiliates as of the same dates or within two weeks of the

insider transaction. Compare the terms of the transactions with the persons not affiliated with the institution to those with insiders, and note in the findings any material differences in the terms favorable to insiders compared to the terms of the transactions with persons not affiliated with the institution or its affiliates.

> ***Commentary:*** *The independent accountant's selection of "similar" transactions and comparison of terms should only relate to objectively measurable characteristics of the loan (for example, the stated interest rate, or the type of loan).*

(7) Aggregate the indebtedness to executive officers, directors, and principal shareholders of the institution and to their related interests from the list obtained as of the end of the fiscal year and one other day selected during the year. Compare this total with 100 percent of the institution's unimpaired capital and surplus at the one day selected during the year and the end of its fiscal year. (The unimpaired capital and surplus calculated from the most recent Call Report or TFR may be used, unless there is reason to believe that a significant change has taken place between the dates.) Report any excess as an exception in the findings.

> ***Commentary:*** *The independent accountant should state his or her objective criterion for "significant change" if applicable.*

e. *Executive Officers' Reports.* Obtain a list of all written reports made by executive officers of the institution concerning debt with other insured institutions, and management's representation concerning the completeness of such list.

Procedure: Select a sample of written reports. For reports selected, note any reported aggregate extensions of credit in excess of the amounts management represents the executive officer would have been able to borrow from the reporting institution and whether the report was made within 10 days of the date the indebtedness reached such a level.

> ***Commentary:*** *The preceding procedures relate to the insider's debt at other institutions. The procedures that follow relate to the insider's debt at the covered institution.*

Obtain management's calculation of:

(i) The aggregate amount of loans and other extensions or lines of credit to the executive officer and

(ii) 2.5 percent of the institution's capital and unimpaired surplus.

Recalculate management's computations for mathematical accuracy and trace amounts used in management's computations to the institution's Call Report or TFR. Ascertain whether the aggregate amount of the credits for the executive officer exceeds the greater of 2.5 percent of the institution's capital and unimpaired surplus or $25,000, but in no event more than $100,000, unless such credits are used to finance the education of the executive officer's children or the officer's principal residence. If the credit extended is a real estate loan, obtain documentation for the credit and note whether such documentation contains representations that:

(i) The purpose of the credit is for the purchase, construction, maintenance, or improvement of the executive officer's principal residence;

(ii) The credit is secured by a first lien on the residence; and

(iii) The executive officer owns or expects to own the residence after the extension of credit.

B. Dividend Restrictions

1. *Designated Laws.* The following federal laws and regulations (Designated Dividend Laws) should be read:

(a) The laws codified at 12 U.S.C. 56, 60, 1467(a)(f), 1831o; and

(b) The regulations set forth at 12 CFR 5.61, 5.62, 6.6, 7.6120, 208.19, and 563.134.

Commentary: The independent accountant should also read any state laws identified by management in its assertion.

2. *Information and Procedures.* Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

a. *Management's Assessment.* Obtain management's assessment of the institution's compliance with the Designated Dividend Laws and any applicable state laws and regulations cited in management's assessment. Also obtain management's written representation whether dividends declared comply with the legal limitations and any restrictions on dividend payments under any supervisory agreements, orders, or resolution of any regulatory agency (including a description of the nature of any such agreement, order, or resolution).

b. *Policies and Procedures.* Obtain in the institution's written policies and procedures concerning its compliance with the Designated Dividend Laws. If the institution has no written policies and procedures, obtain from the institution a narrative that describes the institution's methods for complying with Designated Dividend Laws, includes provisions similar to those below.

Procedure: Ascertain whether the policies and procedures include, or incorporate by reference, provisions which are consistent with the Designated Dividend Laws. For banks and savings institutions, these would include capital limitation tests, including section 38 of the FDI Act, earnings limitation tests, transfers from surplus to undivided profits, and restrictions imposed under any supervisory agreements, resolutions, or orders of any federal or state bank regulatory agency. For savings associations, include prior notification to the OTS.

c. *Board Minutes.* Obtain minutes of the meetings of the board of directors for the most recent fiscal year to ascertain whether dividends (either paid or unpaid) have been declared.

Procedure: Trace and agree total dividend amounts to the general ledger records and the institution's appropriate Call Reports or TFRs filed with regulators.

d. *Calculation.* Obtain management's computation of the amount at which declaration of a dividend would cause the institution to be undercapitalized.

Procedure: Recalculate management's computation (for mathematical accuracy) and compare management's calculations to the amount of any dividend declared to determine whether it exceeded the amount.

e. *National and State Member Banks.* Obtain management's computation concerning its compliance with 12 U.S.C. 56, "Capital Limitation Test," 12 U.S.C. 60, "The Earnings Limitation Test," and transfers from surplus to undivided profits after payment of the dividends referenced in subsection 2c. above.

Procedure: Recalculate management's computations (for mathematical accuracy) and compare management's calculations to the standards defined in the test set forth in subsection 2d. above to ascertain whether the dividends declared fall under the permissible level under this standard. If dividends are not permissible under such standard, ascertain if the dividends were declared under approval of the appropriate federal banking agency or any other exception. If not, report the exception in the findings.

f. *Savings Associations.* Obtain management's documentation of the OTS determination of whether the institution is a Tier 1, Tier 2, or Tier 3 savings institution and management's computation of its capital ratio after declaration of dividends under the Tier determined by the OTS. For dividends declared, obtain a copy of the savings institution's notification to the OTS to ascertain whether notification was made at least 30 days before payment of any dividends.

Procedure: Recalculate management's computation (for mathematical accuracy) and trace amounts used by management in its calculation to the institution's TFRs.

Section II—Procedures for Independent Public Accountant

If the internal auditor has performed the procedures set forth in section I, the following procedures may be performed by the independent public accountant if neither the FDIC nor the appropriate federal banking agency has objected in writing. If the procedures in section I have been performed by an internal auditor employed by a holding company, such procedures should be applied to each subsidiary institution (a Covered Subsidiary) subject to this part. The report of procedures performed and list of exceptions found by the internal auditor, identifying the institution with respect to which any exception was found, should be submitted to the audit committee of the board of directors.

A. Review of Designated Laws

The Designated Insider Laws and Designated Dividend Laws applicable to the institution should be read.

B. Information and Procedures

Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

1. *Designated Laws.* Read section I of this schedule. Obtain management's assessment contained in its management report on the institution's or holding company's compliance with the Designated Laws.

2. *Internal Auditor's Workpapers.* If an internal auditor performed the procedures in Section I, obtain the internal auditor's workpapers documenting the performance of those procedures on the institution, including all Covered Subsidiaries, and the chief internal auditor's written representation that:

(a) The internal auditor or audit staff, if applicable, performed the procedures listed in section I on the institution and each Covered Subsidiary;

(b) The internal auditor tested a sufficient number of transactions governed by the Designated Laws so that the testing was representative of the institution's or Covered Subsidiary's volume of transactions;

(c) The workpapers accurately reflect the work performed by the internal auditor and, if applicable, the internal audit staff;

(d) The workpapers obtained are complete; and

(e) The internal auditor's report, which describes the procedures performed for the preceding fiscal year as well as the internal auditor's findings and exceptions noted, has been presented to the institution's audit committee.

Procedure: Compare the workpapers to the procedures that are required to be performed under section I, and report as an exception any procedures not documented and any procedures for which the sample size is not sufficient.

> ***Commentary:*** *The independent accountant should compare sample sizes to those in the table at the beginning of section I of this appendix. A subjective determination about the sufficiency of sample sizes is beyond the scope of an agreed-upon procedures attestation engagement.*

Compare the exceptions and errors listed by the internal auditor in its report to the audit committee to those found in the workpapers, and report as an exception any exception or error found in the internal auditor's workpapers and not listed in the internal auditor's list of exceptions.

> ***Commentary:*** *The objective of this procedure is to ensure that any findings identified as such by internal auditors in their workpapers are also included in their report to the institution's audit committee.*

C. Testing by Independent Public Accountant

The accountant should perform the procedures listed in section I on a representative sample of the transactions of the institution and Covered Subsidiaries to which each of the Designated Laws applies. The sample tested at each institution, or Covered Subsidiary, should be at least 20 percent of the size of the sample tested by the internal auditor at such institution, although samples selected should be from the population at large.

> ***Commentary:*** *The independent accountant should consult any future guidance issued on reporting of procedures performed on internal auditors' workpapers. The independent accountant's sample should be selected from the population at large, not from the internal auditor's sample.*

If the testing is being performed on a holding company with more than one Covered Subsidiary, the sample tested for each Designated Law should include transactions from each such subsidiary at least every other fiscal year. If the holding company has more than eight Covered Subsidiaries, the sample of transactions tested for each Designated Law should include transactions from each such subsidiary at least every third fiscal year.

D. Reports Concerning Holding Companies

Only one report of any exceptions noted from application of the procedures in section II performed by the independent public accountant on all Covered Subsidiaries of a holding company should be filed as required by guideline 3, but the report should identify, for each exception or error noted, the identity of the Covered Subsidiary to which it relates.

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Appendix C

Guidance for Independent Auditors When Required to Provide Access to or Photocopies of Workpapers to Regulators[1]

[This Notice to Practitioners appeared in the July/August 1993 issue of the *CPA Letter*]

The AICPA AdHoc Task Force on Auditor Workpapers has developed guidance for independent auditors to consider when they are obligated by law, regulation, or audit contract to provide access to or photocopies of audit workpapers to a regulator. This guidance has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

The guidelines that follow were developed to assist auditors in fulfilling these obligations while also maintaining control over the workpapers. (The guidance does not apply to situations involving a request from the IRS, or firm practice-monitoring programs to comply with AICPA or state professional requirements, such as peer or quality reviews, or in response to a subpoena.)

Statement on Auditing Standards (SAS) No. 41, *Working Papers* (AU section 339), provides auditors guidance on the functions, nature, content, ownership and custody of working papers.[2] SAS No. 41 (AU section 339) observes that working papers are the property of the auditor. However, in some situations, auditors may be obligated to provide access to or photocopies of their workpapers to a regulator.

Providing Access to Workpapers

When the auditor is required by law, regulation, or audit contract to provide the regulator access to workpapers, the auditor should:

- Ensure that the client and the audit team are aware that the workpapers may be reviewed by regulators, and have the client acknowledge in the engagement letter that the workpapers are the property of the auditor but the regulator may be provided with access to workpapers, upon request in accordance with the law, regulation, or audit contract.

Sample language which may be included in the engagement letter follows:

> The working papers for this engagement are the property of [*name of firm*] and constitute confidential information. However, as required by [*law, regulation, or the terms of the audit contract*], we are required to make certain workpapers available to [*name of regulator*] upon request for their regulatory oversight purposes. Access to the requested workpapers will be provided to [*name of regulator*] under the supervision of [*name of firm*] audit personnel and at a location designated by our firm.

- Ensure that a request for access to workpapers by the regulator is in writing. The auditor should communicate specific details (such as date, time, and location) to the client of how access to the workpapers will be provided, and request the client acknowledge to the auditor in writing that the auditor is **required** to provide such access to the regulator. In the event the client does not comply with this request, the auditor may wish to consult his or her own legal counsel.

- Maintain control over the workpapers at all times. Unless expressly provided for by law, regulation, or audit contract, only workpapers related to specific requests should be made available.

[1] The term "regulator" includes federal, state, and local government officials with legal oversight authority over the entity being audited.

[2] SAS No. 41 (AU section 339) states that "working papers are records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the engagement. Examples of working papers are audit programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor."

Providing Photocopies of Workpapers

In addition to the above guidelines, when required by law, regulation, or contract to provide a regulator photocopies of workpapers, the auditor should—

- Provide copies of only those specific portions of workpapers that were requested, preferably only requests made during the course of an on-site review.
- Consider asking the client to review requested workpaper copies before they are submitted to the regulator.
- Ensure that control over copies of the workpapers is maintained by having all workpaper copies clearly labeled as confidential and by noting that secondary distribution of the workpapers is not permitted without the written approval of the auditor. Copies should be transmitted to the regulator with a cover letter requesting confidential treatment of information contained in the workpapers.

  Sample language for the cover letter follows:

  These workpapers are submitted as CONFIDENTIAL. Exemption from disclosure to nongovernmental parties of these documents and any copies of them is claimed under the Freedom of Information Act and all other applicable provisions of law and regulation. **Before** any disclosure is permitted of these documents, including any part or copies of them, please provide notice to [*insert name, address and telephone number of auditor or his or her representatives*].

Members should contact the AICPA's Auditing Standards Division at (212) 596-6036 with questions.

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AAM Section 8200

High-Technology Industry Developments—1995/96

Industry and Economic Developments

.01 The high-technology industry, though not precisely defined, is generally considered to include those companies employing scientific theories and applications to develop new products that significantly enhance productivity. High-technology companies are those involved in fields such as computer hardware and software, telecommunication activities, robotics, biotechnology, electronics, medical technology, and the like.

.02 The high-technology industry continues to be one of the fastest growing segments of the U.S. economy. Since the beginning of the bull market in 1990, the Standard & Poor's 500 stock index has shown an overall return of 112 percent. By comparison, an index for 100 high-technology companies showed a 300 percent gain over the same period. The increase in high-technology stock prices has generally been a function of the industry's rapid and sustained sales and earnings growth.

.03 Fueling this growth are the efforts by many businesses to maintain or increase their competitive edge through the implementation of the latest technological advances. Huge amounts of human and financial capital are being invested by businesses as they build technological infrastructures using computers and telecommunications equipment. And, even when businesses attempt to reduce costs by downsizing, high-technology companies still benefit since their products, which tend to enhance efficiency and increase productivity, are considered essential investments. Given such strong demand, analysts expect continued and substantial growth for the high-technology industry during 1995 and well beyond.

.04 The technology sector has virtually dominated the initial public offering (IPO) market during 1995. By midyear, over fifty technology IPOs were completed. Almost 90 percent of those were eventually trading above their offering prices. Expectations of industry growth are so high that one recent IPO of a small software company, with one product line and no profits to date, generated a market value of more than $2 billion. However, auditors should keep in mind that while many, if not most, high-technology companies are thriving, some do struggle—and others will fail. Accordingly, auditors should not assume that favorable industry trends guarantee that all high-technology ventures will be successful. Factors such as short product life cycles due to rapid obsolescence, global competition, "price war" strategies adopted to increase market share, ineffective marketing and management policies adopted by technically oriented entrepreneurs may work to offset, or negate, the effect of existing trends. The auditor's assessment of risk, while giving consideration to current trends, should be tempered by those unique factors directly affecting the entity being audited.

.05 Mergers and acquisitions have been prevalent within the high-technology industry during 1995 and perhaps most prominent in the computer software segment. Software companies have pursued business combinations in order to expand existing product lines, develop economies of scale, acquire new product lines, eliminate competition through acquisition, and so forth. And, although one celebrated acquisition attempted by a major software company was challenged by the U.S. Justice Department, analysts expect the trend of mergers and acquisitions to continue and to spread to other segments of the high-technology industry. Some of the significant business combination issues to which auditors should be alert are discussed in the "Audit Issues and Developments" section under "Allocation of Purchase Price in 'Purchase' Business Combinations" and in the "Accounting Issues and Developments" section under "Restructurings" of this Audit Risk Alert.

Industry Profile

.06 The high-technology industry consists of companies that range in size and age from small development stage enterprises (refer to Financial Accounting Standards Board [FASB] Statement No. 7, *Accounting and Reporting by Development Stage Enterprises* (AC De4], for relevant accounting guidance) to some of the largest corporations in the world. Development stage enterprises present auditors with unique risks. In developing an audit strategy, assessing risk, and designing substantive procedures, auditors should consider factors such as the entity's:

- Dependence on a limited product line or service.
- Dependence on a limited number of suppliers, customers, or financing sources.
- Credit arrangements imposing restrictive financial covenants or requirements to achieve "target" operating results.
- Related-party sales or purchase or leasing transactions.

See further discussion under "Control Environment" in the "Audit Issues and Developments" section of this Audit Risk Alert.

.07 The business environment of high-technology enterprises is highly competitive and often characterized by efforts to improve performance through research and development (R&D) to meet market demands for new products. Most high-technology enterprises are involved in R&D programs to keep pace with a rapidly changing technological environment. Auditors should consider the risks inherent in R&D as they assess overall audit risk. Authoritative guidance on accounting for R&D costs is set forth in FASB Statement No. 2, *Accounting for Research and Development Costs* (AC R50). FASB Statement No. 2 (AC R50) requires that R&D costs be charged to expense as incurred. Examples of activities that typically would be included in R&D are outlined in FASB Statement No. 2, paragraph 9 (AC R50.111). FASB Statement No. 2, paragraph 10 (AC R50.112), also cites examples of activities that typically would be excluded from R&D. Auditors of high-technology enterprises should be familiar with the requirements of FASB Statement No. 2 (AC R50) and should carefully consider the adequacy of evidential matter available to substantiate the amount and propriety of any deferred costs.

.08 Products introduced by high-technology enterprises are vulnerable to rapid obsolescence due to scientific advances and intense competitive pressures. As a result, concerns about economic obsolescence and asset impairment may present significant auditing and financial reporting issues for high-technology enterprises. Auditors should be aware that the recoverability of asset values is often a significant area of audit risk. Further, related discussions can be found in the "Audit Issues and Developments" section under "Inventory Obsolescence" and in the "Accounting Issues and Developments" section under "Impairment of Long-Lived Assets" of this Audit Risk Alert.

Legislative Developments

.09 Currently under consideration in Congress is a telecommunications deregulation bill that, if enacted, would radically transform many telephone companies by allowing them to move into new technology markets (for example, videoconferencing, cable television systems, etc.). This will likely increase competitive pressures and lower prices (and therefore revenues) in some segments of the high-technology industry. An increase in the level of merger and acquisition activities is also likely as larger telephone companies seek quick access into new high-technology markets. Auditors should consider the effects of such legislation, when finalized, on their high-technology clients.

Audit Issues and Developments

Revenue Recognition

.10 There have been a number of recent prominent audit failures related to the area of revenue recognition. Alleged inappropriate revenue recognition has become one of the major issues facing auditors in recent litigation. Entities in the high-technology industry have been particularly susceptible to revenue recognition problems. As such, auditors should be aware that the consideration of this area warrants special attention in the current year. Auditors should exercise professional skepticism in this area by being alert to possible warning signs such as—

- Material, unusual, or significant year end transactions.
- Past due accounts receivable.
- Sales subject to further performance by the selling entity, their customer, or a third party.

Some specific circumstances to consider are described in the following paragraphs.

.11 Products offered by high-technology enterprises are by their nature innovative and their performances frequently are unproven. Similarly, customers may have unjustified expectations of a product's capabilities. As a result, sales agreements entered into by such enterprises may include provisions for customer approval, cancellation options, return privileges, or price protection. FASB Statement No. 48, *Revenue Recognition When Right of Return Exists* (AC R75), provides accounting guidance that may be helpful in evaluating a high-technology enterprise's revenue recognition policies. In such circumstances, auditors should carefully evaluate the entity's revenue recognition policies and procedures. Auditors should obtain an understanding of contractual relationships with customers and pay particularly close attention to nonstandard clauses that may alter the economic substance of otherwise standard transactions.

.12 Auditors should also consider the possible existence of "side-agreements" that contain additional terms or conditions that may affect the timing of revenue recognition. The use of such side-agreements has been especially prevalent in the computer hardware and software segment of the high-technology industry. Side-agreements may create obligations or contingencies relating to financing arrangements or to product installation or customization. Typically, very few individuals within an entity are aware of the use of side-agreements. Therefore, it may be difficult for auditors to uncover their existence. Management representations and other standard audit procedures may not be adequate in these circumstances. When there is a significant risk that undisclosed side-agreements exist, the auditor should consider confirming, directly with the contract signer, relevant contract terms to obtain assurance from the entity's customer that side-agreements do not exist. Since, in this circumstance, it is difficult to perform alternative procedures on non-replies, auditors should make every effort to obtain responses to these special confirmations.

.13 The Securities and Exchange Commission's (SEC's) Accounting and Auditing Enforcement Releases (AAERs) have addressed revenue recognition by high-technology enterprises. The problem areas noted include—

- Sales recorded before customer acceptance of a product—that is, before the risks and rewards of ownership are passed to the buyer (see AAERs 40, 44, 58, 125, 213, 646, and 647).
- Bill and hold or ship in place sales. Revenue associated with such agreements qualifies for recognition only in unique and controlled circumstances (see AAERs 47, 108, 196, and 215).
- Recorded sales in which the seller has continuing involvement or that are subject to a significant future contingency (see AAERs 40, 78, 86, 145, 303, 646, and 647).

Auditors should be alert to those high risk circumstances in which an entity may prematurely recognize revenue.

.14 Revenue recognition issues may arise with regard to the sale of computer software. High-technology enterprises may sell software by means of a license for its use. The completion of the earnings process in such licensing transactions may vary depending on whether the software is modified to meet customer specifications or whether significant installation support is necessary. Additionally, customer acceptance may be uncertain, and sales agreements may provide for extended payment terms, trial periods, or liberal termination features.

.15 AICPA Statement of Position (SOP) 91-1, *Software Revenue Recognition*, provides guidance on revenue recognition for the licensing, selling, leasing, or marketing of computer software. Applying the provisions of SOP 91-1 may require considerable judgment; therefore, auditors should obtain an understanding of the provisions of contracts with customers, particularly those with unique or unusual terms and conditions. Auditors should assess any nonstandard terms and consider their effect on accounting for revenue associated with a transaction. Auditors should also be alert to the revenue recognition implications of transactions with cancellation privileges, exchange rights, and deferred payment terms, all of which are discussed in SOP 91-1.

.16 Transferring product rights through licensing or royalty arrangements is common among high-technology enterprises. Auditors should consider the existence of any such arrangements, understand the products and related services being sold, and consider whether all products or processes involving licensing or royalty payments are being properly identified and controlled.

.17 Entities in the computer industry, and other segments of the high-technology industry, may sell products that include a combination of product maintenance and customer support contracts, or they may separately sell maintenance and customer support contracts or consulting services. SEC rules require that publicly held companies disclose revenue from such activities, if significant, on the face of the income statement. Specifically, Rule 5-03(b)(1) and (2) of Regulation S-X requires separate reporting of tangible product sales, operating revenues, income from rentals, revenues from services, and other revenues if that category exceeds 10 percent of total revenues. The rule also requires separate reporting of costs and expenses for each line item reported for sales and revenues. Auditors of the financial statements of publicly held high-technology enterprises should be familiar with Rule 5-03(b)(1) and (2) of Regulation S-X and carefully consider the adequacy of the required disclosures.

.18 Auditors should consider whether uncertainties associated with revenue recognition have implications for other audit areas as well. For example, the collectibility of receivables may be affected by customers' perceptions of product performance and by support and maintenance expectations.

Allocation of Purchase Price in "Purchase" Business Combinations

.19 When a business combination involving a high-technology enterprise is accounted for using purchase accounting, a portion of the purchase price may be allocated to R&D in process. Generally accepted accounting principles require that a portion of the purchase price be immediately written off for R&D that did not have an alternative future use. In recent years, a number of high-technology enterprises, specifically software companies, have reported business combinations in which a substantial portion of the purchase price was allocated to software that was to be used in R&D projects. The amounts allocated to software were immediately expensed in accordance with FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method* (AC B50).

.20 Given expectations of increased merger and acquisition activity during 1995, there is a greater likelihood that high-technology enterprises may be involved in business combinations. In such circumstances, auditors should consider whether there is adequate evidential matter regarding the reasonableness of purchase price allocations to the assets acquired and for the valuation of the acquired software or other technology to be used in R&D. Auditors need to be sensitive to indications that clients may be overly aggressive in assigning value to R&D, thereby writing off a substantial part of the purchase price as an "unusual" item and enhancing future operating income. It should also be noted that purchased R&D should be a separately identified and valued amount. Its assigned value should not be the residual remaining after the cost of an acquired entity has been assigned to the acquired entity's net assets.

.21 Auditors should also consider the nature and stage of development of the software acquired, as well as its expected use by the acquirer, when evaluating the appropriateness of management's allocation. The purchase price allocated to software acquired as part of a business combination, for which the acquirer has met the technological feasibility criteria of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed* (AC Co2), and that no longer is considered to be in the R&D stage, should not be immediately expensed.

.22 Companies should have appropriate documentation to support their accounting by reference to appraisals, replacement cost studies, and other supporting data. Auditors should evaluate the evidential matter supporting these transactions as they assess the propriety of the accounting treatment and the adequacy of related financial statement disclosures.

Control Environment

.23 Current favorable market conditions for high-technology products and services, driven by strong demand, have attracted many new entrepreneurs into the industry. As a result, many high-technology entities are young, development stage enterprises or have a number of traits that are similar to those often found in such enterprises. The internal control structures of these companies often include unique characteristics that may affect an auditor's assessment of control risk. Characteristics that may increase control risk include the following:

- High-technology enterprises may experience rapid growth due to current strong product demand. This may place a strain on existing accounting, reporting, and control functions, thus increasing the likelihood of errors.
- Many high-technology companies are relatively small and frequently closely held. In such entities, the entire accounting function may be the responsibility of one or a few employees and thus lacking in adequate segregation of duties. In addition, owners or managers often have the authority to override prescribed control procedures.
- Owners and managers of high-technology companies frequently are entrepreneurs who may be more likely to give priority to R&D functions over accounting systems and related control procedures. As a result, control, accounting, and financial reporting functions may receive less support and attention than might be warranted.
- Although the owners and managers of most small high-technology companies are capable in areas such as manufacturing, marketing, research, and sales, others may not be as well versed in matters of accounting, finance, and administration.
- The limited resources of some high-technology companies may engender informal accounting systems with inadequate control procedures.

If the internal control structure of a high-technology company includes the above characteristics, control risk might be assessed as high. Auditors should adjust the scope of their audits accordingly, and should document the understanding of the entity's internal control structure as required by AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319). If that understanding reveals that the oversight function is weak, there is increased risk that material errors and irregularities will result in misstatements in the financial statements, and reportable conditions, as defined in SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU section 325), may exist.

Research and Development Arrangements

.24 As a result of their need to fund substantial amounts of R&D costs, high-technology enterprises frequently enter into a variety of legal arrangements that may include debt and equity interests as well as contracts to provide R&D services for others. FASB Statement No. 68, *Research and Development Arrangements* (AC R55), specifies how companies should account for their obligations under arrangements for the funding of R&D for others.

Auditors of high-technology enterprises should obtain an understanding of the facts and circumstances surrounding such arrangements, including the relationships among the parties involved, and consider the propriety of their clients' accounting for such arrangements in light of that understanding.

.25 *Loans or Advances to Other Parties.* R&D arrangements sometimes call for extending loans or advances to another party. FASB Statement No. 68 (AC R55) states "If repayment to the enterprise of any loan or advance by the enterprise to the other parties depends solely on the results of the [R&D] having future economic benefit, the loan or advance shall be accounted for as costs incurred by the enterprise. The costs shall be charged to [R&D] expense unless the loan or advance to the other parties can be identified as relating to some other activity, for example, marketing or advertising, in which case the costs shall be accounted for according to their nature." Auditors should consider the propriety of their clients' accounting for such loans.

.26 *Issuance of Warrants or Similar Instruments.* R&D arrangements sometimes also involve the issuance of warrants or similar instruments. FASB Statement No. 68 (AC R55) requires that the portion of the proceeds representing fair value of such instruments at the date of the arrangement be reported as paid-in capital rather than as revenue. Auditors should be alert to the issuance of warrants and similar instruments in connection with such arrangements and evaluate carefully their clients' accounting, particularly the determination of the amount of the proceeds deemed to represent fair value and allocable to paid-in capital.

.27 *Obligation is a Liability to Repay Other Parties.* FASB Statement No. 68 (AC R55) specifies that the enterprises must determine whether they are obligated only to perform contractual R&D for others, or whether they are otherwise obligated. To the extent the enterprises are obligated to repay the other parties regardless of the outcome of the R&D, they should record liabilities and expense R&D costs as incurred. To conclude that a liability to repay the other party does not exist, the transfer of risk related to the R&D must be substantive and genuine. FASB Statement No. 68 (AC R55) and SEC Staff Accounting Bulletin (SAB) No. 63 (Topic 5O), *Research and Development Arrangements,* provide further guidance on assessing whether such risk transfers have occurred and provide examples of conditions leading to the presumption that the enterprise will repay the other party, whether contractually obligated to or not.

.28 As part of the overall effort to reduce the budget deficit, federal grants to the academic and scientific communities, earmarked for R&D, may be reduced or eliminated. The impact of such legislation on the operations of high-technology enterprises may be beneficial or detrimental, depending on the type of R&D arrangement in which the company is involved. If, for example, a high-technology audit client contracts for others to perform R&D, a reduction in federal subsidies may increase the costs of such contracts to the client. Conversely, if the client provides R&D to others, such reductions could drive up the client's R&D related revenue. Auditors should be aware of the final provisions of such legislation and its impact on the entity being audited.

Inventory Obsolescence

.29 Given the speed of technological advances and the highly competitive environment of the high-technology industry, rapid inventory obsolescence is common. Products are often susceptible to frequent changes intended to upgrade their performance. Product life cycles are typically short and competitive products with superior price and performance can quickly enter the marketplace. In such an environment, auditors should consider whether the value at which inventories are carried is appropriate. Auditors may find that increased use of quantitative analyses can be an efficient and effective way to ascertain whether inventory amounts and trends make sense. Factors that should be considered include expected future demand for the product and anticipated technological advancements that render existing inventories obsolete. Auditors may use sales forecasts prepared by management in making inventory obsolescence evaluations and reviewing inventory listings for completeness and accuracy.

Environmental Issues

.30 Environmental remediation liability laws, written at all levels of government, have exposed high-technology enterprises to an increased vulnerability to environmental claims. The Resource, Conservation and Recovery Act, Superfund, along with various clean air and water acts, may be used to hold high-technology enterprises liable for the remediation of environmental contamination. Superfund, for example, legally empowers the U.S. Environmental Protection Agency to seek recovery from current and previous owners or operators of a particular contaminated site, or anyone who generated or transported hazardous substances to such a site. The use of toxic or hazardous materials in manufacturing processes or by-products released into the environment may create environmental cleanup issues.

.31 The accounting literature applicable to accounting for environmental remediation liabilities includes FASB Statement No. 5, *Accounting for Contingencies* (AC C59), FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (AC C59), and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10). In addition, guidance is included in the consensuses reached by the Emerging Issues Task Force (EITF) of the FASB in EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal,* Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination,* and Issue No. 93-5, *Accounting for Environmental Liabilities.*

.32 Auditors of publicly held high-technology enterprises should be aware of SEC SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies.* The SAB provides the SEC staff's interpretation of current accounting literature related to the following:

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities.
- Recognition of liabilities for costs apportioned to other potential responsible parties.
- Uncertainties in the estimation of the extent of environmental liabilities.
- The appropriate discount rate for environmental liabilities, if discounting is appropriate.
- Financial statement disclosures of exit costs and other items and disclosure of certain information outside the basic financial statements.

Audit Risk Alert—1995/96 [AAM section 8010] contains further discussion of issues relating to environmental remediation matters. Also, refer to the "Accounting Issues and Developments" section of this Audit Risk Alert for information on AICPA Exposure Draft: *Proposed Statement of Position on Environmental Remediation Liabilities.*

Elimination of Uncertainty Reporting

.33 The AICPA's Auditing Standards Board (ASB) has issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

.34 The amendment would also expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AU section 508.37), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

.35 The proposal does not affect the provisions of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), which requires that the auditor add an explanatory paragraph to the auditor's report when there is substantial doubt about the entity's ability to continue as a going concern.

.36 Auditors of the financial statements of high-technology entities may consider it necessary to add an uncertainty explanatory paragraph to their reports when, for example, management's inability to make a reasonable estimate of the provision for product warranties raises questions about the appropriateness of the accounting principles used. If the proposed SAS is issued in final form, that requirement will be eliminated. Nonetheless, auditors reporting on financial statements that include such a circumstance may wish to emphasize that fact by adding an emphasis-of-a-matter paragraph to their reports. Such paragraphs, however, are optional and are added solely at the auditor's discretion.

.37 The ASB hopes to finalize this SAS late this year and to issue an SAS that would be effective for reports issued on or after June 30, 1996. Comments on the proposed SAS were due on October 20, 1995.

Accounting Issues and Developments

Stock-Based Compensation

.38 Because many high-technology enterprises in the development stage need to conserve their financial resources, they often use stock options and warrants to compensate key employees.

.39 In October 1995, the FASB issued Statement No. 123, *Accounting for Stock-Based Compensation.* The Statement encourages companies to adopt a new fair value based method of accounting for employee stock compensation plans. However, it also allows companies to continue to measure compensation cost for such plans using the intrinsic value based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (AC C47).

.40 The Statement also requires certain disclosures about stock-based employee compensation arrangements regardless of the method used to account for them. Companies that do not adopt the new fair value based method of accounting are required to make pro forma disclosures of net income and, if presented, earnings per share, determined as if the company had applied the new method.

.41 The accounting requirements of FASB Statement No. 123 are effective for transactions entered into in fiscal years that begin after December 15, 1995, though they may be adopted on issuance of the Statement. The disclosure requirements of the Statement are effective for financial statements for fiscal years beginning after December 15, 1995, or for an earlier fiscal year for which the Statement is initially adopted for recognizing compensation cost. Pro forma disclosures required for entities that elect to continue to measure compensation cost using APB Opinion No. 25 (AC C47) must include the effects of all awards granted in fiscal years that begin after December 15, 1994. Pro forma disclosures for awards granted in the first fiscal year beginning after December 15, 1994, need not be included in financial statements for that fiscal year but should be presented subsequently whenever financial statements for that year are presented for comparative purposes with financial statements for a later fiscal year.

.42 Auditors of high-technology enterprises that issue options and warrants to their employees should consider carefully whether the accounting principles for stock-based compensation plans have been properly applied, whether documentation supporting the values used for stock or options granted is sufficient, and whether financial statement disclosures are adequate.

Impairment of Long-Lived Assets

.43 In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). FASB Statement No. 121 (AC I08) establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

.44 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.45 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.46 As previously discussed, high-technology products are susceptible to rapid obsolescence. Long-lived assets used by enterprises involved in the manufacture of such products may require significant retooling to retain their usefulness. In some cases these assets may not lend themselves to modification and could be rendered obsolete as well. Additionally, the anticipated passage of a telecommunications deregulation bill this year should spur merger and acquisition activity. The elimination of duplicate functions, which typically accompany a merger or acquisition, may affect the carrying amount of certain assets. In these instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.47 In considering a high-technology entity's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AU section 342).

Risks and Uncertainties

.48 In December 1994, the AICPA's Accounting Standards Executive Committee issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. SOP 94-6 requires nongovernmental entities to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires organizations to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.49 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of similar estimates that may be included in the financial statements of high-technology entities include, but are not limited to, the following:

- Capitalized computer software costs
- Inventory or specialized manufacturing equipment subject to technological obsolescence

- Price protection and cancellation options

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of high-technology entities in accordance with paragraph 21 of the SOP include the following:

- Volume of business with a particular supplier of semiconductors
- Revenue from sales of a particular software program
- Significant volume of business with a customer such as a reseller
- Expiration of a patent on a technological device or process

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

.50 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

Costs of Internally Developed and Purchased Software

.51 FASB Statement No. 86 (AC Co2) specifies the accounting for the costs of internally developed and purchased software. It requires that the costs of R&D-related activities, which must be expensed in the period incurred, be differentiated from the costs of production activities, which are capitalized. The difference between these two activities is based on the concept of technological feasibility. To qualify for capitalization, costs must be incurred subsequent to establishing technological feasibility. Software rights purchased or leased for resale and no alternative future use must also meet the requirements for technological feasibility to be capitalized. Production costs for software that is to be used as an integral part of a product or process should not be capitalized until both (1) technological feasibility has been established for the software and (2) all R&D for the other components of the product or process has been completed.

.52 Auditors should evaluate management's judgments regarding technological feasibility. To do this, product plans and software development methodologies should be reviewed at each balance-sheet date. Factors to be considered, include—

- The carrying value of the capitalized software and consider whether revenue forecasts are reasonably constructed, adequately documented, and realistic in view of a company's established channels of distribution and financial resources.
- The reasonableness of the product's life, which typically ranges from three to five years. The amortization of these costs should not be included in R&D costs, but should be charged to costs of goods sold or a similar expense category.

Restructurings

.53 The telecommunications, computer software, and electronics segments of the high-technology industry have seen an increased rate of mergers, acquisitions, and consolidations as well as, breakups and spin-offs. Entities within these industry segments are seeking access to new markets through acquisition or concentrating on their core business by divesting themselves of unrelated divisions. Greater cost efficiencies and economies of scale are being sought through such vertical and horizontal integrations. Restructuring often accompanies these activities as redundant functions are eliminated and existing areas streamlined. Restructuring charges typically include employee-related costs, costs associated with elimination and reduction of product lines, and costs related to the consolidation of operations. Restructuring charges also include asset writedowns and losses on disposal of assets.

When high-technology entities implement restructuring programs, auditors should consider the impact of reductions in personnel on operations and on the entity's and internal control structure, the appropriateness and completeness of recorded liabilities relating to current restructuring plans, and the appropriate period for reporting the costs associated with restructurings.

.54 In considering restructuring liabilities and costs, auditors should be aware of FASB Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, for authoritative guidance on the appropriate accounting for restructurings. EITF Issue No. 94-3 also provides guidance on the types of costs that should be accrued and the timing of recognition of restructuring charges. It also prescribes disclosures that should be included in the financial statements.

.55 For publicly held entities, SEC SAB No. 67 (Topic 5P), *Income Statement Presentation of Restructuring Charges*, requires that restructuring charges be reported as a component of income from continuing operations.

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

.56 High-technology enterprises involved in manufacturing may be subject to environmental remediation costs. Toxic or hazardous materials used in the manufacturing process or by-products released into the environment may pollute or contaminate surrounding locations. In June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities*. The proposed SOP provides that:

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 (AC C59) are met, and it includes benchmarks to aid in determining when those criteria are met.
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent the employees are expected to devote time to the remediation effort.
- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site, and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- Measurement of the liability should be based on enacted laws and existing regulations, policies and remediation technology.
- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed, and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and clean-up laws and the need to consider various individual state and other non-United States government requirements. The proposed SOP also includes guidance for auditing environmental remediation liabilities, that is, addressing audit planning and assessing audit risk, along with the appropriate application of relevant auditing standards.

Management's Discussion and Analysis—Public Companies

.57 SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550), requires that auditors read such information and consider whether the information, or the manner of its presentation, is materially inconsistent with that appearing in the financial statements. As auditors of high-technology entities that are required to file reports with the SEC read the Management's Discussion and Analysis of Operations sections of SEC filings that contain audited financial statements, they might consider whether those discussions include items such as—

- The reasonably likely effects on future operating results of known trends, such as further declines of sales of mature products. The life cycles of products of high-technology entities are frequently short because of the pace of technological change.
- Discretionary operating expenses, such as those relating to R&D, that have materially affected the most recent period presented but are not expected to have short- or long-term implications, or those matters that have not affected the most recent period presented but are expected to materially affect future periods.

Information Sources

.58 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.59 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.60 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.61 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.62 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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.63 This Audit Risk Alert supersedes *High-Technology Industry Developments—1994.*

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.64 Practitioners should also be aware of the economic, industry legislative, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 3 (202) 942-7114 (tty)		*Information Line* (202) 942-8088 (202) 942-7114 (tty)
Telecommunications Industry Association	2001 Pennsylvania Ave., NW Suite 800 Washington, DC 20006-1813	*General Information* (202) 457-4912		
American Electronics Association	5201 Great American Pky. Suite 520 P.O. Box 54990 Santa Clara, CA 95056	*General Information* (408) 987-4200		
Computing Technology Association	450 E. 22nd Street—Suite 230 Lombard, IL 60148	*General Information* (708) 268-1818		
American Software Association c/o ITAA	1616 N. Fort Meyer Dr. Suite 1300 Arlington, VA 22209-998	*General Information* (703) 522-5055		

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AAM Section 8210
Real Estate Industry Developments—1995/96

Industry and Economic Developments

.01 The state of uncertainty that has existed in the real estate industry, as well as the economy in general, continues in 1995. In the 1980s and early 1990s, the U.S. real estate industry experienced a significant downturn as a result of the slowdown of the economy in general. Since the bottom of the downturn, the industry has been anticipating a full recovery. Each year, however, economic, demographic, and structural factors combine to defer the recovery. For instance, trends toward corporate downsizing and telecommuting in recent years have had an unfavorable effect on the commercial market, because businesses need less space. Corporate downsizings also have affected the residential market, as employees affected by these downsizings have seen their ability to save for housing eroded.

.02 Although certain positive trends continue to emerge (for instance, office vacancy rates are down, and housing starts are increasing), there are wide variances among regions and different kinds of property. Auditors should be aware of the economic conditions that affect real estate markets in regions in which their clients operate, and not just in the location in which the client's headquarters are located.

.03 In the 1980s and early 1990s, the commercial markets (particularly office buildings and strip malls) experienced an oversupply of space. The primary factors contributing to oversupply were the general economic recession, a trend toward corporate downsizing, and the changing demographics of many entities. As the general economy faltered, many businesses downsized their operations through staff reductions, work-at-home programs, and so forth. Those cost reductions affected the need for office space adversely. As a result, building slowed drastically.

.04 When the economy improved during 1994, the demand for commercial space increased. That demand was met by available space, and no more than a limited level of new building was required. By the end of 1994, downtown office-vacancy rates decreased to their lowest levels of the 1990s, and suburban vacancy rates hit an all-time low. As the general economy continued to improve in 1995, the commercial markets in a number of areas throughout the country also continued to show improvement. The increased occupancy rates, combined with the eased restrictions on lending in many areas, have raised fears that the industry may react so quickly that a repeat of the disastrous overbuilding of the 1980s recurs. Many in the industry believe that, although occupancy rates are increasing, they are not yet at a level that would justify a surge in new construction.

.05 In the residential market, more single-family homes were built in 1994 than in any of the past fifteen years. However, the downward trend in demand that started near the end of last year persisted during the first quarter of 1995. In recent months, housing starts began to rise again, mainly in response to increased demand resulting from lower mortgage rates. Also, permits for new construction have increased in recent months, indicating that the rebound may be maintained throughout the year.

.06 However, the optimism related to the rebound is somewhat tempered by the fact that the strength is highly concentrated in the Southern United States. Other regions have experienced either a flat market or declines.

.07 Throughout the early 1990's, the real estate industry experienced a marked increase in the formation of real estate investment trusts (REITs). For owners and developers, REITs provide an alternative method of raising capital in tight credit markets. For investors, REITs offer a securitized investment that may be an attractive vehicle for increasing investment yields. As discussed in the "Audit Issues and Developments" section of this Audit Risk Alert, auditors should be aware of recent developments in the REIT marketplace that may indicate going-concern or asset-valuation issues.

.08 AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), requires that in planning their audits, auditors consider matters that affect the industry in which the entity operates, such as the economic factors. With respect to audits of real estate entities, this would include the commercial and residential market factors described above. These factors also have affected real estate values. Although overall values have been increasing slightly, the values of many properties have not returned to their prerecession levels. Decreases in equity have led some owners to abandon their properties and precipitated a number of foreclosures by financial institutions and other lenders. Because they were unwilling owners, these financial institutions have sold foreclosed properties at fire-sale prices, which exerted downward pressure on real estate values. As a result, credit had been nearly unavailable to the real estate industry, except for projects with proven economic viability. More recently, however, real estate values have maintained their slow upward trend, however, and lending activity has once again increased. The availability of credit has resulted in increased levels of construction in many markets, which also contributes to the fears of overbuilding.

Regulatory Developments

.09 Real estate entities and the transactions in which they engage have become the focus of an increasing level of government regulation. SAS No. 22 (AU section 311) also requires that in planning their audits, auditors should obtain a knowledge of matters that relate to the entities' business, including, among other things, government regulations. Auditors should consider such regulations in light of their potential effect on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AU section 317), distinguishes between the following two kinds of laws and regulations:

1. Those that have a direct and material effect on the determination of financial statement amounts
2. Those that relate more to an entity's operating aspects than to its financial and accounting aspects and, therefore, have only an indirect effect on the financial statements

Although auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts, an audit performed in accordance with generally accepted auditing standards (GAAS) normally does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

.10 Specific laws and regulations that may affect the real estate industry are discussed in the following paragraphs.

U.S. Department of Housing and Urban Development Regulations

.11 Through the Federal Housing Administration, the U.S. Department of Housing and Urban Development (HUD) regulates the development and operation of all of the housing projects for which it insures mortgages or provides rent subsidies. Entities that receive financial assistance from HUD are required to submit audited financial statements to HUD annually. Those audits are required to be performed in accordance with GAAS, *Government Auditing Standards* issued by the Comptroller General of the United States (also commonly referred to as the "Yellow Book"), and the *Consolidated Audit Guide for HUD Programs*, issued by the HUD Office of the Inspector General (OIG).

.12 *HUD Audit Guide.* In July 1993, the HUD OIG issued a revised *Consolidated Audit Guide for Audits of HUD Programs* (the revised Guide), which is effective for audits of financial statements for fiscal years ending on or after September 30, 1993. The revised Guide provides program-specific audit requirements for entities that—

- Participate in HUD Section 8 programs
- Participate in insured and coinsured multifamily projects

- Have insured development certifications
- Issue Government National Mortgage Association mortgage-backed securities
- Are HUD-approved title II nonsupervised mortgagees and loan correspondents
- Are HUD-approved title I nonsupervised lenders and loan correspondents

Further significant changes in the revised Guide include the incorporation of final rules (dated December 9, 1992) for mortgage approval reform and direct-endorsement expansion as well as for implementing Office of Management and Budget Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* The revised Guide also deletes the common compliance requirements contained in the prior guide and provides revised suggested audit procedures for testing compliance with laws and regulations. Auditors should be aware of the revised Guide's requirements when planning and performing HUD audits.

.13 Illustrative auditor's reports for HUD audits are included in the appendix [paragraph .108] to this Audit Risk Alert.

.14 *Government Auditing Standards.* Auditors who perform HUD audits should also be alert to the 1994 Revision of *Government Auditing Standards.* The 1994 Revision provides guidance (rather than requirements) for the auditor's consideration of internal controls for control environment, safeguarding controls, controls over compliance with laws and regulations, and control risk assessment. It does not establish new responsibilities for testing controls. Further, the 1994 Revision—

- Adds a requirement for audit organizations to provide a copy of their most recent external quality control review report to parties seeking to contract for an audit
- Sets a new benchmark for the sufficiency of working papers. Working papers should enable an experienced auditor to ascertain from them the evidence that supports the significant conclusions and judgments. It explicitly requires the working papers to include descriptions of transactions and records examined so that an experienced auditor would be able to examine the same transactions and records
- Adds a requirement for auditors to communicate their responsibilities for consideration of internal controls and compliance with laws and regulations to audit committees or the individuals with whom they have contracted for the audit
- Adds a requirement to include a reference to *Government Auditing Standards* in audit reports when they are being submitted in accordance with a law or regulation calling for an audit in accordance with *Government Auditing Standards*
- Adds a requirement that the report on the financial statements either (1) describe the results of the auditor's tests of internal controls and compliance or (2) refer to separate reports on controls and compliance
- Clarifies a requirement that the auditor report irregularities and illegal acts directly to parties outside the client, in certain circumstances, even if he or she has resigned or been dismissed from the audit
- Clarifies a requirement that auditors report all irregularities and illegal acts except for those that are clearly inconsequential
- Adds a requirement to design the audit to provide reasonable assurance of detecting noncompliance with contract provisions and grant agreements that could have a direct and material effect on financial statement amounts
- Deletes the requirement to describe categories of internal controls in reporting on internal controls

- Deletes the requirement to express positive and negative assurance on compliance with laws and regulations
- Incorporates relevant AICPA SASs, for example, SAS No. 62, *Special Reports* (AU section 623), and attestation standards into *Government Auditing Standards* for financial-related audits

Auditors should be mindful that *Government Auditing Standards* also includes general standards, such as standards for continuing professional education and the auditor's participation in external quality control review programs.

.15 *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance.* Auditors of real estate entities that are recipients of governmental assistance also should consider the guidance set forth in SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AU section 801). SAS No. 74 (AU section 801), which supersedes SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance,* is effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994. SAS No. 74 (AU section 801) provides general guidance to practitioners engaged to perform compliance audits of recipients of governmental financial assistance.

.16 SAS No. 74 (AU section 801) continues to recognize three levels of audits—GAAS, *Government Auditing Standards,* and certain other federal requirements—of recipients of governmental financial assistance. SAS No. 74 (AU section 801) is applicable when the auditor is engaged to perform an audit under GAAS, *Government Auditing Standards,* and in certain other circumstances involving governmental financial assistance, such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations. SAS No. 74 (AU section 801) also provides general guidance to the auditor to:

- Apply the provisions of SAS No. 54 (AU section 317), relative to detecting misstatements resulting from illegal acts related to laws and regulations that have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of governmental entities and other recipients of governmental financial assistance.
- Perform a financial audit in accordance with *Government Auditing Standards.*
- Perform a single or organization-wide audit or a program-specific audit in accordance with federal audit requirements.
- Communicate with management if the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of his or her engagement.

Interstate Land Sales and Full Disclosure Act

.17 Developers are required to make certain disclosures in connection with the sale or lease of certain undeveloped subdivided land. The Interstate Land Sales and Full Disclosure Act (the Act) makes it unlawful for a developer to sell or lease, by use of the mail or any other means of interstate commerce, any land offered as part of a common promotional plan unless the land is registered with the Office of Interstate Land Sales Registration. The Act requires that a printed property report be furnished to all prospective purchasers or lessees. Similarly, the Federal Trade Commission has the authority to act on unfair or deceptive trade practices with respect to real estate sales, particularly as they relate to the marketing and selling activities of real estate companies.

Regulation Z of the Consumer Credit Protection Act

.18 Since most real estate purchases are made on credit, truth-in-lending laws can have a significant effect on real estate financing transactions. Regulation Z of the Consumer Credit Protection Act prescribes requirements for both creditors and borrowers for full disclosure of credit costs and is applicable to all real estate transactions, regardless of amount, in which individual borrowers are involved. Certain provisions of truth-in-lending laws and regulations may affect the manner in which interest related to real estate financing transactions should be calculated. As such, violations of such laws could cause a material misstatement of the financial statements of real estate enterprises that finance such transactions. See SAS No. 54 (AU section 317) for further discussion of the auditor's responsibilities regarding illegal acts.

Tax Matters

.19 The Omnibus Budget Reconciliation Act of 1993 permits real estate entities, for taxable years beginning in 1994, to offset net losses from rental real estate activities (previously treated as passive-income losses) in which they materially participate against income from other sources. Material participation has the same meaning as under prior law. The most common method of achieving material participation in an activity is to work more than 500 hours in the activity in the taxable year. Other ways to achieve material participation in a rental real estate activity are to (1) perform substantially all of the participation in the activity, even if less than 100 hours, or (2) have more than 100 hours of participation in the activity and have more hours than anyone else. Limited partners, however, can meet the material participation test for real estate only through the 500-hour test.

.20 Each hour of participation in a real-property trade or business can count for all of the tests for relief under the new law. Real property trades or businesses that meet the requirements of these tests are defined as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental operation, management, leasing, or brokerage trade or business. Auditors should be aware of the impact that the Omnibus Budget Reconciliation Act of 1993 may have on the calculations of entities' tax provisions and the potential resulting effect on financial statements.

Audit Issues and Developments

General Risk Factors

.21 Although conditions vary from region to region and entity to entity, general factors inherent in the real estate industry that influence audit risk include the following.

.22 *Magnitude and Complexity of Transactions.* The financial statements of real estate companies generally include a large number of highly complex transactions. The complexity of these transactions is increased by the fact that a number of them are based on estimates.

.23 *Lengthy Development/Holding Periods.* By their nature, real estate projects involving construction require significant lead time. Delays may result in increased costs and potentially affect the net realizable value of the assets being constructed.

.24 *Financing and Liquidity Concerns.* Real estate enterprises are often highly leveraged, creating concerns about the ability of entities in the industry to continue to obtain adequate capital and to meet obligations as they come due. Auditors should carefully consider these industry-specific conditions and assess the effect they have on audit risk.

Asset Impairment

.25 Impairment of assets continues to be a major concern throughout the real estate industry and requires critical attention in the audits of financial statements of real estate entities. Financial Accounting Standards Board (FASB) Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08), has particular importance in the real estate industry. As discussed in the "Accounting Developments" section of this Audit Risk Alert, FASB Statement No. 121 (AC I08) revises significantly the way in which entities will account for real estate. It requires different accounting for impaired assets based on whether those impaired assets are "to be held and used" or "to be disposed of."

.26 Auditors should obtain reasonable assurance that management has considered all relevant factors in determining whether asset impairment has occurred. The subjectivity of determining the adequacy of the impairment adjustment reinforces the need for careful planning and execution of audit procedures in this area.

.27 Conditions such as the following may indicate a need for adjustment of the amount at which investments in real estate are being carried.

- Cash flows from operating activities are insufficient to cover debt service.
- Current occupancy rates indicate that future cash flows to be received are lower than the amounts needed to fully recover the carrying amount of the investment.
- Major tenants have experienced or are experiencing financial difficulties.
- A significant portion of leases will expire in the near term.
- Lessors are being forced to make significant concessions in order to rent property.
- Properties held for sale remain unsold at subsequent balance sheet dates.
- Other investors have decided to cease providing support or to reduce their financial commitment to a project or venture.
- Auditors' reports on financial statements of investee properties or significant debtors are modified for reasons that relate to real estate investments or mortgage loans. Examples of such reports may include the following.
  - An auditor's report on the financial statements of investee properties is modified for a departure from generally accepted accounting principles (GAAP) due to improper valuation of assets.
  - An auditor's report on the financial statements of a significant debtor is modified for going-concern considerations, indicating that the debtor may not be able to meet its obligations.

.28 Lack of an asset-impairment evaluation system or failure of a real estate entity to document adequately its criteria and methods for determining whether impairments have occurred may indicate a reportable condition in the entity's internal control structure. Further, a lack of documentation generally will increase the extent to which judgment must be applied by auditors in evaluating the adequacy of management's writedowns and will increase the likelihood that differences will result. The AICPA Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* provides guidance to help auditors understand real-estate appraisal concepts and information. SAS No. 57, *Auditing Accounting Estimates* (AU section 342), should be followed in auditing estimates such as impairments.

.29 Auditors should also consider the propriety of the client's classification of assets as "held for sale" or "held for investment." Land to be developed and projects under development should be accounted for in accordance with paragraphs 4 through 7 of FASB Statement No. 121 (AC I08.123-126) (that is, they should be considered *assets to be held and used*). Completed projects should be accounted for in accordance with paragraphs 15 through 17 of the Statement (AC I08.134-136) *(assets to be disposed of)*.

.30 Another source of guidance on auditing estimates of real estate entities is SAS No. 73, *Using the Work of a Specialist* (AU section 336). SAS No. 73 (AU section 336) is effective for audits of periods ending after December 15, 1994. SAS No. 73 (AU section 336) supersedes SAS No. 11, *Using the Work of a Specialist.*

Direct Investments in Real Estate Properties

.31 Real estate held for investment should be reported at cost, less accumulated depreciation, and should be evaluated for impairment if facts and circumstances indicate that impairment may have occurred, in conformity with the provisions of paragraphs 4 through 7 of FASB Statement No. 121 (AC I08.123-126). An impairment is deemed to have occurred if the carrying amount of the asset exceeds the sum of the expected future cash flows (undiscounted and without interest charges from the asset). The impairment is measured as the amount by which the carrying amount exceeds the fair value of the asset. After an impairment is recognized, the reduced carrying amount of the asset should be accounted for as the new cost of the asset and depreciated over the remaining useful life (for depreciable assets). Restoration of previously recognized impairment losses is prohibited.

.32 In assessing the need for adjustment of the amount at which direct investments in real estate are being carried, auditors should be alert for conditions that might indicate that impairments have occurred, such as those discussed in the "Industry and Economic Developments" section of this Audit Risk Alert, and those listed in paragraph 5 of FASB Statement No. 121 (AC I08.124).

Real Estate to Be Disposed Of

.33 All real estate to be disposed of that is not subject to the provisions of Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13), for which management, having the authority to approve the action, has committed to a plan of disposal, should be reported at the lower of carrying amount or fair value less costs to sell. Subsequent revisions to fair value less costs to sell should be reported as adjustments to the carrying amount of the asset to be disposed of. However, the carrying amount may not be adjusted to an amount greater than the carrying amount of the asset before an adjustment was made to reflect the decision to dispose of the asset.

.34 In assessing the valuation of assets to be disposed of, auditors should consider various issues, including the following:

- Is the asset appropriately identified as subject to FASB Statement No. 121 (AC I08), or should APB Opinion No. 30 (AC I13) be applied?
- Has management committed to the plan of disposal? Was the commitment made by management with the authority to approve the action?
- Has fair value been determined using reasonable assumptions and estimates?
- Has the client included only appropriate costs in the estimate of costs to sell? Have the costs to sell been discounted, where appropriate?

Foreclosed and In-Substance Foreclosed Real Estate

.35 AICPA Statement of Position (SOP) 92-3, *Accounting for Foreclosed Assets,* provides guidance on measuring foreclosed assets after foreclosure. In accordance with SOP 92-3, there is a rebuttable presumption that foreclosed assets are held for sale. The SOP requires foreclosed assets held for sale to be carried at the lower of fair value minus estimated costs to sell or cost. Foreclosed assets held for the production of income should be treated the same way they would be had they been acquired in a manner other than foreclosure. The SOP refers to FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (AC D22), for its definition of fair value. In considering the appropriateness of fair values, auditors of publicly held entities should consider the guidance in Section 401.09d of the Securities and Exchange Commission's (SEC's) *Codification of Financial Reporting Policies,* which indicates that the mere adoption of strategies such as hold-for-the-future strategy based on expectations of future price increases, or a strategy of operating repossessed collateral on one's own behalf, cannot justify the use of derived accounting valuations that portray the results of operations more favorably than would the use of current values in active markets.

.36 Certain provisions of SOP 92-3 are inconsistent with the provisions of FASB Statement No. 121 (AC I08). The AICPA's Accounting Standards Executive Committee (AcSEC) is considering actions that it should take on SOP 92-3; however, FASB Statement No. 121 (AC I08) takes precedence for transactions within its scope.

Revenue Recognition

.37 In light of the fact that the industry's persistently optimistic outlooks have not yet fully materialized, combined with the economic indicators reflecting increasing consumer confidence, auditors should consider the appropriateness of their clients' revenue-recognition policies, or changes therein. The increased level of consumer confidence may lead to clients' forecasting improvements in financial results when in fact financial results may not be as positive. A number of clients may view the recent improvement in the general economy, the increasing consumer confidence, and the related heightened optimism within the industry as an opportunity to present improved financial results through changes in operating or accounting policies that affect the timing or propriety of revenue recognition. In evaluating the revenue recognition policies of real-estate-industry clients, auditors should consider carefully whether the criteria set forth in FASB Statement No. 66, *Accounting for Sales of Real Estate* (AC R10), have been met. Auditors should consider the facts and circumstances surrounding property sales carefully to be certain that there are no formal or informal "put" arrangements committing the seller, its officers, or its shareholders to repurchase the property, find other buyers, or indemnify the buyer or third-party guarantors for risk of loss. Auditors should also consider circumstances that would indicate that a seller may have directly or indirectly provided the funds for a down payment (or for the entire purchase price) in a cash sale. Apart from precluding the use of the full accrual method of profit recognition, such circumstances may create relationships that meet the definition of related parties as set forth in FASB Statement No. 57, *Related Party Disclosures* (AC R36). SAS No. 45, *Omnibus Statement on Auditing Standards—1983,* "Related Parties" (AU section 334), describes procedures that are designed to determine the existence of related parties as defined by FASB Statement No. 57 (AC R36).

Availability of Funding

.38 Real estate entities require substantial amounts of capital. Although lending activity appears to be on the rise, it is not at the level of the 1980s. As a result of the prolonged slump in the industry, and losses incurred in recent years, a number of the traditional sources of capital for the industry are no longer lending in the amounts they did previously. Financial institutions have become more selective in their real estate lending, a tendency that is attributable partly to recent losses, as well as to increased regulatory scrutiny. Moreover, sluggish global economic conditions have kept foreign investors from becoming an alternative source of funds.

.39 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), describes an auditor's obligation to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. SAS No. 59 (AU section 341) includes the "need to seek new sources or methods of financing" as an example of a condition or event that indicates there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable amount of time.

Deferred Rents

.40 Although office vacancies appear to be decreasing, occupancy has not improved enough to drive up rents. The perception that it is a renter's market persists, and rent abatements and other enticements continue to be offered. FASB Statement No. 13, *Accounting for Leases* (AC L10), requires that rents be recognized on a straight-line basis over the term of the lease even if payments are not made on a straight-line basis. Because of the number and magnitude of rent abatements and concessions being offered, significant deferred rent balances are sometimes recorded. In auditing such balances, auditors should consider carefully the reasonableness of assertions by management concerning the ability of tenants to perform according to the lease agreement. If tenants are unable to perform according to the lease agreement, deferred rents may not be fully recoverable.

Environmental Issues

.41 The U.S. Environmental Protection Agency (EPA) is empowered by law to order any party that owned or operated a site currently included on the National Priorities List, or anyone who has arranged for disposal or transported hazardous materials to such a site, to remediate the site or to reimburse the EPA for remediation costs and pay additional damages. In many states, state agencies have powers similar to the EPA's with respect to contaminated sites. In view of the liabilities that may be incurred from owning contaminated sites, virtually all entities entering into real estate transactions today consider potential environmental liabilities.

.42 Auditors of real estate entities that face such claims should evaluate carefully whether the accounting and disclosure requirements of FASB Statement No. 5, *Accounting for Contingencies* (AC C59), have been met. Auditors should also be aware of the consensus reached in FASB Emerging Issues Task Force (EITF) Issue No. 93-5, *Accounting for Environmental Liabilities,* which requires (among other things) that an environmental liability be evaluated independently from any potential recovery, and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization. Additional accounting guidance in this area is included in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (AC C59), FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal,* and EITF Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination.*

.43 Auditors of publicly held companies should also consider the requirements of SEC Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies,* which provides the SEC staff's interpretation of current literature related to the following:

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in estimation of the extent of environmental or product liability
- The appropriate discount rate for environmental or product liabilities, if discounting is appropriate
- Accounting for environmental exit costs and related disclosures
- Financial statement disclosures and disclosure of certain information outside the basic financial statements

Audit Risk Alert—1995/96 [AAM section 8010] contains further discussion of issues relating to environmental remediation matters. Also, refer to the "Accounting Developments" section of this Audit Risk Alert for information on AICPA Exposure Draft: *Proposed Statement of Position on Environmental Remediation Liabilities.*

Real Estate Investment Trusts

.44 As discussed previously, the number of REIT offerings proliferated in the early 1990s. Beginning with the second half of 1994, however, interest rates began to rise. This resulted in an increased cost of capital for REITs, which was not necessarily offset by corresponding increases in the returns from properties owned. REIT share prices experienced a downturn, and initial public offering (IPO) activity decreased markedly.

.45 REITs require new capital to fund acquisitions for growth. Because the market tends to penalize REITs that have high debt ratios (relative to other REITs), issuing debt is not considered an attractive alternative. This leaves REITs with several other alternatives, each of which presents issues that an auditor should be aware of.

.46 *Secondary Public Offerings.* Although there have been recent successes in the secondary-public-offering marketplace, this avenue is more likely to be open only for REITs with highly successful past operating results. Those REITs that have not been as successful will be forced to pay higher underwriting costs and incentives to purchasers of the stock. The increased cost of capital, without a corresponding increase in return from the properties, results in decreased yields and cash flows.

.47 Auditors should be aware of the competition involved for secondary-public-offering money. As REITs compete for this money, trusts may overvalue assets in order to increase their desirability to investors. Auditors should obtain reasonable assurance that the valuations of the assets and liabilities are reasonable.

.48 *Mergers and Acquisitions.* The increased cost of capital to REITs, combined with the fact that the majority of property previously owned by the Resolution Trust Corporation has now been purchased, has made it more difficult for REITs to acquire properties at yields that substantially exceed a REIT's cost of capital. Additionally, a number of REITs have not met expectations that had been included in their offering materials. These factors serve to reduce the stock price of affected REITs, which in turn may make them acquisition candidates.

.49 Auditors of REITs that may be acquisition candidates, such as those discussed above, should be aware of the possibility that trusts may overvalue assets in order to maintain a stock price at a level that would make them attractive to investors, but less attractive to potential acquiring entities. Auditors of larger, more successful REITs that may be looking to acquire other REITs also should be aware of this possibility.

.50 *Formation of Umbrella-Partnership Real Estate Investment Trusts.* As a result of the downturn in IPO activity, many property owners found themselves unable or unwilling to proceed with planned IPOs. Many of these property owners are faced with "bullet" loans now coming due. These property owners may wish to consider the alternative of forming an umbrella-partnership real estate investment trust (UP-REIT). Also, for reasons discussed below, a traditional REIT may wish to convert itself to an UP-REIT in order to place itself in an advantageous position for future property acquisitions.

.51 In the formation of a typical UP-REIT, an operating partnership is formed by a sponsor. The sponsor contributes real estate properties and related debt to the operating partnership. The exchange typically is accounted for as a reorganization of entities under common control in a manner similar to a pooling of interests. Accordingly, the contributed assets and liabilities are accounted for by the operating partnership at the sponsor's historical cost.

.52 Concurrent with the formation of the operating partnership, a REIT invests proceeds from a public offering in exchange for a majority interest (general partner) in the operating partnership; the sponsor retains a minority interest in the operating partnership. Because of its controlling financial interest, the REIT consolidates the operating partnership in its financial statements. In the typical UP-REIT structure, the REIT's consolidated financial statements report the assets and liabilities contributed by the sponsor at the sponsor's historical cost basis.

.53 The accounting issue discussed in EITF Issue No. 94-2, *Treatment of Minority Interests in Certain Real Estate Investment Trusts,* involves the question of how, and at what amount, the sponsor's minority interest should be reported in the REIT's consolidated financial statements. The EITF reached a consensus that the sponsor's interest in the operating partnership should be reported as a minority interest. The SEC staff has indicated, on the related issue of the appropriate carrying amount of the REIT's interest in the operating partnership, that the assets and liabilities contributed by the promoters of the offering (and in certain cases, other stockholders) should continue to be recorded at their historical-cost basis in the consolidated REIT financial statements pursuant to SAB No. 48, *Staff Position on Transfer of Assets by Promoters and Shareholders.* This conclusion is based on the SEC staff's view that the operating partnership itself has no significant substance outside tax considerations. Therefore, the typical REIT structure is usually, in substance, a reorganization and subsequent IPO.

.54 When property owners look to sell their properties on a tax-deferred basis, an UP-REIT can acquire the property in question by exchanging limited partnership units for it, thus postponing the taxable gain that the seller would have been required to recognize had it sold the property.

.55 During the year, the EITF discussed several matters that may affect the appropriate accounting for investments in joint ventures. Those matters include—

- Issue No. 95-6, *Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation,* which sets forth criteria for determining whether significant influence exists. While the criteria were developed specifically for real estate investment trusts and service corporations, they may be useful in making that determination for other entities as well.

- Issue No. 94-1, *Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects,* which describes the Task Force's consensus position about how an entity that invests in a qualified affordable housing project through a limited partnership should account for its investment.

- Appendix D-46, *Accounting for Limited Partnership Investments,* which describes discussion of the SEC staff's position that investments in all limited partnerships should be accounted for pursuant to paragraph 8 of SOP 78-9, *Accounting for Investments in Real Estate Ventures.* That guidance requires the use of the equity method unless the investor's interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies."

Auditors should consider these developments as they evaluate the appropriateness of real estate enterprise's accounting for investments in joint ventures and similar entities.

.56 In addition to evaluating the propriety of the entity's method of accounting for an investment in joint ventures, the auditor should be aware that such arrangements may create relationships that meet the definition of related parties as set forth in FASB Statement No. 57 (AC R36). Auditors should consider the guidance contained in SAS No. 45, *Omnibus Statement on Auditing Standards—1983,* "Related Parties" (AU section 334), which outlines procedures to identify related party relationships and transactions, and to assess the propriety of the required financial statement accounting and the adequacy of related disclosures.

Liquidity/Cash Flow Information

.57 The SEC staff has noted that SEC registrants are expected to use the statement of cash flows and other appropriate indicators in analyzing their liquidity, and to present a balanced discussion in the Management's Discussion and Analysis (MD&A) section of SEC filings that addresses the cash flows from investing and financing activities, as well as from operations. A discussion of cash flow from operations by itself is not considered an appropriate presentation. If cash flow information is included in the Selected Financial Data section of SEC filings, it should also be presented in a balanced manner, including cash flows from operations, investing, and financing activities. The SEC staff has also indicated that, in the context of amounts available for distributions, it is more appropriate to discuss "cash available for distribution" than cash flow from operations, since distributions will be paid from available cash. SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550), requires that auditors read such information and consider whether the information, or the manner of its presentation, is materially inconsistent with that appearing in the financial statements.

Non-GAAP Measures of Performance

.58 The SEC staff notes that, increasingly, publicly held real estate entities have been presenting operating income before depreciation and amortization and writedowns of real estate (or, in some cases, funds from operations) in Selected Financial Data and MD&A. The SEC staff believes that such a caption is inappropriate in financial statements because it suggests that the amount represents cash flow for the period, which is rarely the case. Cash flow from operations is the appropriate caption, which must be included in a balanced presentation with cash flows from investing and financing activities in MD&A and elsewhere. Auditors of public entities should read such information and consider whether the information, or the manner of its presentation, is materially inconsistent with that appearing in the financial statements.

.59 The SEC staff has noted that funds from operations (FFO) has been discussed outside of the financial statements in several recent filings with the SEC. Neither GAAP nor the authoritative accounting literature provides a definition for FFO, and the SEC staff's view with respect to the presentation of a cash flow measure as a proxy for net income and the presentation of Funds Generated from Operations are expressed in Accounting Series Release (ASR) 142. ASR 142 states that if such measurements of economic performance are presented in the MD&A section or elsewhere, they should not be presented in a manner that gives them greater authority or prominence than conventionally computed earnings. In no event should the presentation leave the reader with the impression that FFO is the appropriate measure of operating performance for the REIT and an appropriate measure for which dividends are computed and based. Net income and cash flows from operating, investing, and financing activities remain the appropriate measurements.

Investments in Derivatives

.60 Recent years have seen a growing use of innovative financial instruments, commonly referred to as derivatives, that often are very complex and can involve a substantial risk of loss. As interest rates, commodity prices, and many other market rates and indices from which certain financial instruments (derivatives) derive their value have been volatile over the past several months, several entities have incurred significant losses because of their use. Real estate enterprises sometimes use derivatives as risk management tools or as speculative investment vehicles. The use of derivatives often increases audit risk. Although financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditor's approach to achieving related audit objectives may differ because the notional and contractual amounts of certain derivatives—such as futures, forwards, swaps, options, and other contracts with similar characteristics—are not generally recognized in the financial statements.

.61 Auditors should understand both the economics of derivatives used by an entity and the nature and business purpose of the entity's derivatives activities. In addition, auditors should evaluate accounting for any such instruments, especially those reported at amounts other than fair value. To the extent the derivatives qualify as financial instruments as defined in FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), the disclosure requirements set forth in those statements must be met. When derivatives are accounted for as hedges of on-balance-sheet assets or liabilities or of anticipated transactions, auditors should carefully review the appropriateness of the use of hedge accounting, particularly considering whether the criteria set forth in applicable authoritative accounting literature are met.

.62 Audit risk considerations presented by the use of derivatives are discussed in *Audit Risk Alert—1995/96* [AAM section 8010]. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations. (See "Disclosures About Derivatives" in the "Accounting Developments" section herein.)

.63 An advisory council to the Committee of Sponsoring Organizations of the Treadway Commission (COSO) has been preparing a guide on applying COSO's *Internal Control—Integrated Framework* to derivatives activities. COSO plans to issue a final guide in 1996.

Elimination of Uncertainty Reporting

.64 The AICPA's Auditing Standards Board (ASB) has issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

.65 The amendment would also expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AU section 508.37), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

.66 The proposal does not affect the provisions of SAS No. 59 (AU section 341), which requires that the auditor add an explanatory paragraph to the auditor's report if there is substantial doubt about the entity's ability to continue as a going concern.

.67 The ASB hopes to finalize this SAS late this year and to issue a SAS that would be effective for reports issued on or after June 30, 1996. Comments on the proposed SAS were due on October 20, 1995.

Accounting Developments

Impairment of Long-Lived Assets

.68 In March 1995, the FASB issued Statement No. 121 (AC I08) which establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

.69 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by APB Opinion No. 30 (AC I13). Assets covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.70 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. Earlier application is encouraged. Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.71 FASB Statement No. 121 (AC I08) has particular importance to the real estate industry. It amends FASB Statement No. 67, *Accounting for the Costs and Initial Rental Operations of Real Estate Projects* (AC Re2), by requiring that "a real estate project, or parts thereof, that is substantially complete and ready for its intended use shall be accounted for at the lower of carrying amount or fair value less costs to sell." Under FASB Statement No. 67 (AC Re2), such real estate projects were accounted for at the lower of cost or net realizable value.

.72 Further, as previously discussed, current economic conditions suggest slow revenue growth for some real estate enterprises. As a means of increasing profits, cost reduction efforts may be implemented. This could, for example, delay planned capital outlays intended to refurbish or replace existing productive assets. Additionally, environmental regulations may impose restrictions on the use of a long-lived asset, thus significantly reducing its ability to generate future cash flows. In such instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.73 In considering a real estate enterprise's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57 (AU section 342).

Disclosures About Derivatives

.74 In October 1994, the FASB issued Statement No. 119 (AC F25), which requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 (AC F25) and No. 107 (AC F25).

.75 The Statement (AC F25) requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 (AC F25.115P) encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

.76 FASB Statement No. 119 (AC F25) was effective for financial statements issued for fiscal years ending after December 15, 1994, except for institutions with less than $150 million in total assets. For those institutions, the Statement (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1995.

.77 The FASB Special Report, *Illustrations of Financial Instrument Disclosures*, contains illustrations of the application of FASB Statements No. 105 (AC F25), No. 107 (AC F25), and No. 119 (AC F25), including specific illustrations of application by a domestic and an international financial institution.

FASB Statements on Loan Impairment

.78 In May 1993, FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (AC I08), was issued to address the accounting by creditors for the impairment of certain loans. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Statement (AC I08) is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller balance homogeneous loans that are collectively evaluated for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80). It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

.79 FASB Statement No. 114 (AC I08) requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral-dependent. The impairment is recognized by creating or adjusting a valuation allowance for the loan with a corresponding charge to bad debt expense.

.80 FASB Statement No. 114 amends FASB Statement No. 5 (AC C59) to clarify that a creditor should evaluate the collectibility of both the contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15 (AC D22) to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

.81 The Statement (AC I08) applies to financial statements for fiscal years beginning after December 15, 1994.

.82 In October 1994, the FASB issued Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (AC I08). FASB Statement No. 118 (AC I08) amends FASB Statement No. 114 (AC I08) to allow creditors to use existing methods for recognizing interest income on impaired loans. To accomplish that, it eliminates the provisions in FASB Statement No. 114 (AC I08) that describe how creditors should report income on impaired loans.

.83 FASB Statement No. 118 (AC I08) does not change the provisions in FASB Statement No. 114 (AC I08) that require creditors to measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, or as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral-dependent.

.84 FASB Statement No. 118 (AC I08) also amends the disclosure requirements in FASB Statement No. 114 (AC I08) to require the disclosure of information about the recorded investment in certain impaired loans and about how creditors recognize interest income related to those loans.

.85 FASB Statement No. 118 (AC I08) is effective concurrent with the effective date of FASB Statement No. 114 (AC I08), that is, for financial statements for fiscal years beginning after December 15, 1994.

Discussions of the EITF

.86 The EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to real estate enterprises. A description of issues discussed during the year follows; readers should consult detailed minutes for additional information.

.87 *EITF Issue No. 94-1.* The Omnibus Budget Reconciliation Act of 1993 retroactively extended and made permanent the low-income housing credit that expired after June 30, 1992. Investors in limited partnerships operating qualified low-income housing projects earn tax credits over a ten-year period to encourage such investments. The issue is whether a limited-partner (investor) should account for its investment as a tax benefit acquired or as an investment in real estate. The EITF reached a consensus that an entity that invests in a qualified affordable housing project through a limited partnership investment may elect to account for the investment using the effective yield method if all of the following conditions are met:

a. The availability (but not necessarily the realization) of the tax credits allocable to the investor is guaranteed by a creditworthy entity through a letter of credit, a tax indemnity agreement, or another similar arrangement.

b. The investor's projected yield based solely on the cash flows from the guaranteed tax credits is positive.

c. The investor is a limited partner in the affordable housing project for both legal and tax purposes and the investor's liability is limited to its capital investment.

.88 Limited partnership investments in qualified affordable housing projects not accounted for using the effective yield method, should be accounted for in accordance with SOP 78-9.

.89 The EITF also reached a consensus that an investor using the cost method should amortize any excess of the carrying amounts of the investment over its estimated residual value during the periods in which tax credits are allocated to the investor.

.90 The EITF also reached a consensus that a limited partnership investment in a qualified affordable housing project should be reviewed periodically for impairment.

.91 The EITF also reached a consensus that a liability should be recognized for delayed equity contributions that are unconditional and legally binding. A liability should be recognized for equity contributions that are contingent upon a future event if that contingent event becomes probable.

.92 *EITF Issue No. 94-2.* As discussed previously, the SEC staff has concluded that the carrying amounts of the operating partnership's assets and liabilities in the REIT's consolidated financial statements should be the promoter's historical-cost basis in those assets and liabilities (that is, the carrying amounts of the assets and liabilities are not changed as a result of the formation of the REIT). This issue addresses the appropriate accounting for the minority interest shown in the REIT's consolidated financial statements. The EITF reached a consensus that the sponsor's interest in the operating partnership should be reported as a minority interest in the REIT's consolidated financial statements. The EITF also agreed that the net equity of the operating partnership (after the contributions of the sponsor and the REIT) multiplied by the sponsor's ownership percentage in the operating partnership represents the amount to be reported as the minority interest in the REIT's consolidated financial statements.

Risks and Uncertainties

.93 In December 1994, AcSEC issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires nongovernmental entities to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires entities to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.94 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of estimates that may be included in the financial statements of real estate enterprises are:

- Impairment of long-lived assets
- Estimates of environmental remediation liabilities
- Profit recognition on sales recognized on the installment method

Examples of concentrations that may be subject to disclosure in the financial statements of real estate enterprises may include the following:

- Ownership of numerous properties within one geographical area
- Leases with one lessee
- Funding commitments from one financial institution related to project development

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

.95 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

.96 Under environmental laws and regulations, real estate enterprises may be held responsible for clean-up costs related to various aspects of their operations.

.97 In June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities.* The exposure draft provides that—

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 (AC C59) are met, and it includes benchmarks to aid in determining when those criteria are met.
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent the employees are expected to devote time to the remediation effort.
- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site, and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- Measurement of the liability should be based on enacted laws and existing regulations, policies and remediation technology.
- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed, and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and clean-up laws and the need to consider various individual state and other non-United States government requirements.

.98 Comments on the exposure draft were due by October 31, 1995.

.99 Auditors should be aware of the requirements of the proposed SOP and of the fact that ownership of real estate often exposes entities to environmental remediation liabilities.

AICPA Exposure Draft: Proposed Statement of Position on Participating Mortgage Loan Borrowers

.100 In July 1995, the AICPA issued an exposure draft of a proposed SOP, *Accounting by Participating Mortgage Loan Borrowers.* The proposed SOP establishes the borrower's accounting for a participating mortgage loan if the lender participates in increases in the market value of the mortgaged real estate project, the results of operations of that mortgaged real estate project, or both.

Information Sources

.101 Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

.102 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.103 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.104 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.105 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

* * * *

.106 This Audit Risk Alert supersedes Real Estate Industry Developments—1994.

* * * *

.107 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

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Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P O Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. General Accounting Office	*Superintendent of Documents* U S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250(f)		*U.S. Government Printing Office's The Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account User assistance line (202) 512-1530 (202) 512-1387(d) Telnet via internet federal.bbs.gpo.gov 3001	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext 3 (202) 942-7114 (tty)		*Information Line* (202) 942-8088 (202) 942-7114 (tty)

[The next page is 8499-3.]

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Appendix

NON-AUTHORITATIVE PRACTICE AID

ILLUSTRATIVE INDEPENDENT AUDITOR REPORTS BASED ON AUDITS PERFORMED IN ACCORDANCE WITH THE *CONSOLIDATED AUDIT GUIDE FOR AUDITS OF HUD PROGRAMS* ISSUED BY THE U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, OFFICE OF INSPECTOR GENERAL (JULY 1993 EDITION).

[*Note*: This appendix provides sample reports included in Chapter 2 of the HUD Handbook 2000.04 REV-1 as amended by the 1994 revision to *Government Auditing Standards,* which was effective for financial audits of periods ending on or after January 1, 1995 (early application is permissible). These illustrative reports are intended to be a non-authoritative practice aid and have not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.]

Example A

Report on Audited Financial Statements and Supplementary Information

Independent Auditor's Report

To the Partners
ABC Entity
Anytown, U.S.A.

We have audited the accompanying balance sheet of [*Entity*] as of June 30, 199X, and the related statements of income, and cash flows (and changes in partners' equity)(and analysis of net worth) for the year then ended. These financial statements are the responsibility of the [*Entity's*] management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [*Entity*] as of June 30, 199X, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards,* we have also issued a report dated [*date of report*] on our consideration of [*Entity's*] internal control structure and a report dated [*date of report*] on its compliance with laws and regulations.

The accompanying supplementary information (shown on pages XX to XY) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

[*Signature*]
[*Date*]

Example B

Independent Auditor's Report on the Internal Control Structure (Combined Report Applicable to the Financial Statements and HUD-Assisted Programs—Reportable Conditions Were Noted—No Material Weaknesses)[1]

Independent Auditor's Report

[Note: The Consolidated Audit Guide for Audits of HUD Programs (July 1993 edition) illustrates a "combined" report on the internal control structure applicable to the financial statements and HUD-assisted programs. Accordingly, this illustration is a combined report. Auditors should exercise care in issuing such a combined report to assure that the unique requirements in the Guide and varying levels of materiality are met.]

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the financial statements of [*Entity*] as of and for the year ended June 30, 199X, and have issued our report thereon dated [*date of report*].[2] We have also audited [*Entity's*] compliance with requirements applicable to major HUD-assisted programs and have issued our report thereon dated [*date of report*].

We conducted our audits in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States and the *Consolidated Audit Guide for Audits of HUD Programs* (the "Guide"), issued by the U.S. Department of Housing and Urban Development, Office of the Inspector General in July 1993. Those standards and the Guide require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and about whether [*Entity*] complied with laws and regulations, noncompliance with which would be material to a major HUD-assisted program.

The management of [*Entity*] is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles and that HUD-assisted programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audits, we obtained an understanding of the design of relevant internal control structure policies and procedures and determined whether they had been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements of [*Entity*] and on its compliance with specific requirements applicable to its major HUD-assisted programs and to report on the internal control structure in accordance with the provisions of the Guide and not to provide any assurance on the internal control structure.

We performed tests of controls, as required by the Guide, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting

[1] For guidance on departures from the standard internal control structure report and examples of explanatory paragraphs, the auditor should consult AICPA Statement of Position 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, Exhibit D-8, and AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Examples A.26(A) through A.26(E).

[2] Describe any departure from the standard report.

material noncompliance with specific requirements applicable to [*Entity's*] major HUD-assisted programs. Our procedures were less in scope than would be necessary to render an opinion on such internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements or to administer HUD-assisted programs in accordance with applicable laws and regulations.

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited or that noncompliance with laws and regulations that would be material to a HUD-assisted program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of [*Entity*] in a separate letter dated [*date of report*].

This report is intended for the information of the audit committee, management, and the Department of Housing and Urban Development. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

Example C

Independent Auditor's Report on Compliance Based on an Audit of Financial Statements—No Reportable Instances of Noncompliance[1]

Independent Auditor's Report

[NOTE: This report is not illustrated in the Consolidated Audit Guide for Audits of HUD Programs (July 1993 edition). As noted in the Guide, if the IA considered laws and regulations as part of the audit of the financial statements in addition to those noted in the Guide for which noncompliance could have a direct and material effect on the financial statements, as required by SAS No. 54, Illegal Acts by Clients (AU section 317), the auditor should also issue this report in accordance with Government Auditing Standards.]

To the Partners

ABC Partnership

Anytown, U.S.A.

We have audited the financial statements of [*Entity*] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[2]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts and grants applicable to [*Entity*] is the responsibility of the [*Entity's*] management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [*Entity's*] compliance with certain provisions of laws, regulations, and contracts. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards.*[3,4]

This report is intended for the information of the audit committee, management, and the Department of Housing and Urban Development. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

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[1] For guidance on departures from the standard report on compliance based on an audit of the financial statements and examples of explanatory paragraphs, the auditor should consult AICPA Statement of Position 92-9, Exhibits D-4 through D-7, and the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.17(B).

[2] Describe any departure from the standard report.

[3] See *Government Auditing Standards,* Chapter 5, paragraphs 5.18 and 5.19, for reporting criteria.

[4] If the auditor has issued a separate letter to communicate irregularities, illegal acts, or other noncompliance that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards,* this paragraph should be modified to include a statement such as the following:

> We noted certain immaterial instances of noncompliance that we have reported to the management of [*Entity*] in a separate letter dated August 15, 199X.

Example D

Independent Auditor's Report on Compliance With Specific Requirements Applicable to Major HUD Programs[1]

Independent Auditor's Report

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the financial statements of [*Entity*] as of and for the year ended June 30, 199X and have issued our report thereon dated [*date of report*].[2]

We have also audited [*Entity's*] compliance with the specific program requirements governing (list those requirements tested) that are applicable to each of its major HUD-assisted programs, for the year ended June 30, 199X. The management of [*Entity*] is responsible for compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards*, issued by the Comptroller General of the United States, and the *Consolidated Audit Guide for Audits of HUD Programs* (the "Guide") issued by the U.S. Department of Housing and Urban Development, Office of Inspector General in July 1993. Those standards and the Guide require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about [*Entity's*] compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, [*Entity*] complied, in all material respects, with the requirements described above that are applicable to each of its major HUD-assisted programs for the year ended June 30, 199X.

This report is intended for the information of the audit committee, management, and the Department of Housing and Urban Development. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]
[*Date*]

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[1] For guidance on departures from the standard report on compliance with specific requirements applicable to major programs, auditors should consult AICPA Statement of Position 92-9, Exhibits D-9 through D-14, and the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units, Appendix A, Examples A.18 through A.22.*

[2] Describe any departures from the standard report.

Example E

Independent Auditor's Report on Compliance With Specific Requirements Applicable To Nonmajor HUD Programs Transactions

Independent Auditor's Report

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the financial statements of [*Entity*] as of and for the year ended June 30, 199X, and have issued our report thereon dated [*date of report*].[1]

In connection with our audit of the 199X financial statements of [*Entity*] and with our consideration of [*Entity's*] internal control structure used to administer HUD programs, as required by the *Consolidated Audit Guide for Audits of HUD Programs* (the "Guide") issued by the U.S. Department of Housing and Urban Development in July 1993, we selected certain transactions applicable to certain nonmajor HUD-assisted programs for the year ended June 30, 199X. As required by the Guide, we performed auditing procedures to test compliance with the requirements governing [*list requirements tested*] that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*Entity's*] compliance with these requirements. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under the Guide.[2]

This report is intended for the information of the audit committee, management, and the Department of Housing and Urban Development. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]
[*Date*]

[1] Describe any departures from the standard report.

[2] If there are instances of noncompliance that are required to be reported under the Guide, this sentence should be deleted and the instances of noncompliance noted should be reported in this paragraph or in an attached schedule.

Example F

Independent Auditor's Report on Compliance With Specific Requirements Applicable to Affirmative Fair Housing

Independent Auditor's Report

To the Partners

ABC Partnership

Anytown, U.S.A.

We have audited the financial statements of [*Entity*] as of and for the year ended June 30, 199X, and have issued our report thereon dated [*date of report*].[1]

We have also applied procedures to test [*Entity's*] compliance with the Affirmative Fair Housing requirements applicable to its HUD-assisted programs, for the year ended June 30, 199X.

Our procedures were limited to the applicable compliance requirement described in the *Consolidated Audit Guide for Audits of HUD Programs* (the Guide) issued by the U.S. Department of Housing and Urban Development, Office of Inspector General in July 1993. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*Entity's*] compliance with the Affirmative Fair Housing requirements. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under the Guide.[2]

This report is intended for the information of the audit committee, management and the Department of Housing and Urban Development. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

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[1] Describe any departure from the standard report.

[2] If there are instances of noncompliance that are required to be reported under the Guide, his sentence should be deleted and the instances of noncompliance noted should be reported in this paragraph or in an attached schedule.

AAM Section 8220

Public Utilities Industry Developments—1995/96

Industry and Economic Developments

.01 The public utilities industry is an industry in a state of transition. The dynamic environment in which the industry operates holds many challenges and opportunities. The challenges relate to issues such as competition, cost containment, and deregulation. The opportunities relate to diversification and increased operational efficiencies and productivity. The electric, gas, and telecommunications industry is dealing with unprecedented competitive pressures while the water industry is coping with environmental laws, such as the Safe Drinking Water Act and the Clean Air Act, and regulations issued by the Environmental Protection Agency (EPA) and various state regulators.

Electric Utilities

.02 In 1992, Congress passed the National Energy Policy Act, which provides for opening the wholesale power market to full competition. Since then, the Federal Energy Regulatory Commission (FERC) has strived to develop a framework that would ensure equal access to transmission and distribution systems while assuring fair pricing across all customer classes. In order to survive and succeed in the new competitive environment, many electric utilities are implementing strategic plans to cut costs and lower prices. Many of these strategic plans involve business combinations: merging, acquiring, partnering, and joint venturing with other utilities. Such combinations allow utilities to achieve economies of scale and increase overall productivity and efficiency. In addition, many electric utilities are restructuring and realigning existing operations in an effort to contain costs and enhance organizational efficiencies.

Gas Utilities

.03 FERC Order 636 changed the structure of the gas industry to allow open access transportation, enabling end users to purchase gas on the spot market directly from producers. Order 636 requires gas pipelines to unbundle their services from the traditional provision of gas services. Such unbundling has allowed industrial users to bypass local distribution companies and purchase gas directly from producers and pipelines. As a result, gas customers—especially electric generators and other large industrial users—now have the ability to make gas supply choices that are market-driven rather than mandated by regulation. As gas utilities enter their second full year of operations under Order 636, they are adapting to the competitive environment in a number of ways:

- Investing in natural gas storage facilities. Storage allows local distribution companies to purchase natural gas at off-peak prices and pass the savings on to customers.

- Using natural gas marketing initiatives. Marketing initiatives assist gas utilities in their efforts to combine supply, transportation, and storage capabilities into efficient, cost-effective service packages.

- Expanding to different market segments and geographic regions. Market and geographic expansion allows gas utilities to diversify and gain new competitive advantages.

A relaxed regulatory environment, designed to let market forces work, has thus given gas companies an unprecedented level of operational flexibility.

Telecommunications

.04 The advent of competition, the rapid introduction of advanced technology, and the divestiture of local companies by AT&T continue to increase both local telephone rates and the business risks faced by telephone utilities. The breakdown of regulatory barriers at both the state and federal levels has allowed competitors to enter telecommunication services markets with increasing frequency. At the same time, it has allowed telecommunication providers to enter new markets in areas of increased competition, such as cable services.

Water Utilities

.05 Recent environmental laws enacted by Congress and the related regulations administered by the EPA and various state regulators have set stringent standards for water utilities and their operations. For example, the EPA raises national standards for water purity at least once every three years in accordance with the Safe Drinking Water Act and the Clean Air Act. In order to meet the increased standards, water utilities are often faced with increased costs related to (1) substantial capital investments, (2) highly paid technical personnel, and (3) expensive water treatment chemicals. When planning the audit of water utilities, auditors should consider such cost increases and should consider whether they are recoverable from water customers.

The Impact of Competition on Accounting Decisions

.06 The monopoly status granted to utilities in the past brought with it governmental regulation of rates charged for the services the utilities provided. This regulation is performed through various rate-making processes, which determine selling prices and specify overall levels of revenue, the types and amounts of rates that may be charged, and the various classes of users to which the different rates apply. Rate-making also influences the application of generally accepted accounting principles (GAAP) by public utilities.

.07 AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), requires that, in planning the audit, auditors should consider "matters relating to the entity's business and the industry in which it operates." Increased competition and other economic factors affecting the public utilities industry raise a number of issues that may increase audit risk and should be carefully considered by auditors as they plan their audits. For example, as a result of increased competition, some utilities may find that the actual useful lives of certain assets are shorter than originally anticipated or that costs deferred in accordance with Financial Accounting Standards Board (FASB) Statement No. 71, *Accounting for the Effects of Certain Types of Regulation* (AC Re6), may not be recoverable. These and other issues are addressed further in the "Audit Issues and Developments" section of this Audit Risk Alert.

Regulatory and Legislative Development

Rural Utilities Service Approval of AICPA Peer Review Program

.08 In July 1995, the Rural Utilities Service (RUS)—formerly the Rural Electrification Administration—approved the AICPA peer review program as meeting its quality review requirements under Section 1773.5(c)(3)(iii) of the Code of Federal Regulations (CFR). If a CPA firm previously had a review under the AICPA quality review program, it will be deemed to be in compliance with the RUS peer review requirements.

Audit Issues and Developments

The Interrelationship of Rate Making and Accounting

.09 As part of the rate-making process of governmental regulation, rate orders often require rate-regulated entities to observe accounting practices for rate-making purposes that are at variance with GAAP for nonregulated entities. For example, although GAAP requires the immediate recognition of research and development expenses, regulators of public utilities may require the utilities subject to their jurisdiction to defer research and development costs for rate-making purposes and amortize them over the future periods in which compensating revenues will be generated through the rate-making process.

.10 FASB Statement No. 71 (AC Re6) requires utilities to capitalize costs if regulation provides reasonable assurance that incurred costs will be recovered in the future through the rate-making process. For example, a regulator may permit unanticipated repair costs incurred in one fiscal period to be recovered in a future period through higher customer rates. For accounting purposes, the unanticipated repair costs should be deferred until the rates are effective and should be amortized as the revenues are collected. Similarly, if current rates are provided for costs that are expected to be incurred in the future, such as the costs of potential storm damage repairs, FASB Statement No. 71 (AC Re6) requires that those current additional receipts be recognized as liabilities.

.11 As they plan their audits of the financial statements of public utilities, auditors should consider inherent risk, especially risk factors relating to the regulatory structure of the industry. The recovery of regulatory assets, such as deferred energy costs, abandoned plant assets, and phase-in assets, may depend highly on the rate-making process. Assessment of audit risk should include an assessment of the risk that those costs will not be recovered. Auditors should also plan to determine whether such costs have been accounted for properly.

Continued Applicability of FASB Statement No. 71

.12 The environment in which utilities operate is rapidly changing due to changes in the marketplace, technology, and a political climate that favors deregulation. Changes in state and federal regulation of utilities have resulted in increased use of incentive-type rate regulation, regulator-imposed conservation measures (for example, demand side management), significant regulatory disallowances and deferred rate recovery of material costs, and increased competition. In certain industries, changes in technology have created new competitors and caused the rapid obsolescence of plant and equipment. Given the movement toward deregulation and increased competitiveness of the utility operating environment, a utility's auditors must assess whether any one factor or the combined effect of these factors would lead to the conclusion that the criteria for the application of FASB Statement No. 71 (AC Re6) are no longer met by the utility. The basic criteria for the application of FASB Statement No. 71 (AC Re6), as discussed in paragraph 5(a) (AC Re6.115) of that Statement are:

1. The enterprise's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.

2. The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products.

3. In view of the demand for the regulated services or products, and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.

.13 FASB Statement No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71* (AC Re6), provides several examples of reasons that may cause an enterprise, or "a separable portion" thereof, to no longer meet the criteria for applying FASB Statement No. 71 (AC Re6). Reasons cited include deregulation, a change from cost-based rate making to another form of regulation, increasing competition that limits the ability to recover costs, and regulatory actions that limit rate relief to a level insufficient to recover costs. These factors should be considered in determining when an enterprise ceases to meet the criteria for application of FASB Statement No. 71 (AC Re6).

.14 In the face of retail wheeling and other competitive forces, electric utility companies have been offering wholesale customers and large industrial customers large discounts to retain their business. FASB Statement No. 101 (AC Re6) states that a "separable portion" of the business may be the operations within a regulatory jurisdiction or a smaller portion, such as a customer class within a jurisdiction. Auditors of utilities that are discounting rates to certain classes of customers should consider the effect of such discounting on the appropriateness of the continued application of FASB Statement No. 71 (AC Re6) for those classes of customers, even when the remainder of the utility's operations continue to meet the Statement No. 71 (AC Re6) criteria. If discontinuance of Statement No. 71 (AC Re6) is appropriate for a class of customers, applying Statement No. 101 (AC Re6) may require allocation of systemwide assets and liabilities.

.15 Because regulated enterprises may be experiencing one or more of the circumstances cited, it is important that such enterprises assess annually, and auditors consider carefully, the propriety of the continuing applicability of FASB Statement No. 71 (AC Re6). As utilities adopt alternative regulatory plans, auditors should consider the cause-and-effect relationship between a company's own costs and revenues in reaching a determination about the appropriateness of continued application of FASB Statement No. 71 (AC Re6). Auditors can look to such factors as—

- The basis used for setting the company's initial rates under alternative regulation and whether the regulatory intent is that such rates be cost-based.
- The frequency of price adjustments and whether the regulatory intent of adjustments is to maintain rates that are cost-based.
- The company specificity of price-adjustment formulas.
- The degree of adjustment to the company's actual costs through sharing provisions.
- How closely changes in the company's actual costs track the changes in revenues produced by applying price-adjustment formulas.

Auditors should consider whether their clients cease to meet the criteria for applying the provisions of FASB Statement No. 71 (AC Re6) and should consequently apply the provisions of FASB Statement No. 101 (AC Re6). FASB Statement No. 101 (AC Re6) states that once all or a separable portion of an enterprise's operations no longer meet the criteria for application of FASB Statement No. 71 (AC Re6), the enterprise should discontinue its application by eliminating from its balance sheet the effects of any actions of regulators that had been recognized as assets and liabilities pursuant to FASB Statement No. 71 (AC Re6) but that would not have been recognized as assets and liabilities by enterprises in general. However, the carrying amounts of plant, equipment, and inventory measured and reported pursuant to FASB Statement No. 71 (AC Re6) should not be adjusted unless those assets are impaired, in which case the carrying amounts of those assets should be reduced to reflect that impairment. (Impairment should be judged in the same manner as assets of enterprises in general—see "Impairment of Long-Lived Assets" in the "Accounting Issues and Developments" section of this Audit Risk Alert.) The net effect of the adjustments required by FASB Statement No. 101 (AC Re6) should be included in income of the period of the change and classified as an extraordinary item.

Regulatory Assets

.16 Regulatory assets are created when the rate actions of regulators provide reasonable assurance of the existence of an asset. The criteria for the establishment of such assets are contained in paragraph 9 of FASB Statement No. 71 (AC Re6.119).

.17 Because regulatory assets are recorded only if it is "probable" (as defined in FASB Statement No. 5, *Accounting for Contingencies* [AC C59]) that future revenue will recover those costs, a critical assessment of the sufficiency of the audit evidence available to support them is a matter that requires judgment. A currently effective rate order generally provides assurance of the existence of a regulatory asset. Generic orders of regulators may also provide evidence of the existence of a regulatory asset. Sometimes, however, because of the nature and length of the regulatory process, a rate or a generic order may not yet be available. In such cases, auditors may need to look to related jurisdictional precedent, accounting orders, or other evidence involving other utilities in order to test an assertion that recovery of regulatory assets is probable. In the absence of a rate or a generic order, discussion of the situation with the regulatory staff having jurisdiction may be advisable. Recognition of regulatory assets, in the absence of the audit evidence described above, should be approached with a high degree of professional skepticism. Factors such as a good working relationship with regulators or the recent favorable resolution of issues unrelated to the incurred costs being evaluated are not generally an adequate basis for the recognition of regulatory assets.

.18 In addition to the provisions set forth in FASB Statement No. 71 (AC Re6), specific criteria for the recognition and measurement of regulatory assets and related matters are included in the following pronouncements:

- FASB Statement No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs* (AC Re6)
- FASB Statement No. 92, *Regulated Enterprises—Accounting for Phase-in Plans* (AC Re6)
- FASB Statement No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71* (AC Re6)
- FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08)
- FASB Emerging Issues Task Force (EITF) Issue No. 92-7, *Accounting by Rate-Regulated Utilities for the Effects of Certain Alternative Revenue Programs*
- EITF Issue No. 92-12, *Accounting for OPEB Costs by Rate-Regulated Enterprises*
- EITF Issue No. 93-4, *Accounting for Regulatory Assets*

Auditors should refer to these pronouncements, when applicable, in evaluating the propriety of a client's accounting for regulatory assets.

.19 Auditors should consider whether the amount and recovery period of regulatory assets, as well as the amount of regulatory assets not earning a return, are adequately disclosed in the financial statements. The staff of the Securities and Exchange Commission (SEC) has indicated its preference that, for publicly held enterprises, disclosures include the amount and nature of regulatory assets and liabilities as well as the manner in which the financial statements would differ if the enterprise were not regulated, including differences in methods of depreciation. The SEC staff has also indicated that, when a regulated enterprise has a rate case or cases subject to appeal through the regulatory or judicial system, the enterprise should disclose the status of each issue on appeal and indicate how the item is recorded in the financial statements.

.20 Certain regulatory assets (for example, costs deferred under a phase-in plan and those that relate to postretirement benefits other than pensions) have prescribed maximum recovery periods and methods. Other regulatory assets (for example, those arising from flow-through income tax accounting) may have a recovery period related to their underlying nature. Recovery periods related to other regulatory assets are left to the judgment of the utility and its regulator. Auditors should be aware that in the changing regulatory environment the recovery of regulatory assets over a long period of time may call into question whether such assets are probable of recovery.

.21 Deferral of an incurred cost is permitted only if it is probable of recovery. If uncertainties develop after a regulatory asset has been recorded, management should reconsider whether the asset will be recovered through rates. If not, the asset should be written off. If the asset is not impaired but uncertainties exist, auditors should consider the adequacy of disclosures in the financial statements regarding the uncertainty and the need to add an explanatory paragraph in the auditor's report. See also the sections of this Audit Risk Alert entitled "Impairment of Long-Lived Assets", "Risks and Uncertainties", and "Elimination of Uncertainty Reporting."

.22 The addition of an explanatory paragraph to the auditor's report because of an uncertainty concerning the recoverability of a regulatory asset is not a substitute for recognition of a loss when such recognition is appropriate. Accordingly, it should first be determined whether a loss should be recognized in those situations because the asset is impaired. If it is determined that a loss is not recognized when it should be and the effect on the financial statements is material, the auditor's report should be modified for a departure from GAAP. See also the "Risks and Uncertainties" section in this Audit Risk Alert.

Stranded Costs

.23 A recent study, *Stranded Costs Will Threaten Credit Quality of U.S. Electrics,* estimates that a substantial amount of fixed costs approved for recovery in prior regulatory climates may become "stranded," that is, not recoverable by the utility, in the future as the industry moves toward a more free market environment.[1] As regulators move away from cost-based regulation, the issue arises of whether utility customers or utility shareholders and bondholders will ultimately bear the sunk costs associated with previously constructed plants, long-term power purchase contracts, or fuel cost structures that are not economically viable at competitive, market-based rates. An auditor should be aware of and consider the impact of competition on the utility's ability to recover its costs. One factor that the auditor might consider in assessing a company's exposure to stranded costs and the possible impact of such costs on the company's financial statements is the cost structure of the utility in comparison to its competitors and in conjunction with rate-setting developments within its operating jurisdiction. The existence of such costs may suggest that an asset is impaired or that the discontinuation of regulatory accounting under FASB Statement No. 71 (AC Re6) is appropriate, or both.

Depreciation

.24 The estimated useful lives and the estimated removal or retirement costs of plants and other facilities may change significantly over time because of various factors, including changes in planned use due to competitive or environmental factors, governmental requirements, and physical plant changes that shorten or extend the life of the facility. The determination of estimated useful lives and removal or retirement costs involves accounting estimates. SAS No. 57, *Auditing Accounting Estimates* (AU section 342), provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates. In situations involving complex or highly specialized plants or facilities, auditors may need to engage a specialist to achieve the required degree of assurance regarding estimated useful lives. In these instances, auditors should consider the requirements of SAS No. 73, *Using the Work of a Specialist* (AU section 336). Auditors should also consider whether estimates of useful lives of plants and other facilities are the types of significant estimates that would require disclosure under AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*

.25 Regulatory agencies often require specific approval of depreciation rates used by the utilities they regulate and any changes therein. Generally, any differences between the amounts of depreciation expense that would be recognized in accordance with GAAP and those that are allowed in the rate-making process give rise to regulatory assets or liabilities. (An exception to the general rule is prescribed by FASB Statement No. 92 (AC Re6), which prohibits the recognition of a regulatory asset for such differences if they relate to recently completed plant.) Auditors should be familiar with the applicable regulatory requirements for approval of depreciation rates and should read regulatory orders in assessing the propriety of depreciation recorded in the financial statements as well as the propriety of regulatory assets recorded in accordance with FASB Statement No. 71 (AC Re6).

[1] Moody's Investor Service, *Stranded Costs Will Threaten Credit Quality of U.S. Electrics,* August 1995.

Nuclear Decommissioning

.26 Nuclear decommissioning refers to decontaminating a nuclear power plant at the end of its useful life. In 1994, the FASB added to its agenda a project on accounting for obligations for decommissioning of nuclear power plants. Traditionally, the estimated decommissioning obligation for nuclear power plants has been treated as negative salvage value and recognized over the life of the plant as depreciation rather than reflected as a liability. The objective of the FASB's project is to determine if and when a liability for nuclear decommissioning should be recognized, how any such liability should be measured, and whether a corresponding asset is created. At the end of 1995, the FASB expects to release a proposed Statement of Financial Accounting Standards entitled *Liabilities for Closure and Removal of Long-Lived Assets* that will address this issue.

.27 SEC Staff Accounting Bulletin (SAB) Topic 10B, *Estimated Future Costs Related to Spent Nuclear Fuel and Nuclear Electric Generating Plants,* provides guidance that should be followed by publicly held utilities on disclosures that should be made concerning the estimated future costs of storing spent nuclear fuel and decommissioning nuclear generating plants. Auditors of financial statements of utilities that own nuclear power plants should evaluate carefully the adequacy of financial statement disclosures related to decommissioning costs. In particular, they should consider whether a reliable decommissioning study has been conducted and whether estimated costs include all applicable items. Auditors should also consider the reasonableness of estimates of the useful lives of such plants. The useful lives of some plants may be substantially shorter than originally anticipated. (See the previous discussion of issues related to depreciation.) If decommissioning costs are underestimated and useful lives of plants overstated, provisions made over the lives of the plants and recovered in rates may be inadequate to cover the costs that will need to be incurred in the decommissioning process.

.28 Because the determination of decommissioning or removal costs involves accounting estimates, auditors may find useful guidance in SAS Nos. 57 (AU section 342) and 73 (AU section 336).

.29 On June 30, 1995, the FERC issued a final rule entitled *Nuclear Plant Decommissioning Trust Fund Guidelines* that sets forth the guidelines for the formation, organization, and purpose of nuclear plant decommissioning trust funds (Funds) and for Fund investments. The rules are intended to (1) give Funds greater investment flexibility, (2) improve the returns earned on Funds contributed through wholesale electric rates, and (3) decrease the amounts collected from rate payers for decommissioning. The final rule became effective July 31, 1995.

Environmental Matters

.30 Because of the nature of their operations, utilities are often faced with obligations driven by environmental requirements. Such obligations frequently include the disposition of materials containing polychlorinated biphenyl (PCB), the disposition of high- and low-level radioactive waste, the reduction of sulfur dioxide emissions, remediation of residuals associated with manufactured gas plant sites, and asbestos removal. Such environmental issues have the potential to result in significant costs.

.31 Auditors of utilities that face such environmental issues should evaluate whether the accounting and disclosure requirements of FASB Statement No. 5 (AC C59) have been met, as well as the implications of rate regulation and FASB Statement No. 71 (AC Re6). Additional guidance is included in the following:

- FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (AC C59)
- FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10)
- EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal*
- EITF Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination*
- EITF Issue No. 93-5, *Accounting for Environmental Liabilities*

.32 Auditors of publicly held utilities should also consider the requirements of SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies,* which provides the SEC staff's interpretation of current accounting literature related to matters such as—

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in the estimation of the extent of environmental liabilities
- The appropriate discount rate for environmental liabilities if discounting is appropriate
- Financial statement disclosures of environmental exit costs and other items and disclosure of certain information outside the basic financial statements

SAB No. 92 includes a separate section (Topic 10F, *Presentation of Liabilities for Environmental Costs*) that discusses the impact of environmental liabilities on the utilities industry. The SAB indicates that utilities subject to the SEC's rule (1) should not offset regulatory assets against liabilities for environmental costs and (2) should not delay recognition of probable and reasonably estimable liabilities for environmental costs until regulators have determined whether the costs are recoverable in the rate-making process.

.33 SAB No. 92 also states that when estimating liabilities for environmental remediation, a company should consider available evidence, including the company's prior experience in remediation of contaminated sites, other companies' clean-up experience, and data released by the EPA or other organizations. The continued expansion of environmental databases has resulted in the availability of significantly more information to support a reasonable estimate of the amount of loss or range of loss. As has been noted in recent press reports, companies have been using such expanded informational resources in developing or refining their estimates of environmental liabilities. When evaluating a utility's environmental remediation liabilities, auditors may consider the evidence currently provided by the expanded environmental databases. (See also the "Accounting Issues and Developments" section of this Audit Risk Alert for information on environmental remediation liabilities.)

Derivatives

.34 Recent years have seen a growing use of innovative financial instruments, commonly referred to as derivatives, that often are very complex and can involve a substantial risk of loss. Public utilities are increasingly entering into forward contracts, futures contracts, and options in order to hedge against losses related to the effect of changing prices and other uncertainties. As interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments obtain their value have increased in volatility, a number of entities have incurred significant losses as a result of their use. The use of derivatives almost always increases audit risk. Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditors' approach to achieving related audit objectives may differ because certain derivatives are not generally recognized in the financial statements.

.35 It is essential that auditors understand both the economics of derivatives used by the entities whose financial statements they audit and the nature and business purpose of the entities' derivatives activities. In addition, auditors should carefully evaluate their clients' accounting for any such instruments, especially those carried at other than market value. To the extent the derivatives qualify as financial instruments as defined in FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), the disclosure requirements set forth in those Statements (AC F25) must be met. When derivatives are accounted for as hedges of on-balance-sheet assets or liabilities or of anticipated transactions, auditors should carefully review the appropriateness of the use of hedge accounting, particularly considering whether the criteria set forth in applicable accounting literature are met.

.36 The SEC staff has indicated in public speeches and letters of comment to registrants during the past year that publicly held companies should disclose the nature and purpose of certain commodity-based derivatives activities, the nature and terms of certain commodity-based derivatives used, and the accounting methods used even when such derivatives do not meet the definition of financial instruments set forth in the FASB Statements (AC F25) cited above.

.37 Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1995/96* [AAM section 8010]. Also, see "Disclosures About Derivatives" in the "Accounting Issues and Developments" section of this Audit Risk Alert. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations.

Order 636 Transition Costs

.38 FERC Order 636 requires gas pipelines to "unbundle" their services from the traditional provision of gas services. Order 636 was issued in 1992 and was subsequently revised on rehearing by Order 636-A and Order 636-B (collectively referred to herein as Order 636). Order 636 precipitated the complete transition to an open-access and competitive natural gas pipeline industry. Accordingly, pipeline companies subject to FERC jurisdiction are required by Order 636 to unbundle firm and interruptible transportation services, including gas storage services, from gas sales. In light of the increased competition in this segment of the natural gas industry as a result of Order 636, auditors should consider carefully the appropriateness of continued application of FASB Statement No. 71 (AC Re6) by pipeline companies subject to FERC jurisdiction.

Purchased-Power Contracts

.39 The increasing numbers of independent power producers and nonutility generators and the growing significance of purchased-power contracts as a source of system capacity have focused attention on the accounting and disclosure of purchased-power contracts.

.40 Paragraph 7 of FASB Statement No. 47, *Disclosure of Long-Term Obligations* (AC C32.102), specifies the disclosure requirements of long-term unconditional purchase obligations that have the characteristics specified in paragraph 6 of FASB Statement No. 47 (AC C32.101). The disclosure requirements include (1) the nature and term of the obligation(s), (2) the amount of the fixed and determinable portion of the obligation(s) as of the date of the latest balance sheet presented in the aggregate and, if determinable, for each of the five succeeding fiscal years, (3) the nature of any variable components of the obligation(s), and (4) the amounts purchased under the obligation(s) for each period for which an income statement is presented. FASB Statement No. 47 (AC C32) allows disclosures of similar or related unconditional purchase obligations to be combined. FASB Statement No. 105 (AC F25) contains similar disclosure requirements for unconditional purchase obligations not subject to FASB Statement No. 47 (AC C32).

.41 In addition to the disclosure requirements in FASB Statements No. 47 (AC C32) and No. 105 (AC F25), SAB Topic 10D, *Long-Term Contracts for Purchase of Electric Power,* also provides guidance concerning disclosures required for certain purchased-power contracts of publicly held entities. The disclosures suggested by the SAB include the terms and significance of such contracts to the utility, including date of contract expiration, share of plant output being purchased, estimated annual cost, annual minimum debt-service payment required, and amount of related long-term debt or lease obligations outstanding.

.42 The SAB suggests additional disclosure if the contract provides, or is expected to provide, more than 5 percent of current or estimated future system capability. According to the *Glossary of Electric Utility Terms* published by the Edison Electric Institute, capability of a plant is defined as "the maximum load which a unit can carry under specified conditions over a given period of time without exceeding approved limits of temperature and stress." If the 5 percent test is met, the SAB gives two alternatives for disclosure. The first is separate financial statements of the vendor entity. The second is disclosure of the amount of the obligation under contract as a liability on the balance sheet, with a corresponding amount as an asset representing the right to purchase power under the contract.

.43 The accounting for and disclosure of purchased-power contracts are also receiving increased attention. These contracts may have varying terms, but typically they are segregated into capacity and energy components. As accounting for these contracts is being considered, auditors should be aware that some of the contracts may have characteristics similar to leases. FASB Statement No. 13, *Accounting for Leases* (AC L10), defines a lease as an "agreement conveying the right to use the property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time." FASB Statement No. 13 (AC L10) further states that "a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor."

.44 In determining whether a long-term purchased-power contract is appropriately accounted for, auditors should consider whether the purchaser has evaluated the arrangements and assessed the risks and rewards assumed and retained by the parties to the agreement. Specific factors to consider include—

- The amount and timing of the fixed, noncancelable payments due under the contract and their relationship to the fair value of the generating plant.
- The period of the contract in relation to the economic life of the plant, including the existence of any renewal options. (Particular attention should be given to whether the utility would incur a penalty—as defined in FASB Statement No. 13 (AC L10), as amended—if it does not exercise a renewal option.)
- The source of fuel for the plant and which party bears the risk associated with its price and availability.
- The existence of any option that allows the utility to purchase the generating plant.

.45 If the terms of the contract convey the right to use property and equipment, the contract should be accounted for as a lease pursuant to FASB Statement No. 13 (AC L10).

Elimination of Uncertainty Reporting

.46 The AICPA's Auditing Standards Board (ASB) has issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

.47 The amendment would also expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AU section 508), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

.48 The proposal does not affect the provisions of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), which requires that the auditor add an explanatory paragraph to the auditor's report when there is substantial doubt about the entity's ability to continue as a going concern.

.49 The ASB hopes to finalize this SAS late this year and to issue an SAS that would be effective for reports issued on or after June 30, 1996. Comments on the proposed SAS were due on October 20, 1995.

Accounting Issues and Developments

Restructuring Charges

.50 Several public utilities have recently recorded restructuring charges, and with downsizing in the electric industry and the formation of strategic alliances in the telecommunications industry, more companies may be recording such charges in the future. In considering restructuring reserves and costs, auditors should be aware of EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring),* for authoritative guidance on the appropriate guidance for restructurings. EITF Issue No. 94-3 provides guidance on (1) the types of costs that should be accrued and (2) the timing of recognition of restructuring charges. It also prescribes disclosures that should be included in the financial statements. For publicly held entities, SAB No. 67 (Topic 5P), *Income Statement Presentation of Restructuring Charges,* requires that restructuring charges be reported as a component of income from continuing operations.

Revenue Recognition on Long-Term Power Sales Contracts

.51 EITF Issue No. 91-6, *Revenue Recognition of Long-Term Power Sales Contracts,* addresses revenue recognition on long-term power sales contracts that have scheduled price changes. The consensus is applicable for contracts entered into after the date of the consensus (May 21, 1992). Several issues have arisen in applying the consensus to contracts acquired in conjunction with a purchase business combination with a nonutility power generator. The first issue is whether long-term power sales contracts acquired in a purchase business combination subsequent to the date of the consensus must be accounted for by the acquiring entity in accordance with the consensus as if they were "new" contracts. The SEC staff has communicated, in various speeches and comment letters to SEC registrants, its position that contracts that are acquired in a purchase business combination subsequent to the date of the consensus should be considered to be new contracts by the acquiring entity and accounted for in accordance with the consensus.

.52 The second issue involves contracts that in the early years include provision for fixed prices with scheduled price changes but in the later years have pricing provisions based on actual avoided costs. The consensus requires a company to recognize as revenue the lesser of (1) the amount billable under the contract or (2) an amount determined by the kilowatt hours (kwh) made available during the period multiplied by the estimated average revenue per kwh over the term of the contract. The issue is whether the consensus requires a company to determine the average revenue per kwh over the entire life of the contract, including both the years in which there are fixed payments with scheduled changes and the years based on avoided costs or whether the averaging can be applied only to the fixed portion of the contract. The SEC staff has communicated its position, in various speeches and comment letters to SEC registrants, that the estimated average revenue per kwh must be determined over the entire remaining life of the contract, since the consensus specifies "term of the contract" rather than some shorter period.

Impairment of Long-Lived Assets

.53 In March 1995, FASB issued Statement No. 121 (AC I08), which establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement (AC I08) requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.

.54 The Statement (AC I08) also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (AC I13). Assets that are covered by APB Opinion No. 30 (AC I13) will continue to be reported at the lower of the carrying amount or the net realizable value.

.55 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. Restatement of previously issued financial statements is not permitted by the Statement (AC I08). The Statement (AC I08) requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement (AC I08) requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

.56 Auditors of public utilities should be aware that the current industry climate of restructurings, mergers, and realignments has increased the likelihood that events or changes in circumstances that indicate that assets have been impaired may have occurred. In these instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 (AC I08) may need to be applied.

.57 The Statement (AC I08) also has a number of specific implications to rate-regulated enterprises:

- It amends paragraph 9 of FASB Statement No. 71 (AC Re6.119) to require that, if at any time the incurred costs no longer meet the criteria of paragraph 9 (AC Re6.119), they should be charged to earnings. Thus regulatory assets are now subject to a continuing probability-of-recovery test. This provision nullifies the consensus in EITF Issue No. 93-4, *Accounting for Regulatory Assets,* related to the impairment of a regulatory asset.

- It amends paragraph 10 of FASB Statement No. 71 (AC Re6.120) to require that if a regulator excludes all or part of a cost from allowable costs, the carrying amount of any regulatory asset should be reduced to the extent of the excluded cost.

- It provides that if a regulator allows recovery through rates of costs previously excluded from allowable costs, a new regulatory asset should be recognized. The classification of that asset should be consistent with the classification that would have resulted had those costs been initially included in allowable costs.

In considering a public utility's implementation of FASB Statement No. 121 (AC I08), auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57 (AC section 342). SEC registrants should consider the disclosure requirements included in SAB No. 74 (Topic 11M), *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period.*

Disclosures About Derivatives

.58 Utilities are increasingly using derivatives to manage the price risk associated with fuel purchase and energy sales contracts. A variety of instruments including futures, forwards, options, and swap contracts have been used.

.59 In October 1994, the FASB issued Statement No. 119 (AC F25) which requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 (AC F25) and No. 107 (AC F25).

.60 The Statement (AC F25) requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 (AC F25) because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 (AC F25.115P) encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

.61 FASB Statement No. 119 (AC F25) was effective for financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations, the Statement (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1995.

.62 The FASB Special Report, *Illustrations of Financial Instrument Disclosures*, contains illustrations of the application of FASB Statements No. 105 (AC F25), No. 107 (AC F25), and No. 119 (AC F25).

Risks and Uncertainties

.63 In December 1994, the AICPA's Accounting Standards Executive Committee issued SOP 94-6. SOP 94-6 requires organizations to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires organizations to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.64 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of similar estimates that may be present in financial statements of public utilities include, but are not limited to, the following:

- Specialized equipment subject to technological obsolescence
- Capitalized computer software costs
- Environmental remediation-related obligations and other environmental liabilities, such as those related to nuclear decommissioning
- Litigation-related obligations
- Contingent liabilities or obligations of other entities
- Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits
- Estimated net proceeds recoverable or the provisions for expected loss to be incurred, or both, on disposition of a business or assets
- Recoverability of certain regulatory assets

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of public utilities in accordance with paragraph 21 of the SOP include the following:

- Concentrations in the volume of business transacted with a particular class of customer, supplier, lender, grantor, or contributor
- Concentrations in revenue from particular products or services

- Concentrations in the available sources of supply of material, labor, or services or of licenses or other rights used in the entity's operations
- Concentrations in the market or geographic area in which an entity conducts its operations

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

.65 Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

.66 In June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities.* The exposure draft provides that—

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 (AC C59) are met, and it includes benchmarks to aid in determining when those criteria are met.
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent the employees are expected to devote time directly to the remediation effort.
- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- Measurement of the liability should be based on enacted laws and existing regulations, policies, and remediation technology.
- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and cleanup laws and the need to consider various individual state and other non-U.S. government requirements. The proposed SOP also includes guidance for auditing environmental remediation liabilities, addressing audit planning, and assessing audit risk, along with the appropriate application of relevant auditing standards.

.67 Comments on the exposure draft were due by October 31, 1995.

AICPA Accounting and Auditing Literature

Technical Practice Aids

.68 *Technical Practice Aids* is an AICPA publication that includes questions received by the AICPA's Technical Information Service on various subjects and the service's responses to those questions. Section 6200 of *Technical Practice Aids* contains questions and answers specifically pertaining to regulated entities. *Technical*

Practice Aids is available both as a subscription service and in a paperback edition. Order information may be obtained from the AICPA Order Department at (800) TO-AICPA, Department No. 1, and asking for product number 005055.

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.69 This Audit Risk Alert supersedes *Public Utilities Industry Developments—1994.*

* * * *

.70 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* [AAM section 8010] and *Compilation and Review Alert—1995/96* [AAM section 8015].

.71 Copies of AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

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AAM Section 9000

Supervision, Review and Report Processing

This manual is a nonauthoritative kit of practice aids and, accordingly, does not include extensive explanation or discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate.

The exhibits are for illustrative purposes only. They are included as conveniences for users of this manual who may want points of reference when reviewing the working papers or preparing the report.

The material in this section has been extracted from the MAP Handbook and has been edited for this manual.

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AAM Section 9100
Supervision and Review Procedures

Introduction

.01 Supervision is an important phase of all engagements. A supervisor trains staff members, determines that there is an understanding of the work to be performed and ascertains that all procedures were appropriately performed.

.02 Review procedures are necessary to determine whether the objectives of the engagement and the results of the procedures performed were consistent with the conclusions presented in the accountant's or auditor's report.

Authoritative Literature

.03 The necessity for supervision is emphasized in the *AICPA Code of Professional Conduct,* which applies to all major areas of accounting practice, Rule 201, *General Standards* (ET section 201.01) states, "A member shall adequately plan and *supervise* an engagement."

.04 The first standard of fieldwork of generally accepted auditing standards states: "The work is to be adequately planned and assistants, if any, are to be properly *supervised.*"

.05 For compilation and review engagements, SSARS 1, *Compilation and Review of Financial Statements,* paragraph 3 (AR section 100.03), provides the guidance necessary to enable the accountant to comply with the general standards of the profession as explained in .03 above.

.06 For audit engagements, the following Statements on Auditing Standards (SAS) provide specific guidance on supervising and reviewing audit engagements:

a. SAS No. 22, *Planning and Supervision* and SAS No. 77, *Amendments to Statements on Auditing Standards No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, *and No. 62,* Special Reports (AU section 311), establishes broad requirements for the review of the work of assistants.

b. SAS No. 39, *Audit Sampling* (AU section 350), states that nonsampling risk can be reduced to a negligible level through such factors as adequate planning and supervision and proper conduct of a firm's audit practice.

c. SAS No. 41, *Working Papers* (AU section 339), establishes requirements for documenting the supervision of work performed.

d. SAS No. 56, *Analytical Procedures* (AU section 329), provides guidance on the use of analytical procedures and requires their use in both the planning and review of audits.

e. SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Accounts, or Items of a Financial Statement* (AU Section 622), states that accountant's risks can be reduced through adequate planning and supervision and due professional care in performing the procedures, determining the findings, and preparing the report.

.07 In addition, the Quality Control Standard No. 1, *System of Quality Control for a CPA Firm* (QC section 10), provides that a CPA firm shall have a system of quality control. One of the elements of a quality control system discussed in this standard is supervision. Supervision as an element of quality control is defined as policies and procedures for the conduct and supervision of work to provide that the firm's work meets its standard of quality.

Phases of Supervision and Review

.08 Supervision and review are conducted in several phases:

a. Instructing and training assistants.

b. Providing the staff with an efficient and effective approach to the performance of the engagement.

c. Keeping informed of significant problems encountered.

d. Reviewing the work performed.

e. Comparing the time spent on performing the procedures required with the budget prepared for those procedures.

f. Dealing with technical differences of opinion among firm personnel.

Review Organization

.09 A firm's practice for reviewing engagements will vary depending on the size of the firm and on the complexity of the engagement.

.10 Some firms can justify a separate review department, while others cannot afford this functional division of duties. Firms cannot afford to omit any of the review procedures or processes. There should always be some form of reading of the reports for both professional and accounting matters as well as typographical errors after they are typed.

Firm Policy and Procedures Regarding Supervision and Review

.11 The foundation of good supervision is adequate firm policies and procedures on conducting and supervising work performed. Some examples of such policies are:

a. Procedures for planning engagements (AAM section 3000).

b. Procedures for maintaining the quality of work performed (AAM section 11,000).

c. Procedures for reviewing engagement workpapers and reports.

.12 The procedures for reviewing engagement workpapers and reports is broken into two separate components. The two components consist of (1) detailed review of the workpapers by the audit senior and (2) the higher-level supervisory review performed by the manager and partner on the engagement.

Review of Workpapers

.13 The purpose of the detailed review of the workpapers on an engagement is to determine that:

a. All procedures in the program, albeit audit, review or compilation, were performed and documented.

b. The results and conclusions reached are appropriate for the work performed.

c. The results are properly summarized and in agreement with the report to be issued.

Supervisory Review

.14 The purpose of the supervisory review is to determine that:

a. Professional and firm standards have been complied with.

b. Accounting and auditing concerns for the client's industry were evaluated properly.

c. The overall results of the procedures performed are appropriate.

Purpose of Form

.15 The In-Charge's and Partner's Engagement Review Programs are tools used for determining whether all engagement steps were properly considered, completed, and resolved. The In-Charge should complete the respective form by checking off "yes," "no," or "n/a" in the appropriate column. All "no" answers should be explained with a separate memorandum. The Partner should sign off on the In-Charge's Engagement Review Program and then complete the Partner's Engagement Review Program in the same manner.

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AAM Section 9200
In-Charge Engagement Review Program

The Partner's Engagement Review Program should be used for all engagements. The supplemental programs for Not-for-Profit Organizations, Local Governmental Units, and Banks should be completed in conjunction with the Partner's Engagement Review Program.

	Yes	No	N/A
I. General Procedures			
A. .010 General			
1. In planning the audit engagement, were the following matters properly considered?			
a. Matters affecting the environment in which the entity operates, such as accounting practices, economic conditions, government regulations, contractual obligations and technological changes. (SAS No. 22, as amended by SAS No. 77 [AU section 311])	____	____	____
b. Matters affecting the entity's operations, such as legal organization and types of services. (SAS No. 22, as amended by SAS No. 77 [AU section 311])	____	____	____
c. Preliminary judgment about materiality levels for audit purposes. (SAS No. 47 [AU section 312])	____	____	____
d. Consideration of internal control. (SAS No. 55, as amended by SAS No. 78 [AU section 319])	____	____	____
e. Conditions that may require extension or modification of audit tests, such as the possibility of material errors or irregularities and management's ability to override controls. (SAS No. 53 [AU section 316])	____	____	____
f. Other audit risks.	____	____	____
2. If the firm succeeded a predecessor accountant, did the firm:			
a. Communicate with the predecessor accountant to ascertain whether there were disagreements between the predecessor accountant and the entity's management on accounting or auditing matters and consider the implications of such matters in accepting the client?	____	____	____
b. Make other inquiries of the predecessor accountant on significant matters?	____	____	____
c. Satisfy itself on the fair presentation of opening balances, such as reviewing the predecessor accountant's working papers?	____	____	____
3. Did the auditor obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design			

	Yes	No	N/A
of controls relevant to an audit of financial statements, and whether they have been placed in operation? (SAS Nos. 55 and 78 [AU section 319])	____	____	____
a. Did the auditor then assess control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements? (SAS Nos. 55 and 78 [AU section 319])	____	____	____
b. If control risk is assessed below the maximum for an assertion, was evidential matter obtained supporting that lower assessed level? (SAS Nos. 55 and 78 [AU section 319])	____	____	____
c. If the client used computer processing in significant accounting applications, did the assessment of risk in internal control include an evaluation of the extent, as well as the complexity, of that processing, including those, if any, of an outside service center? (SAS Nos. 48, 55 (as amended by SAS No. 78), and 70 [AU sections 311, 319, and 324])	____	____	____
d. If the firm relied on the internal control at a service organization, was a service auditor's report obtained and appropriately considered? (SAS No. 70 [AU section 324])	____	____	____
4. If consideration was given to the work of internal auditors in determining the scope of the audit, was it done in accordance with SAS No. 65 (AU section 322)?	____	____	____
5. Was audit planning appropriately documented?	____	____	____
6. Was a written audit program prepared? (SAS No. 22, as amended by SAS No. 77 [AU section 311])	____	____	____
a. Was it responsive to the needs of the engagement identified during the planning process and was it developed in light of internal control? (SAS No. 55, as amended by SAS No. 78 [AU section 319])	____	____	____
b. Was consideration given to applicable assertions in developing audit objectives and in designing substantive tests? (SAS No. 31 [AU section 326])	____	____	____
c. Were tests considered regarding related party transactions? (SAS No. 45 [AU section 334])	____	____	____
d. If conditions changed during the course of the audit, was the audit program modified as appropriate in the circumstances?	____	____	____
e. Was guidance in the applicable AICPA Audit and Accounting Guide considered?	____	____	____
7. If statistical or nonstatistical sampling was used in test of controls (SAS No. 39 [AU section 350]):			
a. Was appropriate consideration given, in planning the sampling application, to the relationship of the sample to the objective of the test, maximum rate of deviation, allowable risk of assessing control risk too low and likely rate of deviations?	____	____	____

	Yes	No	N/A
b. Was the sample selected in such a way that it could be expected to be representative of the population?	____	____	____
c. Were the results of the sample evaluated as to their effect on the nature, timing, and extent of planned substantive procedures?	____	____	____
d. Was appropriate consideration given, in evaluating the sample, to items for which the planned test or appropriate alternative procedure could not be performed, for example, because the documentation was missing?	____	____	____
e. Was documentation of the foregoing considerations in accordance with firm policy?	____	____	____
8. If statistical or nonstatistical sampling was used for substantive tests of details (SAS No. 39 [AU section 350]):			
a. Was appropriate consideration given, in planning the sampling application, to the relationship of the sample to the audit objective, preliminary judgments about materiality levels, auditor's allowable risk of incorrect acceptance, and characteristics of the population?	____	____	____
b. Was the sample selected in such a way that it could be expected to be representative of the population?	____	____	____
c. Were the misstatement results of the sample projected to the items from which the sample was selected?	____	____	____
d. Was appropriate consideration given, in evaluating the sample, to items for which the planned substantive tests or appropriate alternate procedures could not be performed?	____	____	____
e. Was appropriate consideration given in the aggregate to projected misstatement results from all audit sampling applications and to all known misstatements from nonsampling applications in evaluating material misstatements in the financial statements?	____	____	____
f. Was documentation of the foregoing considerations in accordance with firm policy?	____	____	____
9. Were the guidelines of SAS No. 56 (AU section 329), followed in the performance of analytical procedures for:			
a. Audit planning?	____	____	____
b. Use as a substantive test?	____	____	____
c. Overall review of the audit?	____	____	____
10. Did the firm obtain timely and appropriate responses from the auditee's attorney concerning litigation, claims, and assessments? (SAS No. 12 [AU section 337])	____	____	____
11. Have all required engagement forms and documents been completed, signed, and dated?	____	____	____

	Yes	No	N/A
12. Have all questions, exceptions, or notes, if any, posed during the audit been followed up and resolved, including consideration of the views obtained from responsible officials of the organization, program, activity, or function audited concerning the auditor's findings, conclusions, and recommendations?	____	____	____
13. Did the firm obtain a timely appropriate letter of representation from management? (SAS No. 19 [AU section 333])	____	____	____
14. Does it appear that appropriate consideration was given to all past adjustments and to the risk that the current period's financial statements are materially misstated? (SAS No. 47 [AU section 312])	____	____	____
15. Were errors, irregularities, or illegal acts, if any, followed up in accordance with SAS Nos. 53 and 54 (AU sections 316 and 317)?	____	____	____
16. Have reportable conditions, if any, in the internal control been communicated to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one? (SAS No. 60 [AU section 325])	____	____	____
17. If required by firm policy, was an appropriate engagement letter issued?	____	____	____
18. Were communications of internal control related matters issued in accordance with SAS No. 60 (AU section 325)?	____	____	____
19. Was consideration given to the work of internal auditors in determining the scope of the audit in accordance with SAS No. 65 (AU section 322)?	____	____	____
20. If specialized skills were used (e.g., computer auditing, statistical sampling, etc.), were they properly evaluated by persons with training in these areas? (SAS No. 39 [AU section 350])	____	____	____
21. Did the planning and execution of the engagement include an assessment of the risk of errors and irregularities and management's ability to override control procedures? (SAS No. 53 [AU section 316])	____	____	____
22. Did the audit strategy and expected conduct and scope of the audit reflect the following assessments:			
a. The risk of material misstatement in the financial statements?	____	____	____
b. The risk of management misrepresentation?	____	____	____
23. Was the audit designed to provide reasonable assurance of detecting material misstatements?	____	____	____
24. If it has been determined that an audit adjustment is, or may be, an irregularity but it has also been determined that the effect on the financial statements would not be material, has the following been performed:			
a. Referral of the matter to an appropriate level of management that is at least one level above those involved?	____	____	____

	Yes	No	N/A
b. Obtain satisfaction that, in view of the organizational position of the likely perpetrator, the irregularity has no implications for other aspects of the audit or that those implications have been adequately considered?	____	____	____
25. If it has been determined that an audit adjustment is, or may be, an irregularity and the auditor has either determined that the effect could be material or has been unable to evaluate the potential materiality, has the following been performed?			
a. Consideration of the implications for other aspects of the audit.	____	____	____
b. Discussions of the matter and the approach to further investigate the irregularity with an appropriate level of management that is at least one level above those involved.	____	____	____
c. Obtaining sufficient competent evidential matter to determine whether, in fact, material irregularities exist and, if so, their effect.	____	____	____
d. If appropriate, suggestions that the client consult with legal counsel on matters concerning questions of law.	____	____	____
26. When it has been concluded that an illegal act has or is likely to have occurred, have the following been considered?			
a. The effect on the financial statements.	____	____	____
b. The implications for other aspects of the audit.	____	____	____
c. Communication with the audit committee.	____	____	____
d. The effect on the auditor's report.	____	____	____
27. If the engagement included the use of the work (domestic or international) of another office, correspondent, or affiliate:			
a. Do the instructions to the other office or firm appear adequate?	____	____	____
b. Does it appear that control exercised over the work of others through supervision and review was adequate?	____	____	____
c. Was there appropriate follow-up of open matters?	____	____	____
d. Were appropriate inquiries made as to its professional reputation?	____	____	____
28. Does the firm's disclosure checklist document that the audit report is properly prepared and that the financial statements are fairly stated?	____	____	____
29. Were matters related to the conduct of the audit communicated to those who have responsibility for oversight of the financial reporting process? (SAS No. 61 [AU section 380])?	____	____	____
30. Was the applicable disclosure checklist completed?	____	____	____

II. Working Paper Areas

A. .020 Cash

	Yes	No	N/A
1. Was due consideration give to cash transactions shortly before and shortly after the balance sheet date to determine that transactions were recorded in the proper period?	____	____	____

	Yes	No	N/A
2. Were bank accounts confirmed at the audit date and were reconciling items existing at the balance sheet date cleared by reference to subsequent statements obtained directly from the bank?	____	____	____
3. Do the working papers indicate that the following were considered?			
a. Restrictions on cash balances.	____	____	____
b. Confirmation of bank credit arrangements such as compensating balances.	____	____	____
c. Review of confirmation responses for indication of related party transactions.	____	____	____
4. Based on the assessed level of control risk, do the substantive tests of cash appear adequate?	____	____	____
B. .030 Receivables			
1. Was a summary prepared (or obtained) properly classifying receivables (i.e., notes and accounts receivable; trade; officers, directors, and employees; parent and subsidiary companies; other related party transactions; etc.)?	____	____	____
2. If accounts receivable are not confirmed, has the reason been documented? One of the following is acceptable:			
a. Accounts receivable are immaterial to the financial statements.	____	____	____
b. Use of confirmations would be ineffective.	____	____	____
c. Combined assessed level of inherent and control risk is low (as addressed in the internal control section), and the assessed level, in conjunction with other evidence (analytical procedures or other substantive tests) reduced audit risk to an acceptably low level for applicable financial statement assertions.	____	____	____
3. Were accounts receivable confirmations sent out and appropriate follow-up steps taken?	____	____	____
4. If confirmation work was performed prior to year-end, is there evidence that an adequate review was made of transactions from the confirmation date to the balance sheet date?	____	____	____
5. If a significant number and amount of accounts receivable confirmations were not sent out, is there evidence that other auditing procedures were performed?	____	____	____
6. Were significant notes receivable confirmed as of the audit date?	____	____	____
7. Were the results of confirmation procedures summarized in the working papers?	____	____	____
8. Was collateral (if any) for receivables examined with respect to existence, ownership, and value?	____	____	____
9. Were adequate tests made of discounts and allowances?	____	____	____

	Yes	No	N/A
10. Was the reasonableness of allowances for doubtful accounts covered in the working papers and collectibility of receivables adequately considered?	___	___	___
11. Is there evidence in the working papers that inquiry was made and consideration given to whether receivables are pledged or factored?	___	___	___
12. Was receivables work coordinated with test of sales including inventory cut-off tests?	___	___	___
13. Are notes receivable accounted for to reasonably represent the present value of the consideration exchanged and at an appropriate interest rate? (APB Opinion No. 21 [AC I69])	___	___	___
14. Based on the assessed level of control risk, do the substantive tests of receivables appear adequate?	___	___	___
C. .040 Inventories			
1. Was an inventory summary prepared (or obtained) showing basis (e.g., "cost," "market," "LIFO," "FIFO," etc.) with respect to the various classifications of inventory (e.g., finished goods, work-in-process, raw materials, etc.)?	___	___	___
2. Where the physical inventory is taken at a date other than the balance-sheet date (or where rotating procedures are used), do the working papers indicate that consideration was given to inventory transactions between the inventory date(s) and the balance-sheet date?	___	___	___
3. Do the working papers contain evidence that counts were correctly made and recorded (i.e., was control maintained over inventory tags or count sheets) and were test count quantities reconciled with counts reflected in final inventory?	___	___	___
4. Do the working papers indicate that adequate tests were made of:			
a. The clerical accuracy of inventory footings?	___	___	___
b. Costing methods and substantiation of costs used in pricing all elements (raw materials, work-in-process, finished goods) of the inventory?	___	___	___
5. Do the working papers indicate that a lower of cost or market test was performed (including obsolescence)?	___	___	___
6. If perpetual inventory records are maintained, do the working papers indicate that differences disclosed by the client's physical inventory (or cycle counts) are properly reflected in the accounts?	___	___	___
7. Was an examination of purchase and sales commitments made, including consideration as to any possible adverse effects?	___	___	___
8. Were appropriate inventory cut-off tests performed?	___	___	___

	Yes	No	N/A
9. Where applicable, were gross profit percentage tests employed to check overall valuation of inventories?	____	____	____
10. Where the physical inventory in the hands of others was not observed, were inventory confirmations received (i.e., inventory in public warehouses, on consignment, etc.)?	____	____	____
11. Do the working papers indicate that steps were performed to determine if any inventory is pledged?	____	____	____
12. Based on the assessed level of control risk, do the substantive tests of inventory appear adequate?	____	____	____
D. .050 Investments			
1. Was a summary schedule prepared (or obtained) and details examined with respect to description, purchase price and data, changes during period, classification of investment income market value, etc., of investments?	____	____	____
2. Were all securities (including stock certificates of subsidiary companies) examined or confirmed?	____	____	____
3. Was investigation made of carrying value and possible cost impairment of long-term investments?	____	____	____
4. Do working papers indicate that consideration was given to indications that investments were pledged?	____	____	____
5. Were financial statements and other information reviewed to support the amounts presented for investments accounted for using the equity method?	____	____	____
6. Do the working papers indicate that adequate evidential matter has been accumulated for long-term investments?	____	____	____
7. Based on the assessed level of control risks, do the substantive tests of investments appear adequate?	____	____	____
E. .060 Prepaid Expenses, Intangible Assets, Deferred Charges, Etc.			
1. Were adequate tests made and/or confirmations received for all material:			
a. Prepaid expenses?	____	____	____
b. Intangible assets?	____	____	____
c. Deferred charges?	____	____	____
d. Other?	____	____	____
2. For prepayments, intangibles, and deferred charges, is there adequate support for deferral and amortization (or lack thereof)?	____	____	____

	Yes	No	N/A
3. If insurance policies were pledged as collateral or subjected to premium financing, were the related loans properly accounted for?	____	____	____
4. Based on the assessed level of control risk, do the substantive tests of prepaid expenses, intangible assets, deferred charges, etc., appear adequate?	____	____	____
F. .070 Property, Plant, and Equipment			
1. Was a summary schedule prepared (or obtained) to show beginning balances, changes during the period, and ending balances for:			
a. Property, plant, and equipment?	____	____	____
b. Accumulated depreciation?	____	____	____
2. Do tests appear adequate with respect to:			
a. Additions:			
(1) Examination of supporting documents?	____	____	____
(2) Physical inspection?	____	____	____
b. Retirement, etc. (including examination of miscellaneous income, scrap sales, etc.)?	____	____	____
c. The adequacy of current and accumulated provisions for depreciation and depletion?	____	____	____
d. Compliance with control procedures?	____	____	____
e. Status of idle facilities?	____	____	____
3. Do the working papers indicate the presence of liens on property?	____	____	____
4. Were differences between book and tax depreciation reconciled?	____	____	____
5. Was investigation made of possible impairment?	____	____	____
6. Based on the assessed level of control risk, do the substantive tests of property, plant, and equipment appear adequate?	____	____	____
G. .080 Current Liabilities			
1. Were accounts payable adequately tested for propriety?	____	____	____
2. Was an adequate test made of subsequent transactions (i.e., cash disbursements, voucher register entries, vouchers, unpaid invoices, etc.) to determine if any material unrecorded liabilities existed?	____	____	____
3. Was the payable work correlated with the purchase cutoff examination?	____	____	____
4. Was consideration given to costs and expenses that might require accrual (e.g., compensated absences), and to whether accrued expenses were reasonably stated?	____	____	____
5. Based on the assessed level of control risk, do the substantive tests of liabilities appear adequate?	____	____	____

	Yes	No	N/A
H. .090 Long-Term Debt			
1. Were confirmations received for significant debt obligations, together with verification of interest rates, repayment period, etc.?	____	____	____
2. Is there evidence that covenants to long-term debt obligations are being complied with?	____	____	____
3. Have leases been examined to determine that capital leases have been properly accounted for?	____	____	____
4. Do the working papers include evidence as to compliance with any loan restrictions?	____	____	____
5. Based on the assessed level of control risk, do the substantive tests of long-term debt appear adequate?	____	____	____
I. .100 Deferred Credits			
1. Do the working papers indicate that:			
a. The basis of deferring income is reasonable and is on a consistent basis from year to year?	____	____	____
b. Deferrals have been established on a reasonable basis?	____	____	____
2. Based on the assessed level of control risk, do the substantive tests of deferred credits appear adequate?	____	____	____
J. .110 Income Taxes			
1. Were current and deferred tax accrual accounts and related provisions analyzed and reviewed as to adequacy?	____	____	____
2. Do the workpapers document the determination of the adequacy of the income tax accruals and provisions in accordance with federal, state, local regulations and GAAP and any possible adjustments required for:			
a. Tax positions taken by the client that might be challenged by the taxing authorities?	____	____	____
b. Possible assessments, penalties or interest indicated by tax return examinations completed during the year or in progress, including similar adjustments applicable to years not yet examined?	____	____	____
3. Based on the review of the financial statements and working papers and, if necessary, discussions with engagement personnel, does it appear tax matters were adequately considered?	____	____	____
4. Based on the assessed level of control risk, do the substantive tests of income taxes appear adequate?	____	____	____
K. .120 Commitments and Contingencies			
1. Do the working papers include indication of the following?			
a. Inspection of minutes of meetings of the stockholders, board of directors, and executive and other committees of the board.	____	____	____

	Yes	No	N/A
b. Inspection of contracts, loan agreements, leases, and correspondence from taxing and other governmental agencies, and similar documents.	____	____	____
c. Accumulation and analysis of confirmation responses from banks and lawyers.	____	____	____
d. Inquiry and discussion with management (including management's written representations concerning liabilities, and litigation, claims, and assessments).	____	____	____
e. Inspection of other documents for possible guarantees by the client.	____	____	____
2. Is there indication that procedures were performed to uncover the need for recording or disclosure of events subsequent to the date of the financial statements?	____	____	____
3. Based on the assessed level of control risk, do the substantive tests of commitments and contingencies appear adequate?	____	____	____

L. .130 Capital Accounts

	Yes	No	N/A
1. Were changes in capitalization checked to authorizations?	____	____	____
2. Do the working papers indicate that adequate inquiries were made as to:			
a. Stock options?	____	____	____
b. Warrants?	____	____	____
c. Rights?	____	____	____
d. Redemptions?	____	____	____
e. Conversion privileges?	____	____	____
3. Based on the assessed level of control risk, do the substantive tests of capital accounts appear adequate?	____	____	____

M. .140 Income and Expenses

	Yes	No	N/A
1. Were tests made of payrolls, including account distribution?	____	____	____
2. With regard to pension and profit sharing plans (including impact of ERISA), do tests of expenses and liabilities appear adequate?	____	____	____
3. Were revenue and expenses for the period compared with those of the preceding period and reviewed for reasonableness with significant fluctuations explained?	____	____	____
4. Was adequate consideration given to review of the client's revenue recognition policy and unusual sales transactions?	____	____	____
5. Has adequate consideration been given to loss contingencies in accordance with FASB Statements No. 5 (AC C59)?	____	____	____
6. Based upon the assessed level of control risk, do the substantive tests (review, analysis, and casting) of income and expense appear adequate?	____	____	____

	Yes	No	N/A
N. .150 Other			
1. Were procedures applied to supplementary information in accordance with SAS No. 52 (AU section 558), as applicable?	____	____	____
2. If the work of a specialist was used, was the effect of the specialist's work on the auditor's report considered in accordance with SAS No. 73 (AU section 336)?	____	____	____
3. Were specific procedures applied for determining the existence of related parties and examining identified related party transactions? (SAS No 45 [AU section 334])	____	____	____
4. Was the guidance in SAS No. 47 (AU section 312) regarding audit risk and materiality considered during the planning and performance of the engagement?	____	____	____

This audit engagement has been completed in accordance with professional standards and firm policy.

In-Charge ______________________________ Date ______________

Partner ______________________________ Date ______________

[*The next page is 9241.*]

AAM Section 9210

Partner's Engagement Review Program

.01

	Yes	No	N/A
a. Were all issues regarding independence considered including policies and procedures and reporting considered?	____	____	____
b. Were all issues relating to assigning personnel to engagements including policies, procedures, scheduling, staffing, and training considered?	____	____	____
c. If outside consultation was required, was proper documentation made and differences resolved in accordance with firm policy?	____	____	____
d. Was engagement planning adequate and did it cover staff and specific industry issues?	____	____	____
e. Were all forms, checklists, and questionnaires adequately completed?	____	____	____
f. Were the financial statements reviewed to ensure compliance with professional standards, authoritative literature, and firm policy?	____	____	____
g. Did the firm comply with its quality review guidelines and firm policy and procedures regarding acceptance and continuance of clients?	____	____	____
h. Were all necessary inquiries and communications with the predecessor accountant made and was the firm satisfied with the responses?	____	____	____
i. Did the firm obtain timely and appropriate responses from the auditee's attorney concerning litigation, claims, and assessments?	____	____	____
j. Have all questions, exceptions, or notes, if any, posed during the audit been resolved, including consideration of the views obtained from responsible officials of the organization, program, activity, or function audited concerning the auditor's findings, conclusions, and recommendations?	____	____	____
k. Did the firm obtain a timely appropriate letter of representation from management?	____	____	____
l. Does it appear that appropriate consideration was given to all past adjustments and to the risk that the current period's financial statements are materially misstated?	____	____	____
m. Were errors, irregularities, illegal acts, and reportable conditions adequately followed up and communicated including reporting, communication, other audit effects, legal consultation, etc.?	____	____	____

	Yes	No	N/A
n. Does the firm's disclosure checklist document that the audit report is properly prepared and that the financial statements are fairly stated?	____	____	____
o. Were matters related to the conduct of the audit communicated to those who have responsibility for oversight of the financial reporting process?	____	____	____
p. Did the partner sign the In-Charge Engagement Review Program?	____	____	____

This audit engagement has been completed in accordance with professional standards and firm policy.

Partner ______________________________ Date ______________

[*The next page is 9271.*]

AAM Section 9220

Partner's Engagement Review Program Supplement for Not-for-Profit Organizations

To be completed in conjunction with Partner's Engagement Review Program [AAM section 9210]

	Yes	*No*	*N/A*
I. General Audit Procedures			
A. .010 General			
[No additional General Audit Procedures are required as part of this supplement.]			
II. Working Paper Areas			
A. .020 Cash			
1. Do the working papers indicate that the following were considered?			
a. Confirmation of liabilities and contingent liabilities to banks.	____	____	____
b. Authorization for interfund cash transactions.	____	____	____
c. Determination that all cash accounts have been identified and appropriately recorded.	____	____	____
B. .030 Receivables			
1. Were procedures performed to provide evidence that pledged receivables are properly recorded in the appropriate funds?	____	____	____
C. .040 Investments			
1. Were income and realized and unrealized gains and losses from investments examined for proper allocation to the individual funds?	____	____	____
2. Do the working papers indicate that risk of loss on repurchase agreements was properly considered?	____	____	____
3. Do the working papers indicate that repurchase security transactions were reviewed for consistency with the disclosures of the terms or circumstances of the transactions?	____	____	____
D. .050 Collections of Works of Art and Similar Items			
1. If the collection is considered inexhaustible (i.e., exhibits owned by museums, art galleries, botanical gardens, etc.) and has been capitalized, do the working papers indicate that the auditor tested the reasonableness of the collection's carrying value?	____	____	____

	Yes	No	N/A
2. If the collection is considered exhaustible and has been capitalized, do the working papers indicate that the auditor tested the reasonableness of the collection's carrying value and related amortization?	____	____	____
3. Are the tests adequate with respect to acquisitions and deaccessions?	____	____	____
4. If the collection is capitalized:			
a. Were physical inventories observed at all locations where relatively large amounts are located?	____	____	____
b. Do the working papers contain evidence that counts were correctly made and recorded (i.e., was control over inventory tags or count sheets maintained) and were test count quantities reconciled with the quantities reflected in the final inventory?	____	____	____
5. If the collection is considered inexhaustible and has been capitalized, do the working papers indicate that the auditor:			
a. Evaluated the internal controls over the collection?	____	____	____
b. Observed a physical inventory at all locations where large amounts are located?	____	____	____
6. Based on the assessed level of control risk, do the substantive tests of collections of works of art and similar items appear adequate?	____	____	____
E. .060 Property, Plant, and Equipment			
1. Was a review made to determine that capital expenditures are classified in the proper fund accounts?	____	____	____
F. .070 Liabilities			
1. Were liabilities properly classified as current or long-term and in the proper fund?	____	____	____
2. Were procedures performed to determine whether tax deferred annuity plans are appropriately calculated to conform with GAAP and IRS regulations?	____	____	____
3. Was consideration given to any liabilities (including the effect of any temporary differences) resulting from the federal excise tax on investment income and any federal and state taxes on unrelated business income?	____	____	____
4. Do the tests of interfund borrowings appear adequate with respect to:			
a. Legal restrictions, if any, on such borrowings?	____	____	____
b. Authorization?	____	____	____
c. Classification?	____	____	____
d. Collectibility of amounts due from other funds?	____	____	____
e. Appropriateness of interest accruals and payments?	____	____	____

	Yes	No	N/A
G. .080 Deferred Revenue			
1. Do the working papers indicate that consideration was given to whether the basis of deferring revenue is reasonable and consistent with the donors' or grantors' restrictions?	___	___	___
2. Was consideration given to matching requirements, if any?	___	___	___
3. Do the working papers indicate that consideration was given to the appropriateness of the amounts of restricted gifts, grants, bequests, donations, or other income recognized as current revenue or support?	___	___	___
4. Based on the assessed level of control risk, do the substantive tests of deferred revenue appear adequate?	___	___	___
H. .090 Commitments and Contingencies			
1. Did the auditor consider evidence of the entity's activities (such as lobbying) which might cause the entity to lose its tax exempt status or be subject to penalties or taxes?	___	___	___
2. If the entity is a private foundation, as defined by IRC section 509, did the auditor determine whether the entity complied with IRS regulations concerning required distribution of income and prohibited activities?	___	___	___
I. .100 Fund Balance			
1. Where appropriate, were authorizations of changes in reserves and designated balances examined?	___	___	___
2. Do the working papers indicate that there were adequate inquiries, where appropriate, as to proper classification, description and disclosure of components of the fund balance?	___	___	___
3. Do the working papers indicate that fund transfers were properly approved and recorded?	___	___	___
4. If an endowment fund is maintained, do the working papers indicate that fund income is distributed to unrestricted and restricted funds in accordance with donors' stipulations?	___	___	___
5. Based on the assessed level of control risk do the substantive tests of fund balances appear adequate?	___	___	___
J. .110 Revenues, Expenses, Support, and Capital Additions			
1. Were revenues and expenses for the period compared with those of the preceding period and reviewed for reasonableness and were significant fluctuations explained?	___	___	___
2. Was adequate consideration given to:			
a. The entity's revenue recognition policy?	___	___	___
b. Income recognition on transactions where the earnings process is not complete?	___	___	___

	Yes	No	N/A
3. Do the working papers indicate that consideration was given to the valuation and classification of revenue derived from service fees, such as subscription and membership income, and sales of publications and other items?	____	____	____
4. If the entity is reimbursed by a third party for costs incurred in connection with providing services to others:			
a. Were pertinent sections of significant third party contracts reviewed to determine the basis for reimbursement?	____	____	____
b. Were cost reimbursement reports and the underlying support reviewed?	____	____	____
c. Were appropriate allocations made of indirect costs among the entity's programs?	____	____	____
5. Do the working papers indicate that the auditor considered actual receipt of, rights to, and any restrictions placed on amounts received during the current period from:			
a. Cash contributions?	____	____	____
b. Donated services?	____	____	____
c. Gifts of securities, materials, facilities, and other nonmonetary items?	____	____	____
d. Future interests and interest free loans?	____	____	____
6. If expenses are classified by function, did the auditor adequately test the classifications and allocations?	____	____	____
7. If grants are awarded to other organizations, did the auditor review:			
a. The classification of the grants?	____	____	____
b. The effects of the grantees' compliance or noncompliance with performance requirements?	____	____	____
8. Were tests of payrolls performed, including account distribution?	____	____	____
9. With regard to pension plans, do the tests made of the expense and liabilities appear adequate?	____	____	____
10. Based upon the assessed level of control risk, did the substantive tests (review, analysis, and testing) of revenues and expenditures/expense appear adequate?	____	____	____

K. .120 Other

	Yes	No	N/A
1. If the entity is affiliated or otherwise financially related to other entities, did the auditor consider the need for combined financial statements or disclosure of the relationship?	____	____	____

	Yes	No	N/A

III. Audits of Governmental Grantees

Note: These questions are derived from the U.S. General Accounting Office's (GAO) *Government Auditing Standards* ("Yellow Book") and the Office of Management and Budget, Circular A-110 (*Uniform Administrative Requirements for Grants and Other Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations*).

A. .130 General

1. If the audit was required to be conducted in accordance with the *Government Auditing Standards,* do the auditor's report(s) include references to *Government Auditing Standards,* and appropriately cover:

   a. The financial statements, including, where presented, the combining and individual fund financial statements? ____ ____ ____

   b. Tests of controls based solely on the evaluation of the effectiveness of the controls made as part of the audit of the financial statements? ____ ____ ____

   c. Compliance with finance-related legal and contractual provisions, including a summary of questioned costs and/or instances of noncompliance? ____ ____ ____

   d. Instances or indications of illegal acts that could result in criminal prosecution of the top officials of the entity arranging the audit? ____ ____ ____

2. If required, did the auditor's report on internal control identify:

   a. The scope of the auditor's work in obtaining an understanding of the internal control structure and in assessing control risk? ____ ____ ____

   b. The entity's significant internal control structure including those controls established to ensure compliance with laws and regulations that have a material impact on the financial statements? ____ ____ ____

   c. The reportable conditions, including the identification of material weaknesses identified as a result of the auditor's work in understanding and assessing control risk? ____ ____ ____

3. If required, did the auditor's report on compliance include:

   a. A statement of positive assurance with respect to those items tested for compliance with applicable laws and regulations? ____ ____ ____

   b. Negative assurance on those items not tested? ____ ____ ____

   c. A summary of material instances of noncompliance? ____ ____ ____

4. If required by contractual obligations, were findings presented in accordance with the guidance in the *Government Auditing Standards* regarding reporting on economy and efficiency audits and program results audits? ____ ____ ____

5. Was interfund activity properly reviewed and were differences between total interfund receivables and total interfund payables investigated and resolved? ____ ____ ____

	Yes	*No*	*N/A*
6. If applicable, were adequate tests of controls with applicable laws and regulations made?	____	____	____
7. Were all reportable conditions in the internal control structure and all identified instances of noncompliance with applicable laws and regulations:			
a. Adequately evaluated and documented?	____	____	____
b. Appropriately reported in accordance with applicable standards? (SAS No. 60 [AU section 325]; GAO's *Government Auditing Standards,* paragraphs 5-26 through 5-28; OMB A-110, Attachment F)	____	____	____
8. Do the working papers indicate that consideration was given to prior audits of government financial assistance programs that disclosed questionable or disallowed costs, or instance of noncompliance?	____	____	____

This audit engagement has been completed in accordance with professional standards and firm policy.

Partner ____ Date ______________

[*The next page is 9301.*]

AAM Section 9230

Partner's Engagement Review Program Supplement for Banks

To be completed in conjunction with Partner's Engagement Review Program [AAM section 9210]

	Yes	No	N/A
I. General Procedures			
A. .010 General			
1. Were FIRREA regulations considered in planning the audit engagement?	___	___	___
II. Working Paper Areas			
A. .020 General			
1. Do the working papers document the consideration of the results of inquiries, readings, excerpts or other evidence of an understanding of regulatory examinations, their findings and actions and the recognition of the above in planning the audit?	___	___	___
2. Did the engagement team obtain an adequate understanding of those factors that have a significant effect on the bank's business (i.e., interest rates, liquidity, off-balance sheet financing)?	___	___	___
3. If the client engaged in the following types of transactions, was there a review of the propriety of the accounting and recording for:			
a. Loan originations?	___	___	___
b. Loan commitments?	___	___	___
c. Fees?	___	___	___
d. Loan refinancing and restructuring?	___	___	___
e. Transfers between trading account and investment securities?	___	___	___
f. Wash sale transactions?	___	___	___
g. Hedging transactions, including interest rate swaps and interest rate futures?	___	___	___
h. Coupon stripping?	___	___	___
i. Adjusted price forward placement trades?	___	___	___
j. Reposition swaps?	___	___	___
k. Repos to maturity?	___	___	___
l. Dollar repos?	___	___	___
m. Commitments for the purchase or sale of securities?	___	___	___

	Yes	No	N/A
n. Industrial development bonds?	____	____	____
o. Purchase or sale of options?	____	____	____
p. Purchase or sale of securities?	____	____	____
4. Did audit planning and the implementation of audit procedures adequately consider:			
a. Off-balance sheet transactions?	____	____	____
b. The appropriate accounting for investments?	____	____	____
c. Related party transactions?	____	____	____
d. Regulatory examination reports?	____	____	____
e. Regulatory agreements?	____	____	____
f. Apparent fraud and insider abuse?	____	____	____
5. Did the engagement team consider the risks to the bank of possible violations of regulations such as the following?			
a. The Bank Secrecy Act.	____	____	____
b. Legal lending limit regulations and interest rates charged.	____	____	____
c. Affiliated party transactions.	____	____	____
d. The current minimum capital ratio requirements.	____	____	____
e. FIRREA.	____	____	____
6. Was the following considered in connection with foreign exchange transactions?			
a. Reasonable assurance that material commitments and contingent liabilities related to international operations have been properly recorded and disclosed.	____	____	____
b. Reasonable assurance that gains and losses from foreign exchange activities of the international department are properly recorded and disclosed.	____	____	____
B. .030 Cash			
1. Were bank accounts in the financial institutions confirmed at the audit date and were reconciling items existing at the balance-sheet date cleared by reference to subsequent statements obtained directly from the financial institutions?	____	____	____
2. Do the working papers indicate that the following were considered?	____	____	____
a. Confirmation of liabilities and contingent liabilities to other banks.	____	____	____
b. Proper recording of interest.	____	____	____
3. Do the workpapers indicate whether cash on hand represents currency and coins on hand?	____	____	____
4. Was it determined whether clearings, exchanges and in-transit items represent valid claims against the drawee bank?	____	____	____

	Yes	*No*	*N/A*
5. Do the workpapers reflect whether cash items (checks cashed after close of business, maturing coupons and bonds, returned checks and other items held temporarily pending their liquidation) are properly classified?	____	____	____

C. .040 Investment and Trading Securities

1. Do the workpapers indicate physical evidence of the ownership of securities on hand or held in custody or safekeeping by others for the account of the bank?	____	____	____
2. Do the workpapers indicate whether interest and dividend income and security gains and losses were properly recorded?	____	____	____
3. Do the workpapers indicate whether investments have suffered a permanent reduction in recorded value?	____	____	____
4. Do the workpapers indicate whether allowances for losses have been provided where necessary?	____	____	____
5. Do the workpapers indicate whether securities have been properly identified as investment or trading securities and valued appropriately?	____	____	____
6. Do the workpapers indicate whether amounts for investment securities and the related income, gains and losses are properly presented in the financial statements, including disclosures of amounts pledged, market value and other related disclosures?	____	____	____
7. Were substantive tests of investment and trading securities adequate based on the assessed level of control risk?	____	____	____

D. .050 Federal Funds and Repurchase/Reverse Repurchase Agreements

1. Do the workpapers indicate whether federal funds and repurchase/reverse repurchase agreements represent valid claims against the borrower or obligations to the lender?	____	____	____
2. Do the workpapers indicate whether amounts shown on the financial statements are properly classified and described?	____	____	____
3. Based on the assessed level of control risk were substantive tests of federal funds and repurchase/reverse repurchase agreements and trading securities adequate?	____	____	____

E. .060 Loans

1. Was an evaluation of the adequacy of the allowance for loan losses and the selection of loans to be evaluated performed and documented?	____	____	____
2. Did the evaluation in 1 above include:			
a. The bank's lending policies and procedures including its control over loan file documentation and maintenance?	____	____	____
b. Consideration of the qualification of the bank loan officers?	____	____	____

	Yes	No	N/A
c. Consideration of the effectiveness of the bank's internal audit and loan review program?			
d. Consideration of the results of prior years' examinations and industry statistics?			
e. Consideration of overall portfolio mix (industry and location), loan loss experience, and charge-off policy?			
3. Was consideration given to the relative degrees of inherent risk, by type, for: unsecured, depressed areas or industries; concentration or political risk; geographic or economic risks?			
4. Was consideration given to the participations purchased or sold?			
5. Was consideration given to overdrafts?			
6. Was consideration given to the accounting for and disclosures of related party transactions?			
7. Was consideration given to the extent to which loan renewals and extensions are used to maintain loans on a current basis?			
8. Was consideration given to appraisals obtained on originations and foreclosures, including the qualifications, independence and findings of the appraisers?			
9. Was consideration given to the disclosure of indirect (off-balance sheet) liabilities such as loan commitments, interest rate swaps, loans sold with recourse and standby letters of credit as well as direct liabilities?			
10. Were management's responses to discussions concerning the adequacy of the allowance appropriate?			
11. Was consideration given to the propriety of acquisition, development, and construction loans? (February 1986 AICPA Notice to Practitioners)			
12. Was consideration given to the use of watch lists, delinquency reports and other sources of potential problems including troubled debt restructurings and in-substance foreclosures?			
13. Were individual loan files reviewed, including borrowers financial statements, evidence of collateral and cash flow information?			
14. Did the final assessment of the adequacy of loan losses consider specific loans and historical trends?			
15. Was there comprehensive documentation to 14 above?			
16. If real estate or other assets acquired through foreclosure were significant to the client:			
a. Was the carrying value at the time of foreclosure evaluated and properly classified in the financial statements?			
b. Was the continuing carrying value assessed?			

	Yes	No	N/A
c. Were loans restructured by the client reviewed for proper recording under the principles of FASB Statement No. 15 (AC D22)?	____	____	____
d. Was the accounting for in-substance foreclosures reviewed to determine that they were accounted for as troubled debt restructuring?	____	____	____
17. For loans, was the following considered?			
a. The bank's compliance with its internal control, i.e., approval, reports, documentation, disbursement, and collection.	____	____	____
b. Selection of a sample from all significant loan areas.	____	____	____
c. Did the tests include executed notes, loan applications, financial statements of borrowers, chattels, other credit information and approvals.	____	____	____
d. Confirmation with bank customers.	____	____	____
e. Proper accounting recognition of unearned income, interest income, recognition of acquisition and other fees such as "points".	____	____	____
f. Tests of interest income to average loan balance and yield to interest rates in effect.	____	____	____
g. Testing of related party transactions and conflicts of interest.	____	____	____
h. Testing of the bank's credit card operations.	____	____	____
i. Testing of lease financing operations.	____	____	____
j. Testing of loan participations.	____	____	____
k. Review of underlying collateral.	____	____	____
18. Based on the assessed level of control risk, were substantive tests of loans adequate?	____	____	____
F. .070 Deposits			
1. Do the workpapers indicate whether deposits are recorded at the proper amounts, segregated as to type and represent valid claims?	____	____	____
2. Was it determined whether the related accrued interest and interest expense is stated on a reasonable and consistent basis?	____	____	____
3. Was it determined whether the amounts shown on the financial statements are properly classified and adequately described?	____	____	____
4. Based on the assessed level of control risk were substantive tests of deposits adequate?	____	____	____
G. .080 Director's Examinations			
1. Because the procedures may be limited in a director's examination, were the nature and extent of such procedures clearly set forth in the engagement letter?	____	____	____

	Yes	No	N/A
2. Were state requirements considered in determining the scope of the audit?	____	____	____
3. If the examination consisted of performing certain agreed-upon procedures did the firm's report comply with the provisions of SAS No. 35 (AU section 622)?	____	____	____

H. .090 Trust Operations

	Yes	No	N/A
1. Were the audit procedures directed to uncover the existence of contingent liabilities arising from trust department operations?	____	____	____
2. Did the procedures include a determination of whether administrative activities (including execution of trust instructions), safekeeping of assets, recordkeeping, tax, and reporting of the trust department were appropriate to meet the trust's fiduciary responsibilities?	____	____	____
3. Do the workpapers indicate whether trust assets exist, are recorded as trust assets, segregated from bank assets and are accounted for properly?	____	____	____
4. If other independent auditors or internal auditors audit the trust operations, were appropriate procedures performed to justify reliance on them?	____	____	____

[The next page is 9401.]

AAM Section 9500
Report Processing

Drafting the Report

.01 This section provides guidance for preparing and processing the financial statements and notes and the appropriate auditor's report.

.02 Auditors should establish policies and procedures that would define responsibility regarding the preparation and review of the financial statements and the notes thereto and preparation of the auditor's report. (See AAM section 10,100 for a detailed discussion of the auditor's report.)

Uniformity

.03 Strict uniformity may stifle creative thinking, but a consistent format adds quality to the financial statement notes and auditor's report (the "report").

a. The client's name should appear at the top of every statement with identical spelling and punctuation. The certificate of incorporation should be inspected to determine the exact name of the corporation. Accuracy in seemingly small matters, such as whether "the" is part of the name, the word "Company" or "Incorporated" is abbreviated or spelled out, or commas are part of the name, is important to the accountant's reputation.

b. Descriptive phraseology should be uniform. If the phrase "cost of goods sold" is used in the income statement, then a schedule of these costs should show "cost of goods sold," not "cost of sales."

c. The manner in which the date or period covered is indicated should also be uniform. If the income statement is headed "for the year ended December 31, 19___," then all supporting schedules should be headed that way, rather than "for the year 19___."

d. Schedule and statement headings should conform to a pattern. For example, if "schedule of cost of goods sold" is used, then all other schedules should begin with "schedule of."

e. Statement and schedule headings should be the same in the letter, table of contents, index, and other references.

f. Each page should be well balanced, paragraphs should break in the right places, tables should be centered and not broken except when a table is longer than a page, page numbers should be in the same place on each sheet, type should be clean and alignment even, and there should be no "strikeovers" or visible erasures.

g. As part of firm policy, the following should be standardized:

Title	Captions
Indexing	Spacing
Salutation	Indentation
Page Numbering	Paragraphing
Closing and Signing	Capitalization
Dating	Underscoring
Whole Dollar Reporting	Punctuation
Headings	Dollar Signs

Double or Single Spacing

Draft of Report

.04 In some cases a draft of the report, clearly identified as a draft, can be used effectively to afford the client an opportunity to comment on the report before it is in final form.

Report Production

.05 A *report guide sheet* usually accompanies all reports submitted for processing. Included in the report guide sheet is the basic information which relates to the specific client, such as:

a. Client name

b. Audit date

c. Engagement partner and manager

d. Date audit commenced

e. Date audit completed

f. Date report submitted for review

g. Date review completed

h. Date submitted for typing

i. Date submitted for checking

j. Date sent to client

k. Special comments, such as "rush," "date promised to client," and "hold for confirmation."

.06 The purpose of the report guide sheet is to enable the audit team to know the status of the report at all times, and to ascertain if there are any time lags in the processing of the report. The following procedures are used in its preparation.

Engagement information. The in-charge accountant enters the engagement information, delivery instructions, and "hold items" (items to be cleared prior to releasing report). He signs the report guide sheet as initial reviewer.

Review. The report is approved at various levels or review. If there is more than one reviewer (for example, two department reviewers for phases of a large job), the primary reviewer should sign the report guide sheet. If another partner or manager performed the entire review in the absence of the primary reviewer, then such other reviewer should sign the report guide sheet as overall reviewer.

Processing. The various processing levels are signed off. If more than one typist is involved, the head of the typing department or the primary typist may sign the report guide sheet. If more than one person is involved in comparing and proofing, the person primarily responsible should sign the report guide sheet. The review partner or his delegate should sign as final reader.

Final release. The person who signs for final release must ascertain that all other required signatures are on the report guide sheet before releasing the report.

Report production. The reverse side of the report guide sheet is usually completed by the in-charge accountant. A photocopy may be given to the report production department as advance notice of production requirements (for example, where numerous printed covers will be needed).

.07 The report guide sheet is bound with the operating office's file copy of the report. With the busy atmosphere prevailing at most firms, it is of vital importance that all work as it moves through the production process be under tight control independent of the work product and its guide sheet.

.08 A simple schedule can be maintained to control the flow of work from the date an audit engagement is begun to the date the report is finally mailed to the client. The schedule has key items arranged in columnar form and can be maintained by the office manager or another person in charge of staff assignments. Frequent references to the schedule should reveal any unusual delays in completing an engagement or typing a report.

.09 To account for each report from the time it is placed for typing to the time it is mailed or delivered to the client, some firms maintain a record in the typing department, in place of or as a supplement to the foregoing record. (See Report Production Control in AAM section 9500.13.)

.10 If this record indicates any time lags, the matter should be investigated; it may indicate either an abnormal backlog of work or some other problem.

.11 In preparing the report production control form, the following procedures are suggested:

- It should be manually prepared and updated daily by a control clerk.
- It should be retained in a notebook in a readily accessible location so that audit personnel can check report status without interfering with review and production operations.
- When a report and related workpapers are received by the reviewer, the client name, report description, fiscal year end, report-letter date, and due date should be entered.
- The review partner should assign a reviewer and record the date forwarded to the reviewer and the forwarding date for tax review.
- The person's name to whom the report is given for rework (if required) should be entered and the dates forwarded for tax and audit reviews of rework are recorded (if required).
- Other dates should be recorded through final release.

.12

Report Guide Sheet

(To be bound with the—colored copy of report)

Engagement Information

Client ______________________ Date Due ______________

Assignment Number ______________ Assignment Name ______________

Partner ____________ Manager ____________ In-Charge Accountant ____________

____ Compiled Financial Statements Period ______________

____ Reviewed Financial Statements Period ______________

____ Audited Financial Statements Period ______________

____ Review of Interim Financial Information Period ______________

____ Special Reports—Description: Date ______________

Delivery Instructions:

Name—attention of: ______________ ____ Mail

Address: ______________ ____ Delivery by:

______________ ______________

Hold Items

	Cleared by	Date
____ Attorney Letter	____	____
____ Letter of Representation	____	____
____ ______________	____	____
____ ______________	____	____

Report Review:

	Signature	Date
Prepared by	______________	____
Manager	______________	____
Review Department	______________	____
Tax Department	______________	____
Partner	______________	____

Report Processing:

	Signature	Date
Typing Department	______________	____
Comparing and Proofing	______________	____
Final Reading	______________	____

Final Release:

The report(s) described above were released by me after all hold items were cleared. All appropriate levels of review were signed off, and all processing steps completed.

______________________ ______________

Signature Date

Report Guide Sheet (continued)

Report Description (Exactly as it will appear):

____ Financial Statements and Accountant's Report (Compilation) (Review) Report
____ Financial Statement and Independent Auditor's Report
____ Unaudited (Interim) Financial (Statements) (Information) (and Accountant's Review Report)
____ Other Title

____

____

Client ______________________________________ Date ______________

Report Production:
Covers: ____ Printed ____ Typed

Report Copies:

In covers

Client	______	______	______	______	______
File	______	______	______	______	______
Other	______	______	______	______	______

Uncovered	Workpaper copies (at least two)	Extra file copies
Working Paper	______	______
Extra	______	______

Other Production Instructions:

____

____

____

____

____

____

____

____

____

.13

Report Production Control

Client	Report description	Dates			Reviewer name	Dates forwarded for										
						Review		Rework		Rework review		Type & proof	Final read	Multilith	Hold	Final release
		FYE	Report letter	Due		Audit	Tax	Date	To (*name*)	Audit	Tax					

Signing Reports

.14 After the report has been reviewed, typed, proofread, and corrected, it is usually submitted to a partner for reading and signature.

.15 Some firms do not bind the report until after it is signed. This saves unbinding in case the signing partner orders any revisions. In offices where the reports have been sufficiently and systematically reviewed and referenced before or after typing, they may be submitted to the partner for his signature in final bound form. This saves time and additional handling.

.16 The transmittal letters and addressed envelopes should be submitted to the partner with the reports. This gives him an opportunity to review the mailing directions, so that reports are directed to the proper person.

.17 Report letters are usually signed by a partner using the firm name. Where reproducing equipment is used, a signature on the original is sufficient. It is important to establish rules applying to report signatures since all reports (add correspondence) issued to clients carry with them the reputation, authority, and responsibility of the firm.

Delivery of Completed Work

.18 Audit reports are rightfully considered by clients to be confidential documents. For this reason, care should be taken to address them to a responsible person, usually the treasurer or principal executive, in an envelope clearly marked "confidential." Where there is some question as to the person or persons to whom the report should be delivered, address it to the specific source of authority authorizing the report. In a majority of cases, especially for recurring engagements, the reports are mailed. However, some firms make it a practice to have a partner deliver the report personally and discuss it with the client.

.19 The report should be mailed in envelopes or boxes sturdy enough to withstand the rough treatment they may receive in transit.

.20 Many firms send separate transmittal letters with their reports. The letter should contain no comments on the report because it might be construed as a modification of the opinion on the report. It is advisable to write a letter requesting that a printer's proof be submitted to the accounting firm for review before any printed reports are released by the client to stockholders or the public.

.21 Reports are generally issued only to the client who engaged the services. The unauthorized distribution of a report represents a violation of the confidential relationship between a firm and its client. Firms are sometimes asked by clients to mail copies of their reports directly to third parties. Clients should be discouraged from making such requests. In rare instances, where a firm assumes this added responsibility, distributions are made only upon specific written instruction from the client, and reference to the client's instructions should be included in the transmittal to the third party. Printed annual reports to shareholders, prospectuses, and other reports that are a matter of public record, such as those filed with certain governmental agencies, are obvious exceptions to this rule.

[*The next page is 10,001.*]

AAM Section 10,000
Accountants' Reports

These examples are for illustrative purposes only. They are included as conveniences for users of this manual who may want points of departure when drafting reports to meet their individual needs. This manual is a nonauthoritative kit of practice aids and accordingly, does not include extensive explanation or discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate.

These examples illustrate the body of various reports. For comment on addressing and dating of the report, see AAM section 10,100.

Examples which are assembled from illustrative reporting language set forth in Statements on Auditing Standards (SASs) and Statements on Standards for Accounting and Review Services (SSARSs) include citation of the particular source and its location in *AICPA Professional Standards.*

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AAM Section 10,100
Format of Accountants' Reports

Report Preparation

.01 Firms should develop standard policies and procedures for preparing and issuing reports. The following are some suggested report preparation policies:

- *Letterhead.* The report should be presented on firm letterhead.
- *Addressee.* The report should be addressed to the board of directors, stockholders, partners, general partner, proprietor, or to the company whose financial statements are being audited. If the firm was engaged by others, the report should be addressed thereto.

  The Board of Directors
  XYZ Credit Union
  City, State Zip Code

- *Salutation.* A salutation should not be included on the report.
- *Report signing.* The firm name should be manually signed by the engagement partner. The words "Certified Public Accountants" should be excluded from the signature if they are a normal part of the firm's letterhead.
- *Report dating.* Audit reports should be dated as of the last day of field work.
  - The date should be presented at the bottom of the page along with the city and state, if not included in firm letterhead, as follows:

    City, State
    April 5, 199Y

  - If significant subsequent events are discovered before the report is issued, but after the completion of field work, the report should be dual-dated for the subsequent event.
  - Subsequent events affecting previously issued reports that are being reissued will also cause the report to be dual-dated. The following illustrates dual-dating:

    City, State
    February 26, 199Y, except for Note X as to which the date is
    April 5, 199Y

- *Level of service.* The level of service performed and the nature of the report are typically outlined in the engagement letter. The letter should be revised for any significant changes from the original understanding with the client, such as, in the event of a step-up or step-down in the level of service.
  - The partner should approve any step-up or step-down in level of service. A step-up in level of service may occur after obtaining a revised understanding with the client. A step-down in level of service should occur only after carefully evaluating the reasons for the change because the reasons for the change may also affect the report on lower levels of service. Limitations on the scope of an audit, for example, may also preclude issuing a review or compilation report.

— If more than one level of service is performed for financial statements of the same period (e.g., compilation and audit), the financial statements need only be accompanied by the report on the highest level of service performed.

Reports on Audited Financial Statements

.02 Generally accepted auditing standards (GAAS) establish reporting responsibilities. The four standards of reporting stated in AU section 150.02 are:

a. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).

b. The report shall identify those circumstances in which GAAP has not been consistently applied in the current period in relation to the preceding period.

c. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

d. The report shall contain either an expression of opinion regarding the financial statements taken as a whole, or a statement that an opinion cannot be expressed. When an opinion cannot be expressed, the reasons should be stated. In all cases, the report should contain a clear-cut indication of the degree of responsibility, if any, the auditor is taking.

Standard Report

.03 The standard auditor's report prescribed by SAS No. 58, *Reports on Audited Financial Statements*, as amended by SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements (AU section 508), should be used when the auditor has formed an opinion, based on the application of GAAS, that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in accordance with GAAP. It should address all financial statements presented. A standard auditor's report for the presentation of comparative financial statements is illustrated in AAM section 10,210.010.

Modifications of the Standard Auditor's Report

.04 SAS No. 58 (AU section 508), as amended, describes situations that may require auditors to modify the standard report, and also provides illustrations of the appropriate modifying language. These modifications, which are discussed in greater depth in the following sections, are:

- *Explanatory language.* A wide variety of situations may arise that require a modification of the standard auditor's report, without affecting the expression of an unqualified opinion. Some of the more common of such situations are going-concern problems, part of the financial statements have been audited by another auditor, or a significant change in accounting principles. The explanatory paragraph for situations that do not affect the auditor's opinion should be placed after the opinion paragraph.

- *Qualified opinion.* Qualified opinions result from two general categories of situations: scope limitations and departures from GAAP. A scope limitation arises when the auditor has been unable to perform all of the auditing procedures he or she believes are necessary to express an unqualified opinion on the financial statements. Financial statements containing a material departure from GAAP, including inadequate disclosures in the financial statements, may lead the auditor to qualify his or her opinion. Both situations require that an explanatory paragraph, preceding the opinion paragraph, be included that describes the nature of the scope limitation or the departure from GAAP.

- *Disclaimer of opinion.* A disclaimer of opinion may be required when:
  - The scope of the audit has been restricted so significantly that the auditor does not have a basis for forming an opinion on the financial statements. In this case, an explanatory paragraph, preceding the disclaimer paragraph, should be included in the auditor's report to explain all significant reasons for the disclaimer.
  - The auditor is not independent, in which case a one-paragraph disclaimer is issued (applies for publicly held entities only). A compilation report with a lack of independence noted should be issued for nonpublic entities.
- *Adverse opinion.* An adverse opinion should be expressed on financial statements that do not present fairly the entity's financial position, results of operations, or cash flows in conformity with GAAP. In other words, the auditor concludes that the financial statements are *not* fairly presented in accordance with GAAP. Issuance of an adverse opinion requires inclusion of an explanatory paragraph, preceding the opinion paragraph, that explains all of the reasons for the adverse opinion and, if practicable, the effects of the subject matter of the adverse opinion on the financial statements.

Scope Limitations

.05 Restrictions on the scope of an audit, whether imposed by the client or by circumstances such as the timing of the auditor's work, the inability to obtain sufficient, competent evidential matter, or an inadequacy in the client's accounting records, may require a qualified opinion or a disclaimer of opinion. Deciding whether to qualify or disclaim is a matter of judgment, and generally the primary factor in this decision is the materiality of the financial statement items affected. However, other factors should be considered, such as the pervasiveness of the effects of the omitted auditing procedures and the nature of the financial statement items affected.

Departures From GAAP

.06 ***Unacceptable Principles.*** Significant departures from GAAP require that the auditor issue either a qualified or adverse opinion. Choosing between a qualified or adverse opinion depends on the magnitude of the departure. While the materiality of the effects of the departure is a primary consideration, the auditor should also consider the pervasiveness of the departure, such as the number of financial statement items affected, the importance of the departure to the organization's activities and its ability to obtain funding, and the dollar effect of the departure on individual financial statement items as well as the statements as a whole.

.07 For both qualified and adverse opinions, an explanatory paragraph should be included, preceding the opinion paragraph, that describes all of the substantive reasons for the auditor's opinion, and the effects on the financial statements, if readily determinable. If it is not practical to determine the effects of the departure, the explanatory paragraph should contain a statement to that effect. If information about the effects of the departure are described in the notes, the explanatory paragraph can be shortened by referring to the note.

.08 ***Inadequate Disclosure.*** Departures from GAAP include not just inappropriate application of accounting principles, but also omitted or inadequate disclosures in the financial statements. Such situations require the auditor to add an explanatory paragraph, preceding the opinion paragraph, that describes the nature of the inadequate or omitted disclosure and, if practical, the information that should have been disclosed. The significance of the omitted or inadequate disclosure will determine whether a qualified or adverse opinion is appropriate.

.09 ***Report Modification.*** The opinion paragraph for a qualified opinion due to a departure from GAAP should include the words "except" or "exception" and a reference to the explanatory paragraph that describes that departure. Adverse opinions should include language such as "do not present fairly" and should also include a reference to the explanatory paragraph. A qualified opinion indicating a departure from GAAP is presented in AAM section 10,240.020. An adverse opinion indicating a departure from GAAP is presented in AAM section 10,220.01.

Errors, Irregularities, and Illegal Acts

.10 If the financial statements are materially affected by an error, irregularity or illegal act that has not been properly accounted for and disclosed, a qualified or adverse opinion should be considered. If the auditor is precluded from applying necessary procedures or from obtaining sufficient information to conclude whether an error, irregularity or illegal act that could be material to the financial statements has occurred, a qualified or disclaimer of opinion should be issued. All such matters should be discussed immediately with the engagement partner.

.11 If a client will not accept modification of the report under the circumstances above, the firm should consider withdrawing from the engagement and consulting with legal counsel.

Consistency Exceptions

.12 Accounting changes affecting consistency include:

- A change from one generally accepted accounting principle to another method, practice or principle that is different from the one previously used.
- A change from an unacceptable to an acceptable principle (correction of an error).
- A change in financial statement classification that significantly affects financial position or results of operations (e.g., classification of an item in earnings from operations as other income or expense).
- A change in reporting entity.

.13 Accounting changes not normally affecting consistency include:

- Initial adoption of an existing accounting principle for a new event or transaction.
- Insignificant reclassification.
- Correction of errors not involving a principle.
- Changes in accounting estimates.

.14 The nature of the accounting change will determine whether prior periods should be restated or a cumulative adjustment should be included in current activities. In either event, the change should be disclosed in the notes to the financial statements and in the auditor's report in a separate paragraph following the opinion paragraph. The auditor's concurrence with a change is implicit unless he or she takes exception to the change. The opinion paragraph would be standard unless the change is to an unacceptable principle or method, the change is not justified, or a prospective change of a principle requiring retroactive adjustment is not discussed. In such situations, either a qualified or adverse opinion should be issued.

Uncertainties

.15 Uncertainties are significant circumstances, events, or transactions affecting the financial statements, the outcome of which cannot be reasonably estimated. Uncertainties are a particularly complex area because they can result in a qualified or adverse opinion due to a departure from GAAP, or a qualified opinion or disclaimer due to a scope limitation. Uncertainties include, but are not limited to, contingencies covered by FASB Statement No. 5, *Accounting for Contingencies* (AC C59), and matters related to estimates covered by SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*

.16 ***Uncertainties Not Requiring Modification of the Opinion.*** SAS No. 58, paragraph 29, as amended by SAS No. 79 (AU section 508.29), states that when the auditor has concluded that sufficient information supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

.17 ***Scope Limitations.*** A qualified opinion or disclaimer of opinion may be required if the auditor is unable to obtain sufficient information to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements. In some ways, information about uncertainties may always be considered insufficient because it is dependent on future, unknown events. However, if the auditor determines that information did or does exist, but it is unavailable to him or her (e.g., because the information was destroyed or management will not allow the auditor to have access to it), the auditor should consider modifying the report for a scope limitation.

.18 ***Departures From GAAP.*** SAS No. 58, paragraph 45, as amended by SAS No. 79 (AU section 508.45), describes three categories of departures from GAAP involving risks or uncertainties:

- Inadequate disclosure
- Inappropriate accounting principles
- Unreasonable accounting estimates

.19 A qualified or adverse opinion due to a departure from GAAP may be necessary if the auditor concludes that a matter involving an uncertainty has not been appropriately disclosed in the financial statements in conformity with GAAP.

.20 Also, a departure from GAAP may exist if management has made inappropriate estimates of future events in applying accounting principles (such as the use of unreasonable expected lives of depreciable assets for calculating depreciation) or in making other accounting estimates.

.21 ***Going-Concern Uncertainties.*** If the auditor concludes that there is substantial doubt about the organization's ability to continue as a going concern, the situation should be described in an explanatory paragraph, following the opinion paragraph. The explanatory paragraph should describe the principal events and conditions related to the going concern, their possible effects on the financial statements, management's plans for corrective actions, and the auditor's conclusion that substantial doubt exists. SAS No. 64, *Omnibus Statement on Auditing Standards—1990* (AU section 341.12 and .13), imposes the additional requirement that the explanatory paragraph include the terms "substantial doubt" and "going concern." The auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern in the going-concern explanatory paragraph.

.22 If financial statement disclosures about the uncertainty are inadequate, a departure from GAAP exists, and either a qualified or adverse opinion may be necessary.

Reporting on Supplementary Information

.23 Supplementary information includes detailed schedules of other data that are not necessary for a fair presentation of the basic financial statements. Whenever supplementary information is included in an auditor-submitted document, the auditor must indicate the degree of responsibility, if any, taken for this information. A separate report on the supplementary information or a separate paragraph in the report on the basic financial statements may be used to report on supplementary information. If a separate report is issued, it should be on the firm's letterhead and be signed. The report date should be the same as for the basic financial statements.

.24 Reports on supplementary information should express or disclaim audit assurance. The extent and results of testing of supplementary information will determine the firm's responsibility in each circumstance. If a separate report on the supplemental information is issued, the first sentence of that report should refer to the report on the basic financial statements.

Reporting on a Single Statement

.25 In certain circumstances, an engagement to audit a single financial statement may be accepted. Generally these engagements, called "limited reporting engagements," are a result of the client needing a single financial statement to fulfill a contractual requirement, such as an organization that must provide its landlord with an audited income statement for purposes of calculating rent. Also, entities that have never been audited often request an audit of the statement of financial position only for the first year, with the intention of having audits of the entire financial statements in the future. Generally such engagements are accepted as long as there is a legitimate reason for the limited engagement, and provided there are no restrictions on access to information underlying the financial statements or on the scope of the procedures the auditor needs to perform. In such engagements, an unqualified opinion can be expressed on the financial statement the auditor was engaged to audit. If the other financial statements are presented, a disclaimer of opinion should be issued on those statements. An unqualified opinion on a single statement audit is presented in AAM section 10,210.030.

Relying on the Work of a Specialist

.26 The firm may engage specialists to perform certain work supporting representations in the financial statements. SAS No. 73, *Using the Work of a Specialist* (AU section 336), says if a review of the specialist's work finds it satisfactory, and if no report modification is necessary because of the specialist's findings, there is no need to refer to the specialist's work.

.27 If the specialist's work is not adequate to support the financial statement representations, a qualification or disclaimer of opinion because of a scope limitation may be required. Findings of the specialist that indicate the financial statements are not in accordance with GAAP may require a qualified or adverse opinion.

Lack of Independence

.28 For public entities, whenever the auditor is not independent with respect to a client whose financial statements have been audited, a disclaimer of opinion should be issued. For nonpublic entities, the firm may only issue a compilation report that includes a statement that the firm is not independent.

Reissuance of Audit Reports as Predecessors

.29 If the auditor is asked by a former client to reissue its report on prior-period financial statements, he or she should inform the client of the procedures necessary to comply with that request. If the client agrees to perform these procedures, and pay the fee for these services, the auditor would ordinarily agree to reissue the report.

.30 Before reissuing a report, the auditor should consider whether the previous opinion on those prior-period statements is still appropriate. Differences in the current form and presentation of the financial statements for the prior period, or the possibility of material subsequent events affecting those financial statements, could make the previous opinion inappropriate. The auditor should perform at least the following procedures:

- Read the financial statements of the current period.
- Compare the prior-period financial statements with the financial statements to be presented in comparative format by the successor.
- Obtain a letter of representation from the successor auditor. The successor should represent that his or her audit has not revealed any matters that may have a material effect on the prior-period financial statements.

.31 If the firm reissues its report without change, the previous report date should be used. If the financial statements or the report of the prior period are revised, the report should be dual-dated as to the event or matter causing the revision. There should be no reference to the report or the work of the successor auditor.

Reissuance of the Audit Report Subsequent to the Date of Original Issue[1]

.32 Occasionally the firm may be requested by a client to furnish additional copies of a previously issued report. Approval of the engagement partner is necessary to reissue a previously issued report. In such situations the engagement partner may prepare a memo stating the reasons for the reissuance and that he or she is not aware of any circumstances occurring since the original report date that would require adjustment to or disclosure in the financial statements.

.33 Use of the original report date removes any implication that records, transactions, or events after that date have been audited or reviewed. Although the auditor has no responsibility to make further investigation or inquiry as to subsequent events, the engagement partner should consider a brief discussion with the client's chief financial or executive officer before reissuing his or her report.

Subsequent Discovery of Facts Existing at Report Date

.34 Although the auditor has no obligation to make any continuing inquiries or perform other procedures after issuing his or her report, the auditor may become aware of information that affects the financial statements upon which he or she has previously reported. When becoming aware of such information, the auditor should determine the reliability of the information and whether such information existed at the date of the report. The engagement partner should make inquiries of client management in this regard.

.35 If the information is reliable and did exist at the date of the report, if the report would have been affected if the information had been known at the report date, and if there are persons relying on the financial statements who would attach importance to the information, the auditor should take action to prevent future reliance on the report. If the engagement partner concludes that action should be taken to prevent future reliance on the report, he or she should advise the client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to the persons known to be, or likely to be, relying on the financial statements and related report. Disclosures should be made in one of the following ways:

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[1] The AICPA Auditing Standards Board recently issued an Auditing Interpretation, *Eliminating a Going-Concern Explanatory Paragraph From a Reissued Report* (AU section 9341.01 and .02), which deals with situations where a previously issued report contains a going-concern explanatory paragraph, and the situation that gave rise to the going-concern has been resolved.

- If the effects of subsequent facts can be promptly determined, disclosure should include reissuing revised financial statements and a revised report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the auditor's report.

- If the current financial statements have not been released, appropriate disclosure of the revision of the prior-period financial statements can be included therein.

- When the effects of subsequent facts cannot be readily determined, revisions of financial statements and reports may be delayed. In this case, persons known to be, or likely to be, relying on the financial statements should be notified by the client that the financial statements and related reports should not be relied on, and that revised financial statements and report will be forthcoming.

.36 If the client refuses to make the disclosures discussed above, the auditor should contact legal counsel. He or she should also notify all members of the board of directors of such refusal and that the firm will take the following steps to prevent future reliance on its report:

- Notify the client that the auditor's report must no longer be associated with the financial statements.

- Notify any applicable regulatory agencies that the report should no longer be relied upon.

- Notify each person known to be relying on the financial statements that the report should no longer be relied upon.

.37 If the auditor's investigation of the subsequently discovered information is satisfactory, and he or she has determined that the information is reliable, the notifications in AAM section 10,100.36 should include a description of the effects of the information on the financial statements. If the client has not cooperated and, as a result, the auditor has been unable to conduct a satisfactory investigation, the auditor does not need to indicate the details of the information. Instead, he or she should indicate that the auditor's report must no longer be relied upon nor should the auditor be associated with the financial statements.

[*The next page is 10,211.*]

AAM Section 10,210
Unqualified Opinions

.010 Auditor's Standard Report—Comparative Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 8, as amended by SAS No. 79 (AU section 508.08).]

.020 Auditor's Standard Report—Single Year Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 8, as amended by SAS No. 79 (AU section 508.08).]

.030 Report on a Single Statement Audit (Balance Sheet Only Presented) [Assuming the auditor is able to satisfy himself or herself regarding the consistency of application of accounting principles]

<u>Independent Auditor's Report</u>

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19XX. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall balance sheet presentation. We believe that our audit of the balance sheet provides a reasonable basis for our opinion.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 19XX, in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 34, as amended by SAS No. 79 (AU section 508.34).]

Note: If reporting on a single statement (for example, balance sheet only) when other financial statements are also presented, the following paragraph should be added after the opinion paragraph:

> Because we were not engaged to audit the statements of income, retained earnings, and cash flows, we did not extend our auditing procedures to enable us to express an opinion on the results of operations and cash flows for the year ended December 31, 19XX. Accordingly, we express no opinion on them.

.040 Reference to Other Auditors—Successor Auditor's Report When Predecessor's Report (Unqualified) Is Not Presented

Independent Auditor's Report

Addressee:

We have audited the balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, were audited by other auditors whose report dated March 31, 19X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 74, as amended by SAS No. 79 (AU section 508.74).]

Practice Tips

(1) The successor auditor should not name the predecessor auditor in his report; however, the successor auditor may name the predecessor auditor if the predecessor auditor's practice was acquired by, or merged with that of the successor auditor.

[Source: SAS No. 58, paragraph 74, footnote 27, as amended by SAS No. 79 (AU section 508.74).]

(2) If the predecessor's report was issued before February 29, 1996 (the effective date of SAS No. 79 [AU section 508]) and contained an uncertainties explanatory paragraph, a successor auditor's report issued or reissued after the effective date of SAS No. 79 (AU section 508) should not make reference to the predecessor's previously required explanatory paragraph.

[Source: SAS No. 58, paragraph 74, footnote 28, as amended by SAS No. 79 (AU section 508.74).]

.050 Reference to Other Auditors in Report

Independent Auditor's Report

Addressee:

We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X2 and 19X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $______ and $______ as of December 31, 19X2 and 19X1, respectively, and total revenues of $______ and $______ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 19X2 and 19X1, and the results of their operations and their cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 13, as amended by SAS No. 79 (AU section 508.13).]

.060 Reference to Other Auditors—Successor Auditor's Unqualified Report When Predecessor's Report That included an Explanatory Paragraph Is Not Presented

Independent Auditor's Report

Addressee:

We have audited the balance of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, were audited by other auditors whose report dated March 1, 19X2, on those statements included an explanatory paragraph that described the change in the Company's method of computing depreciation discussed in Note X to the financial statements.

We conducted our audits in accordance with generally accepted auditing standards. 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 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 74, as amended by SAS No. 79 (AU section 508.74).]

Note: If the predecessor's report was issued before February 29, 1996 (the effective date of SAS No. 79 [AU section 508]) and contained an *uncertainties* explanatory paragraph, a successor auditor's report issued or reissued after the effective date of SAS No. 79 (AU section 508) should not make reference to the predecessor's previously required explanatory paragraph.

[Source: SAS No. 58, paragraph 74, footnote 28, as amended by SAS No. 79 (AU section 508.74).]

.070 Reference to Other Auditors—Successor Auditor's Report When Prior Year Financial Statements Have Been Restated Following Issuance of the Predecessor's Report

<u>**Independent Auditor's Report**</u>

Addressee:

We have audited the balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, before the restatement described in Note X, were audited by other auditors whose report dated March 31, 19X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

We also audited the adjustments described in Note X that were applied to restate the 19X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.*

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 74, as amended by SAS No. 79 (AU section 508.74).]

* This paragraph may be added to the report when the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself as to the appropriateness of the restatement adjustment.

.080 Reference to Other Auditors—Prior Year Financial Statements Restated Following a Pooling of Interests

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated balance sheet of XYZ Company as of December 31, 19X2, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of XYZ Company as of [at] December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

We previously audited and reported upon the consolidated statements of income and cash flows of XYZ Company and subsidiaries for the year ended December 31, 19X1, prior to their restatement for the 19X2 pooling of interests. The contribution of XYZ Company and subsidiaries to revenues and net income represented ______ percent and ______ percent of the respective restated totals. Separate financial statements of the other companies included in the 19X1 restated consolidated statements of income and cash flows were audited and reported upon separately by other auditors. We also audited the combination of the accompanying consolidated statements of income and cash flows for the year ended December 31, 19X1, after restatement for the 19X2 pooling of interests; in our opinion, such consolidated statements have been properly combined on the basis described in Note A of notes to consolidated financial statements.

[Signature]

[Date]

[Source: SAS No. 1, section 543.16, as modified, October 1980, by the Auditing Standards Board, and as amended by SAS No. 64 (AU section 543.16).]

Note: This report is used when the auditor concludes that he or she cannot serve as principal auditor for the restated financial statements.

.083 Reference to Other Auditors—Successor Auditor Report When Prior Period Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, were audited by other auditors who have ceased operations and whose report dated March 31, 19X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Sources: SAS No. 58, paragraph 74, as amended by SAS No. 79 (AU section 508.74) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations*, paragraph 6.*]

* This Notice to Practitioners was issued by the Auditing Standards Division and is intended to provide guidance to accountants in situations in which the predecessor accountant has ceased operations. The guidance in this Notice does not apply to situations in which a firm of independent accountants assumes responsibility for the work of another firm in conjunction with, for example, a merger with, or acquisition of, the other firm.

.084 **Reference to Other Auditors—Successor Auditor Report When Prior Period Financial Statements Were Audited By a Predecessor Auditor Who Has Ceased Operations Have Been Restated**

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, before the restatement described in Note X, were audited by other auditors who have ceased operations and whose report dated March 31, 19X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

We also audited the adjustments described in Note X that were applied to restate the 19X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.[*]

[*Signature*]

[*Date*]

[Sources: SAS No. 58, paragraph 74, as amended by SAS No. 79 (AU section 508.74) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations*, paragraphs 5 and 6.[**]]

[*] This paragraph may be added to the report when the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself as to the appropriateness of the restatement adjustment.

[**] This Notice to Practitioners was issued by the Auditing Standards Division and is intended to provide guidance to accountants in situations in which the predecessor accountant has ceased operations. The guidance in this Notice does not apply to situations in which a firm of independent accountants assumes responsibility for the work of another firm in conjunction with, for example, a merger with, or acquisition of, the other firm.

.085 Reference to Other Accountants—Report on Nonpublic Entity Presented With Prior Period Financial Statements Reviewed by a Predecessor Accountant Who Has Ceased Operations

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We have conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

The 19X1 financial statements were reviewed by other accountants who have ceased operations, and their report thereon, dated March 1, 19X2, stated they were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

[*Signature*]

[*Date*]

[Sources: SAS No. 58, paragraph 74, as amended by SAS No. 79 (AU section 508.74) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations*, paragraph 7.*]

* This Notice to Practitioners was issued by the Auditing Standards Division and is intended to provide guidance to accountants in situations in which the predecessor accountant has ceased operations. The guidance in this Notice does not apply to situations in which a firm of independent accountants assumes responsibility for the work of another firm in conjunction with, for example, a merger with, or acquisition of, the other firm.

.086 Reference to Other Accountants—Report on Nonpublic Entity Presented With Prior Period Financial Statements Compiled by a Predecessor Accountant Who Has Ceased Operations

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosure in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by managements, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepting accounting principles.

The 19X1 financial statements were compiled by other accountants who have ceased operations, and their report thereon, dated February 1, 19X2, stated that they did not audit or review those financial statements and, accordingly, express no opinion or any other form of assurance on them.

[*Signature*]

[*Date*]

[Sources: SAS No. 58, paragraph 74, as amended by SAS No. 79 (AU section 508.74) and Notice to Practitioners, February 1991, *Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations*, paragraph 7.*]

* This Notice to Practitioners was issued by the Auditing Standards Division and is intended to provide guidance to accountants in situations in which the predecessor accountant has ceased operations. The guidance in this Notice does not apply to situations in which a firm of independent accountants assumes responsibility for the work of another firm in conjunction with, for example, a merger with, or acquisition of, the other firm.

.090 Change in Accounting Principles or Method of Accounting

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentations. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, the Company changed its method of computing deprecation in 19XX.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 17, as amended by SAS No. 79 (AU section 508.17).]

.100 Going Concern—Uncertainty

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[*Signature*]

[*Date*]

[Source: SAS No. 59, paragraph 13, as amended by SAS No. 77 (AU section 341.13).]

Note: In a going-concern explanatory paragraph, the auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern.

.110 Liquidation Basis of Accounting—Single Year Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of net assets in liquidation of X Company as of December 31, 19X2, and the related statement of changes in net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2. In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 19X2 to April 25, 19X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets in liquidation of X Company as of December 31, 19X2, the changes in its net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2, and the results of its operations and its cash flows for the period from January 1, 19X2 to April 25, 19X2, in conformity with generally accepted accounting principles applied on the bases described in the following paragraph.

As described in Note X to the financial statements, the stockholders of X Company approved a plan of liquidation on April 25, 19X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 19X2 from the going-concern basis to a liquidation basis.

[*Signature*]

[*Date*]

[Source: Interpretation No. 8 of SAS No. 58 (AU section 9508.36).]

.120 Liquidation Basis of Accounting—Comparative Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 19X2 to April 25, 19X2. In addition, we have audited the statement of net assets in liquidation as of December 31, 19X2, and the related statement of changes in net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X1, and the results of its operations and its cash flows for the year then ended and for the period from January 1, 19X2 to April 25, 19X2, its net assets in liquidation, as of December 31, 19X2, and the changes in its net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2, in conformity with generally accepted accounting principles applied on the bases described in the following paragraph.

As described in Note X to the financial statements, the stockholders of X Company approved a plan of liquidation on April 25, 19X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 19X2 from the going-concern basis to a liquidation basis.

[*Signature*]

[*Date*]

[Source: Interpretation No. 8 of SAS No. 58 (AU section 9508.36).]

.130 Comparative Financial Statements—Unqualified Opinion on the Current Year's Financial Statements With Disclaimer of Opinion on the Prior Year's Statements of Income, Retained Earnings, and Cash Flows

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 19X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 19X0, enter into the determination of net income and cash flows for the year ended December 31, 19X1.

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 19X1.

In our opinion, the balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 19X2, present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the year ended December 31, 19X2, in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 67, as amended by SAS No. 79 (AU section 508.67).]

Note: This report assumes that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles.

.140 Comparative Financial Statements—Subsequent Restatement of Prior-Period Financial Statements to Conform With Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our report dated March 1, 19X2, we expressed an opinion that the 19X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 19X1 financial statements to conform with generally accepted accounting principles. Accordingly, our present opinion on the 19X1 financial statements, as presented herein, is different from that expressed in our previous report.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 69, as amended by SAS No. 79 (AU section 508.69).]

.150 Comparative Financial Statements—Current Year's Statements Audited and Prior Year's Statements Reviewed

<u>**Independent Auditor's Report**</u>

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

The 19X1 financial statements were reviewed by us (other accountants) and our (their) report thereon, dated March 1, 19X2, stated we (they) were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraph 17 (AU section 504.17).]

Notes: When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.

When the financial statements are those of a public entity, the separate paragraph should include a disclaimer of opinion or a description of a review. (A sample of a disclaimer of opinion is provided in AAM section 10,210.170.)

.160 Comparative Financial Statements—Current Year's Statements Audited and Prior Year's Statements Compiled

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

The 19X1 financial statements were compiled by us (other accountants) and our (their) report thereon, dated March 1, 19X2, stated we (they) did not audit or review those financial statements and, accordingly, express no opinion or other form of assurance on them.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraph 17 (AU section 504.17).]

Note: When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.

.170 Comparative Financial Statements—Current Year's Statements Audited and Disclaimer on Prior Year's Unaudited Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

The 19X1 financial statements were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

Notes: The above report illustrates a disclaimer of opinion as described in SAS No. 26, paragraph 17 (AU section 504.17) when the financial statements are those of a public entity. For a nonpublic entity, see AAM section 10,210.150 and .160.

When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.

.180 U.S.-Style Report Modified to Report on Financial Statements Prepared in Conformity With Accounting Principles Generally Accepted in Another Country That Are Intended for Use Only Outside the United States

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of International Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended which, as described in Note X, have been prepared on the basis of accounting principles accepted in [*name of country*]. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States (and in [*name of country*]). U.S. standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of International Company as of December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in [*name of country*].

[*Signature*]

[*Date*]

Note: The above illustrates a report as described in SAS No. 51, paragraph 10, as amended (AU section 534.10).

.190 Report on Financial Statements Prepared in Conformity With the Accounting Principles Generally Accepted in Another Country That Will Have More Than Limited Distribution in the United States

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of International Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X to the financial statements, the Company has recorded fixed assets in excess of historical cost using appraised value as the basis for adjustment in accordance with accounting principles generally accepted in [*name of country*]. If the fixed assets had been recorded at historical cost, fixed assets and retained earnings would be decreased by $XXX,XXX and $XXX,XXX respectively, as of December 31, 19XX, and net income and earnings per share would be increased by $X,XXX and $X.XX respectively for the year then ended.

In our opinion, except for the effects of recording the fixed assets in excess of historical costs, discussed in the preceding paragraph, the financial statements present fairly, in all material respects, the financial position of International Company as of December 31, 19XX, and the results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles.

(Optional Paragraph)

In our opinion, the financial statements referred to above present fairly the financial position of the International Company at December 31, 19XX, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in [*name of country*].

[*Signature*]

[*Date*]

Note: The above illustrates a report as described in SAS No. 51, paragraphs 14 and 15 (AU section 534.14 and .15). This report does not apply to reports on financial statements of U.S. subsidiaries of foreign registrants presented in SEC filings of foreign parent companies where the subsidiaries' financial statements have been prepared on the basis of accounting used by the parent company.

.200 Correction of an Error, Not Involving an Accounting Principle

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, certain errors resulting in an understatement of previously reported expenses for the years ended December 31, 19X1 and 19X0 were discovered by the Company's management during the current year. Accordingly, the 19X1 financial statements have been restated and an adjustment has been made to retained earnings as of January 1, 19X1 to correct the errors.

[*Signature*]

[*Date*]

[Sources: SAS No. 58, paragraph 8, as amended by SAS No. 79 and SAS No. 1, section 420, paragraph 11 (AU sections 508.08 and 420.11, respectively).]

Note: This report would be used when the issuance of financial statements accompanied by the auditor's report for a subsequent period is imminent so that disclosure is not delayed (SAS No. 1, section 561, paragraph .06b [AU section 561.06b]).

.210 Subsequent Event Prior to Issuance of Auditor's Report

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, on March 1, 19X3, the Company entered into an agreement to sell Subsidiary A. This Subsidiary represents X% of the Company's total assets and X% of its revenues.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraphs 8 and 19, as amended by SAS No. 79 (AU section 508.08 and .19).]

.220 Reissued Report Due to Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note 10 to the financial statements, the Company's 19X2 [*specify account corrected*] previously reported as $XX,XXX should have been $X,XXX. This discovery was made subsequent to the issuance of the financial statements. The financial statements have been restated to reflect this correction.

[*Signature*]

[*March 31, 19X3, except for Note 10, as to which the date is April 30, 19X3*]

[Sources: SAS No. 1, section 561, paragraph .06a and SAS No. 58, paragraph 8, as amended by SAS No. 79 (AU sections 561.06a and 508.08, respectively).]

[*The next page is 10,271.*]

AAM Section 10,220
Adverse Opinions

.01 Departures from GAAP

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note X to the financial statements, the Company carries its property plant, and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Generally accepted accounting principles require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from generally accepted accounting principles identified above, as of December 31, 19X2 and 19X1, inventories have been increased $_____ and $_____ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant, and equipment, less accumulated depreciation, is carried at $_____ and $_____ in excess of an amount based on the cost to the Company; and deferred income taxes of $_____ and $_____ have not been recorded, resulting in an increase of $_____ and $_____ in retained earnings and appraisal surplus of $_____ and $_____, respectively. For the years ended December 31, 19X2 and 19X1, cost of goods sold has been increased $_____ and $_____, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of $_____ and $_____ have not been provided, resulting in an increase in net income of $_____ and $_____, respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company as of December 31, 19X2 and 19X1, or the results of its operations or its cash flows for the years then ended.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 60, as amended by SAS No. 79 (AU section 508.60).]

[*The next page is 10,321.*]

AAM Section 10,230
Disclaimers of Opinion

.01 Beginning Inventory Not Observed (First Examination)

<u>Independent Auditor's Report</u>

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.*

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Because we were not engaged as auditors until after December 31, 19X1, we were not present to observe the physical inventory taken at that date and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities. Accordingly, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying statements of income, retained earnings and cash flows for the year ended December 31, 19X2.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 19X2, in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 26, as amended by SAS No. 79 (AU section 508.26).]

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* Although the introductory paragraph of the standard disclaimer of opinion begins with "We were engaged to audit ..." and the scope paragraph of the report is omitted, SAS No. 58, paragraph 67, as amended by SAS No. 79 (AU section 508.67), shows that the introductory paragraph does not need to be modified nor does the scope paragraph need to be omitted when the disclaimed financial statements are with audited financial statements.

.02 Inability to Obtain Sufficient Competent Evidential Matter Due to a Scope Limitation

Independent Auditor's Report

Addressee:

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

The Company did not make a count of its physical inventory in 19X2 or 19X1, stated in the accompanying financial statements at $______ as of December 31, 19X2, and at $______ as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 63, as amended by SAS No. 79 (AU section 508.63).]

.03 Scope Limitation—Inventory and GAAP Departure—Capitalized Lease Obligations

Independent Auditor's Report

Addressee:

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by $______ and $______, long-term debt by $______ and $______, and retained earnings by $______ and $______ as of December 31, 19X2 and 19X1, respectively. Additionally, net income would be increased (decreased) by $______ and $______ and earnings per share would be increased (decreased) by $______ and $______, respectively, for the years then ended.

The Company did not make a count of its physical inventory in 19X2 or 19X1, stated in the accompanying financial statements at $______ as of December 31, 19X2, and at $______ as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraphs 39 and 63, as amended by SAS No. 79 (AU section 508.39 and .63).]

Note: This report would be used if the GAAP departure is not so material to require an adverse opinion. See AAM section 10,220.01 for an example of an adverse opinion.

[*The next page is 10,371.*]

AAM Section 10,240
Qualified Opinions

.010 Scope Limitation—Investment in Foreign Affiliate (Assuming Effects Are Such That Qualification Rather Than Disclaimer is Appropriate)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $______ and $______ at December 31, 19X2 and 19X1, respectively, or its equity in earnings of that affiliate of $______ and $______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 26, as amended by SAS No. 79 (AU section 508.26).]

.020 Departure from GAAP—Leases Not Capitalized

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by $______ and $______, long-term debt by $______ and $______, and retained earnings by $______ and $______ as of December 31, 19X2 and 19X1, respectively. Additionally, net income would be increased (decreased) by $______ and $______ and earnings per share would be increased (decreased) by $______ and $______, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 39, as amended by SAS No. 79 (AU section 508.39).]

.030 Departure from GAAP—Leases Not Capitalized—Pertinent Facts Disclosed in Note

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, generally accepted accounting principles require that such obligations be included in the balance sheets.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 40, as amended by SAS No. 79 (AU section 508.40).]

.040 Inadequate Disclosure—Omission of Disclosures

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by generally accepted accounting principles.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 42, as amended by SAS No. 79 (AU section 508.42).]

Note: This report assumes the effects are such that the auditor has concluded an adverse opinion is not appropriate.

.050 Inadequate Disclosure—Omission of Statement of Cash Flows

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income and retained earnings for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company declined to present a statement of cash flows for the years ended December 31, 19X2 and 19X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by generally accepted accounting principles.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 44, as amended by SAS No. 79 (AU section 508.44).]

.060 Change in Accounting Principle Without Reasonable Justification

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As disclosed in Note X to the financial statements, the Company adopted, in 19X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with generally accepted accounting principles, in our opinion the Company has not provided reasonable justification for making this change as required by generally accepted accounting principles.

In our opinion, except for the change in accounting principle discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 52, as amended by SAS No. 79 (AU section 508.52).]

Note: If the change was from an accounting principle that is not generally accepted to one that is generally accepted it would be a correction of an error and would require recognition in the auditor's report as to consistency. However, because the middle paragraph contains all of the information required in an explanatory paragraph (following the opinion paragraph) as required by SAS No. 58, paragraphs 16–18, as amended by SAS No. 79 (AU section 508.16–.18), an explanatory paragraph is not required in this instance.

.070 Change to an Accounting Principle Not in Conformity With Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The company previously recorded its land at cost but adjusted the amounts to appraised values during the year, with a corresponding increase in stockholders' equity in the amount of $______. In our opinion, the new basis on which land is recorded is not in conformity with generally accepted accounting principles.

In our opinion, except for the change to recording appraised values as described above, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraph 55, as amended by SAS No. 79 (AU section 508.55).]

.080 More than One Reason—Qualified Opinion on Prior Year's Financial Statements With the Current Year Qualified for the Same Reason and an Additional Reason

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $______ and $______ at December 31, 19X2 and 19X1, respectively, or its equity in earnings of that affiliate of $______ and $______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

The Company has excluded, from property and debt in the accompanying 19X2 balance sheet, certain lease obligations that were entered into in 19X2, which in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by $______, long-term debt by $______, and retained earnings by $______, as of December 31, 19X2. Additionally, net income would be increased (decreased) by $______ and earnings per share would be increased (decreased) by $______ for the year then ended.

In our opinion, except for the effects on the 19X2 and 19X1 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investmeht and earnings, and except for the effects of the 19X2 financial statements of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 58, paragraphs 26 and 39, as amended by SAS No. 79 (AU section 508.26 and .39).]

[*The next page is 10,421.*]

AAM Section 10,245

Information Accompanying Audited Financial Statements

.010 Omission of Supplementary Information Required by the FASB

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The Company has not presented [*describe the supplementary information required by the FASB in the circumstances*] that the Financial Accounting Standards Board has determined is necessary to supplement, although not required to be part of, the basic financial statements.

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

.015 Omission of Supplementary Information Required by the GASB

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose financial statements of City of Example, Any State as of and for the year ended December 31, 19XX. These general-purpose financial statements are the responsibility of City of Example, Any State management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types for the year then ended in conformity with generally accepted accounting principles.

The City of Example, Any State has not presented [*describe the supplementary information required by the GASB in the circumstances*] that the Governmental Accounting Standards Board has determined is necessary to supplement, although not required to be part of, the basic financial statements.

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

.020 Material Departures From FASB Guidelines on Supplementary Information

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The [*specifically identify the supplementary information*] on page XX is not required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As result of such limited procedures, we believe that the [*specifically identify the supplementary information*] is not in conformity with guidelines established by the Financial Accounting Standards Board because [*describe the material departure(s) from the FASB guidelines*].

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

Note: Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the FASB. However, management may choose not to place the required supplementary information outside the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 2 (AU section 558.10).] (See AAM section 10,245.060.)

.025 Material Departures From GASB Guidelines on Supplementary Information

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose financial statements of City of Example, Any State as of and for the year ended December 31, 19XX. These general-purpose financial statements are the responsibility of City of Example, Any State management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX and the results of its operations and cash flows of its proprietary fund types for the year then ended in conformity with generally accepted accounting principles.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As a result of such limited procedures, we believe that the [*specifically identify the supplementary information*] is not in conformity with guidelines established by the Governmental Accounting Standards Board because [*describe the material departure(s) from the GASB guidelines*].

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

Note: Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the GASB. However, management may choose not to place the required supplementary information outside the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 2 (AU section 558.10).] (See AAM section 10,245.060.)

.030 Prescribed Procedures Not Completed Regarding Supplementary Information Required by the FASB

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [*state the reasons*].

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

Notes: Even though he or she is unable to complete the prescribed procedures, if, on a basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she describes the nature of any material departure(s) in his or her report. [Source: SAS No. 52, paragraph 2 (AU section 558.08).]

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the FASB. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 2 (AU section 558.10).] (See AAM section 10,245.060.)

.035 Prescribed Procedures Not Completed Regarding Supplementary Information Required by the GASB

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose financial statements of City of Example, Any State as of and for the year ended December 31, 19XX. These general-purpose financial statements are the responsibility of City of Example, Any State management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types for the year then ended in conformity with generally accepted accounting principles.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [*state the reasons*].

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

Notes: Even though he or she is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in his or her report. [Source: SAS No. 52, paragraph 2 (AU section 558.08).]

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the GASB. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 2 (AU section 558.10).] (See AAM section 10,245.060.)

.040 Unresolved Doubts About Adherence to Guidelines Regarding Supplementary Information Required by FASB

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by the Financial Accounting Standards Board. [*The auditor should consider including in his or her report the reason(s) he or she was unable to resolve his or her substantial doubts.*]

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

Notes: Even though he or she is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she describes the nature of any material departure(s) in his or her report. [Source: SAS No. 52, paragraph 2 (AU section 558.08).]

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the FASB. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 2 (AU section 558.10).] (See AAM section 10,245.060.)

.045 Unresolved Doubts About Adherence to Guidelines Regarding Supplementary Information Required by GASB

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose financial statements of City of Example, Any State as of and for the year ended December 31, 19XX. These general-purpose financial statements are the responsibility of City of Example, Any State management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types for the year then ended in conformity with generally accepted accounting principles.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by the Governmental Accounting Standards Board. [*The auditor should consider including in his or her report the reason(s) he or she was unable to resolve his or her substantial doubts.*]

[*Signature*]

[*Date*]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

Notes: Even though he or she is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she describes the nature of any material departure(s) in his or her report. [Source: SAS No. 52, paragraph 2 (AU section 558.08).]

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the GASB. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 2 (AU section 558.10).] (See AAM section 10,245.060.)

.050 Report on Accompanying Information

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: SAS No. 29, paragraph 12, as amended by SAS No. 52 (AU section 551.12).]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

This form of reporting on accompanying information is not appropriate with respect to supplementary information required by the FASB; see SAS No. 52, paragraph 3 (AU section 551.15).

.060 Disclaimer on Accompanying Information (Not Audited)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify the accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

[*Signature*]

[*Date*]

[Source: SAS No. 29, paragraph 13, as amended by SAS No. 52 (AU section 551.13).]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

When the auditor disclaims an opinion on all or part of the accompanying information in a document that he or she submits to his or her client or to others, such information should either be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances.

.070 Disclaimer on Part of the Accompanying Information (Not Audited)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information on pages XX-YY is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: SAS No. 29, paragraph 13, as amended by SAS No. 52 (AU section 551.13).]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

When the auditor disclaims an opinion on all or part of the accompanying information in a document that he or she submits to his or her client or to others, such information should either be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances.

.080 Qualification on Basic Financial Statements and Accompanying Information (Departure From GAAP)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by $______ and $______, long-term debt by $______ and $______, and retained earnings by $______ and $______ as of December 31, 19X2 and 19X1, respectively. Additionally, net income would be increased (decreased) by $______ and $______ and earnings per share would be increased (decreased) by $______ and $______, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedules of property and related depreciation (page X), and long-term debt with related interest (page Y), as of December 31, 19X2, are presented for purposes of additional analysis and are not a required part of the basic financial statements. The information in such schedules has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, except for the effects on the schedule of property of not capitalizing certain lease obligations as explained in the third paragraph of this report, such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

[Sources: SAS No. 29, paragraph 14, as amended by SAS No. 52 and SAS No. 58, paragraph 39, as amended by SAS No. 79 (AU sections 551.14 and 508.39, respectively).]

Note: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

.090 Supplementary Information Required by the FASB Included in Auditor-Submitted Document

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by the Financial Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

[*Signature*]

[*Date*]

[Source: SAS No. 29, paragraph 15, as amended by SAS No. 52 (AU section 551.15).]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

When supplementary information required by the FASB is presented outside the basic financial statements in an auditor-submitted document, the auditor should disclaim an opinion on the information unless he or she has been engaged to examine and express an opinion on it.

In certain circumstances, the auditor's report should be expanded in accordance with SAS No. 52, paragraph 2 (AU section 558.08). The illustrative reports at AAM section 10,245.010–.045 are assembled from illustrative reporting language in SAS No. 52, paragraph 2 (AU section 558.08).

.095 Supplementary Information Required by the GASB Included in Auditor-Submitted Documents

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose financial statements of City of Example, Any State as of and for the year ended December 31, 19XX. These general-purpose financial statements are the responsibility of City of Example, Any State management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types for the year then ended in conformity with generally accepted accounting principles.

The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

[*Signature*]

[*Date*]

[Source: SAS No. 29, paragraph 15, as amended by SAS No. 52 (AU section 551.15).]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted documents.

When supplementary information required by the GASB is presented outside the basic financial statements in an auditor-submitted document, the auditor should disclaim an opinion on the information unless he or she has been engaged to examine and express an opinion on it.

In certain circumstances, the auditor's report should be expanded in accordance with SAS No. 52, paragraph 2 (AU section 558.08). The illustrative reports at AAM section 10,245.010–.045 are assembled from illustrative reporting language in SAS No. 52, paragraph 2 (AU section 558.08).

.100 Consolidating Information Not Separately Audited

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated balance sheets of X Company and subsidiaries as of December 31, 19X2 and 19X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company and subsidiaries as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: SAS No. 29, paragraph 18, as amended by SAS No. 52 (AU section 551.18).]

Notes: The report on the consolidating information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

When the auditor is engaged to express an opinion only on the consolidated financial statements and consolidating information is also included, the auditor should be satisfied that the consolidating information is suitably identified. For example, when the consolidated financial statements include columns of information about the components of the consolidated group, the balance sheets might be titled, "Consolidated Balance Sheet—December 31, 19X1, with Consolidating Information," and the columns including the consolidating information might be marked, "Consolidating Information." When the consolidating information is presented in separate schedules, the schedules presenting balance sheet information of the components might be titled, for example, "Consolidating Schedule, Balance Sheet Information, December 31, 19X1."

.110 Unqualified Opinion on Selected Financial Data in a Client-Prepared Document That Includes Audited Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated balance sheets of X Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company and subsidiaries as of December 31, 19X5 and 19X4, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 19X5 in conformity with generally accepted accounting principles.

We have also previously audited, in accordance with generally accepted auditing standards, the consolidated balance sheets as of December 31, 19X3, 19X2, and 19X1, and the related consolidated statements of income, retained earnings, and cash flows for the years ended December 31, 19X2 and 19X1 (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements.

In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 19X5, appearing on page XX, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

[*Signature*]

[*Date*]

[Source: SAS No. 42, paragraph 10 (AU section 552.10).]

[*The next page is 10,471.*]

AAM Section 10,250

Engagements to Report on Internal Control

.010 Unqualified Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control When Management's Assertion is Presented in a Separate Report

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained effective internal control over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*].

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

Because of inherent limitations in any internal control, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion [*identify management's assertion, for example, that W Company maintained effective internal control over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify stated or established criteria*].[1]

[Source: SSAE No. 2, paragraph 46, as amended by SSAE No. 6 (AT section 400.46).]

[1] For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.020 Unqualified Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control When Management's Assertion is Presented Only in a Letter of Representation to the Practitioner

Independent Accountant's Report

We have examined management's assertion, included in its representation letter dated February 15, 19XY, that [*identify management's assertion, for example, W Company maintained effective internal control over financial reporting as of December 31, 19XX*].

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

Because of inherent limitations in any internal control, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion [*identify management's assertion, for example, that W Company maintained effective internal control over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify stated or established criteria*].[1]

This report is intended solely for the information and use of the board of directors and management of W Company [*and, if applicable, a specified regulatory agency*] and should not be used for any other purpose.[2]

[Source: SSAE No. 2, paragraph 49, as amended by SSAE No. 6 (AT section 400.49).]

[1] For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

[2] If the report is a matter of public record, the following sentence should be added: "However, this report is a matter of public record and its distribution is not limited."

.030 Modified Report on Management's Assertion About the Effectiveness of an Entity's Internal Control When Management Includes in Its Assertion a Description of the Weakness and Its Effect on the Achievement of the Objectives of the Control Criteria and When It Appropriately Modifies Its Assertion About the Effectiveness of the Entity's Internal Control

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained effective internal control over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*].

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

Because of inherent limitations in any internal control, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that, except for the effect of the material weakness described in its report, [*identify management's assertion, for example, W Company maintained effective internal control over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].[1]

As discussed in management's assertion, the following material weakness exists in the design or operation of the internal control of W Company in effect at [*date*]. [*Describe the material weakness and its effect on the achievement of the objectives of the control criteria.*][2] A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.

[Source: SSAE No. 2, paragraph 53, as amended by SSAE No. 6 (AT section 400.53).]

Note: If an examination report on management's assertion about the effectiveness of the entity's internal control is issued within the same document that includes the auditor's report on the entity's financial statements, the following sentence should be included in the paragraph of the examination report that describes the material weakness:

> These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 19XX financial statements, and this report does not affect our report dated [*date of report*] on these financial statements.

[Source: SSAE No. 2, paragraph 57, as amended by SSAE No. 6 (AT section 400.57).]

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[1] For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

[2] The language used by the practitioner ordinarily should conform with management's description of the effect of the material weakness on the effectiveness of the entity's internal control.

.040 Adverse Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control[1]

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained effective internal control over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*].

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

Because of inherent limitations in any internal control, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our examination disclosed the following condition, which we believe is a material weakness in the design or operation of the internal control of W Company in effect at [*date*]. [*Describe the material weakness and its effect on achievement of the objectives of the control criteria.*] A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, management's assertion [*identify management's assertions, for example, that W Company maintained effective internal control over financial reporting as of December 31, 19XX*] is not fairly stated based upon [*identify established or stated criteria*].[2]

[Source: SSAE No. 2, paragraph 55, as amended by SSAE No. 6 (AT section 400.55).]

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[1] This report should be issued if:

a. Management disagrees with the practitioner over the existence of a material weakness and does not include in its assertion a description of the weakness and its effect on the achievement of the objectives of the control criteria, or

b. Management describes the material weakness but does not modify its assertion that the entity's internal control is effective.

[2] For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.050 Qualified Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control Due to a Scope Limitation

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained effective internal control over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*].

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

Because of inherent limitations in any internal control, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our examination disclosed the following material weaknesses in the design or operation of the internal control of W Company in effect at [*date*]. A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis. Prior to December 20, 19XX, W Company had an inadequate system for recording cash receipts, which could have prevented the Company from recording cash receipts on accounts receivable completely and properly. Therefore, cash received could have been diverted for unauthorized use, lost, or otherwise not properly recorded to accounts receivable. Although the Company implemented a new cash receipts system on December 20, 19XX, the system has not been in operation for a sufficient period of time to enable us to obtain sufficient evidence about its operating effectiveness.

In our opinion, except for the effect of matters we may have discovered had we been able to examine evidence about the effectiveness of the new cash receipts system, management's assertion [*identify management's assertion, for example, that W Company maintained effective internal control over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].[1]

[Source: SSAE No. 2, paragraph 59, as amended by SSAE No. 6 (AT section 400.59).]

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[1] For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.060 Disclaimer of Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control Due to a Scope Limitation

Independent Accountant's Report

We were engaged to examine management's assertion [*identify management's assertion, for example, that W Company maintained effective internal control over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management's report*].

[Scope paragraph should be omitted.]

[Explanatory paragraph.]

[*Include paragraph to describe scope restrictions.*]

Since management [*describe scope restrictions*] and we were unable to apply other procedures to satisfy ourselves as to management's assertion about the entity's internal control over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on management's assertion.

[Source: SSAE No. 2, paragraph 61, as amended by SSAE No. 6 (AT section 400.61).]

.070 Unqualified Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control Based in Part on the Report of Another Practitioner

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained effective internal control over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*]. We did not examine management's assertion about the effectiveness of the internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 19XX. Management's assertion about the effectiveness of B Company's internal control over financial reporting was examined by other accountants whose report has been furnished to us, and our opinion, insofar as it relates to management's assertion about the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other accountants.

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

Because of inherent limitations in any internal control, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, based on our examination and the report of the other accountants, management's assertion [*identify management's assertion, for example, that W Company maintained effective internal control over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*][1]

[Source: SSAE No. 2, paragraph 63, as amended by SSAE No. 6 (AT section 400.63).]

[1] For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.080 Unqualified Opinion on Management's Assertion About the Effectiveness of a Segment of the Entity's Internal Control

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company's retail division maintained effective internal control over financial reporting as of December 31, 19XX*], included in the accompanying [*title of management report*].

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

Because of inherent limitations in any internal control, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion [*identify management's assertion, for example, that W Company's retail division maintained effective internal control over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].[1]

[Source: SSAE No. 2, paragraph 67, as amended by SSAE No. 6 (AT section 400.67).]

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[1] For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.090 Unqualified Opinion on Management's Assertion About the Suitability of Design of the Entity's Internal Control

Independent Accountant's Report

We have examined management's assertion [*identify management's assertion, for example, that W Company's internal control over financial reporting is suitably designed to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 19XX*] included in the accompanying [*title of management report*].

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

Because of the inherent limitations in any internal control, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertions [*identify management's assertion, for example, that W Company's internal control over financial reporting is suitably designed to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].[1]

[Source: SSAE No. 2, paragraph 69, as amended by SSAE No. 6 (AT section 400.69).]

Notes: This report assumes that the control criteria of the regulatory agency have been subjected to due process and, therefore, are considered reasonable criteria for reporting purposes. Therefore, there is no limitation on the distribution of this report.

When management presents such an assertion about an entity's internal control that has already been placed in operation, the report should be modified by adding the following to the scope paragraph:

> We were not engaged to examine and report on the operating effectiveness of W Company's internal control over financial reporting as of December 31, 19XX, and, accordingly, we express no opinion on operating effectiveness.

[1] For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.100 Unqualified Opinion on Management's Assertion About the Effectiveness of the Entity's Internal Control Based on Criteria Established by a Regulatory Agency That Did Not Follow Due Process

Independent Accountant's Report

We have examined management's assertion included in its representation letter dated February 15, 19XY, [*identify management's assertion, for example, that W Company's internal control over financial reporting as of December 31, 19XX is adequate to meet the criteria established by* ________ *agency, as set forth in its audit guide dated* ________].

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

Because of inherent limitations in any internal control, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

We understand that the agency considers the controls over financial reporting that meet the criteria referred to in the first paragraph of this report adequate for its purpose. In our opinion, based on this understanding and on our examination, management's assertion [*identify management's assertion, for example, that W Company's internal control over financial reporting is adequate to meet the criteria established by* ________ *agency*] is fairly stated, in all material respects, based upon such criteria.

This report is intended solely for the information and use of the board of directors and management of W Company [*and, if applicable, a specified regulatory agency*] and should not be used for any other purpose.[1]

[Source: SSAE No. 2, paragraph 72, as amended by SSAE No. 6 (AT section 400.72).]

[1] If the report is a matter of public record, the following sentence should be added: "However, this report is a matter of public record and its distribution is not limited."

.110 Communication of Internal Control Structure Matters Noted in an Audit

Addressee:

In planning and performing our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

[*Include paragraphs to describe the reportable conditions noted.*]

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency or other specified third party).

[*Signature*]

[*Date*]

THE AUDITOR SHOULD NOT ISSUE A REPORT REPRESENTING THAT NO REPORTABLE CONDITIONS WERE NOTED.

[Source: SAS No. 60, paragraphs 12 and 17 (AU section 325.12 and .17).]

.120 Communication of Internal Control Structure Related Matters Noted in an Audit When One or More Reportable Conditions Were Identified, But None is Deemed to be a Material Weakness

Addressee:

In planning and performing our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted certain matters involving the internal control structure and its operations that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

[Include paragraphs to describe the reportable conditions noted.]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions described above is believed to be a material weakness.

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency or other specified third party).

[*Signature*]

[*Date*]

THE AUDITOR SHOULD NOT ISSUE A REPORT REPRESENTING THAT NO REPORTABLE CONDITIONS WERE NOTED.

[Source: SAS No. 60, paragraphs 12, 16, and 17 (AU section 325.12, .16, and .17).]

.130 Report on Policies and Procedures Placed in Operation at a Service Organization

To XYZ Service Organization:

We have examined the accompanying description of the (payroll) application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization's policies and procedures that may be relevant to a user organization's internal control structure, (2) the control structure policies and procedures included in the description were suitably designed to achieve the control objectives specified in the description, if those policies and procedures were complied with satisfactorily,[1] and (3) such policies and procedures had been placed in operation as of (*date*). The control objectives were specified by the (board of directors). Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

We did not perform procedures to determine the operating effectiveness of policies and procedures for any period. Accordingly, we express no opinion on the operating effectiveness of any aspects of XYZ Service Organization's policies and procedures, individually or in the aggregate.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's policies and procedures that had been placed in operation as of (*date*). Also, in our opinion, the policies and procedures, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described policies and procedures were complied with satisfactorily.

The description of policies and procedures at XYZ Service Organization is as of (*date*) and any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the system in existence. The potential effectiveness of specific policies and procedures at the Service Organization is subject to inherent limitations and, accordingly, errors or irregularities may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.

[Source: SAS No. 70, paragraph 38 (AU section 324.38).]

Notes: This report should have an attachment containing a description of the service organization's policies and procedures that may be relevant to a user organization's internal control structure.

This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

See SAS No. 70, paragraph 39 (AU section 324.39), for an example explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that the description is inaccurate or insufficiently complete for user auditors.

See SAS No. 70, paragraph 40 (AU section 324.40), for an example explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that there are sufficient deficiencies in the design or operation of the service organization's policies and procedures.

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[1] If the application of internal control structure policies and procedures by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the internal control structure policies and procedures contemplated in the design of XYZ Service Organization's policies and procedures" following the words "complied with satisfactorily"in the scope and opinion paragraphs.

.140 Report on Policies and Procedures Placed in Operation at a Service Organization and Tests of Operating Effectiveness

To XYZ Service Organization:

We have examined the accompanying description of the (payroll) application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization's policies and procedures that may be relevant to a user organization's internal control structure, (2) the control structure policies and procedures included in the description were suitably designed to achieve the control objectives specified in the description, if those policies and procedures were complied with satisfactorily,[1] and (3) such policies and procedures had been placed in operation as of *(date)*. The control objectives were specified by the (board of directors). Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's policies and procedures that had been placed in operation as of *(date)*. Also, in our opinion, the policies and procedures, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described policies and procedures were complied with satisfactorily.

In addition to the procedures we considered necessary to render our opinion as expressed in the previous paragraph, we applied tests to specific policies and procedures, listed in Schedule X, to obtain evidence about their effectiveness in meeting the control objectives, described in Schedule X, during the period from *(date)* to *(date)*. The specific policies and procedures and the nature, timing, extent, and results of the tests are listed in Schedule X. This information has been provided to user organizations of XYZ Service Organization and to their auditors to be taken into consideration, along with information about the internal control structure at user organizations, when making assessments of control risk for user organizations. In our opinion the policies and procedures that were tested, as described in Schedule X, were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives specified in Schedule X were achieved during the period from *(date)* to *(date)*. [However, the scope of our engagement did not include tests to determine whether control objectives not listed in Schedule X were achieved; accordingly, we express no opinion on the achievement of control objectives not included in Schedule X.][2]

The relative effectiveness and significance of specific policies and procedures at XYZ Service Organization and their effect on assessments of control risk at user organizations are dependent on their interaction with the policies, procedures, and other factors present at individual user organizations. We have performed no procedures to evaluate the effectiveness of policies and procedures at individual user organizations.

The description of policies and procedures at XYZ Service Organization is as of *(date)*, and information about tests of the operating effectiveness of specified policies and procedures covers the period from *(date)* to *(date)*. 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 in existence. The potential effectiveness of specified policies and procedures at the Service Organization is subject to inherent limitations and, accordingly, errors or irregularities may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

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[1] If the application of internal control structure policies and procedures by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the internal control structure policies and procedures contemplated in the design of XYZ Service Organization's policies and procedures" following the words "complied with satisfactorily"in the scope and opinion paragraphs.

[2] This sentence should be added when all of the control objectives listed in the description of policies and procedures placed in operation are not covered by the tests of operating effectiveness. This sentence would be omitted when all of the control objectives listed in the description of policies and procedures placed in operation are included in the tests of operating effectiveness.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.

[Source: SAS No. 70, paragraph 54 (AU section 324.54).]

Notes: This report should have two attachments: (*a*) a description of the service organization's policies and procedures that may be relevant to a user organization's internal control structure and (*b*) a description of policies and procedures for which tests of operating effectiveness were performed, the control objectives the policies and procedures were intended to achieve, the tests applied, and the results of these tests.

This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

See SAS No. 70, paragraph 55 (AU section 324.55), for an example explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that the description is inaccurate or insufficiently complete for user auditors.

See SAS No. 70, paragraph 56 (AU section 324.56), for an example explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that there are sufficient deficiencies in the design or operation of the service organization's policies and procedures.

.150 Reports on Internal Control Required by SEC Rule 17a-5

Board of Directors

Standard Stockbrokerage Co., Inc.

In planning and performing our audit of the consolidated financial statements of Standard Stockbrokerage Co., Inc. for the year ended December 31, 19X1, we considered its internal control structure, including procedures for safeguarding securities, in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on the internal control structure.

Also, as required by rule 17a-5(g)(1) of the Securities and Exchange Commission, we have made a study of the practices and procedures (including tests of compliance with such practices and procedures) followed by Standard Stockbrokerage Co., Inc. that we considered relevant to the objectives stated in rule 17a-5(g), (1) in making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under rule 17a-3(11) and the reserve required by rule 15c3-3(e); (2) in making the quarterly securities examinations, counts, verifications and comparisons, and the recordation of differences required by rule 17a-13;* (3) in complying with the requirements for prompt payment for securities under section 8 of Regulation T of the Board of Governors of the Federal Reserve System; and (4) in obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by rule 15c3-3.

The management of the Company is responsible for establishing and maintaining an internal control structure and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the Commission's above-mentioned objectives. Two of the objectives of an internal control structure and the practices and procedures are to provide management with reasonable, but not absolute, assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in any internal control structure or the practices and procedures referred to above, errors or irregularities may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operations may deteriorate.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure, including procedures for safeguarding securities, that we consider to be material weaknesses as defined above.[1]

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* If the broker or dealer is exempt from compliance with Rule 15c3-3, does not maintain customer accounts and does not handle securities this report should be modified as stated in the AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*, appendix A, exhibit I, footnotes 35 and 36.

[1] If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fifth paragraph of the report should be modified as follows:

> However, we noted the following matters involving the [control environment, accounting system, control procedures, or procedures for safeguarding securities] and its [their] operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the Commission to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures were adequate at December 31, 19X1, to meet the Commission's objectives.[2]

This report is intended solely for the use of management, the Securities and Exchange Commission, the New York Stock Exchange and other regulatory agencies which rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 and should not be used for any other purpose.

Accounting Firm
New York, New York
February 15, 19X2

[Source: AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities,* Appendix A, Exhibit I.]

Notes: The issuance of Statement on Standards for Attestation Engagements No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting* (AT section 400), has not changed the reporting requirements under the Securities Exchange Act of 1934. This report would still be issued under Rule 17a-5.

AAM section 10,650 illustrates the auditor's reports on the financial statements of brokers and dealers in securities.

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procedures to be performed in our audit of the consolidated financial statements of Standard Stockbrokerage Co., Inc. for the year ended December 31, 19X1, and this report does not affect our report thereon dated February 15, 19X2. [*A description of the material weaknesses that have come to the auditor's attention and corrective action would follow.*]

[2] Whenever inadequacies are described, the report should include the last sentence of the fifth paragraph as modified in the note above. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period unless management already has reported them to the SEC.

.160 Report on Internal Control Required by SEC Rule 17a-5 When Broker or Dealer Has Not Made the Required Notification or When the Auditor Does Not Agree With the Statements Therein

December 10, 19X1

Securities and Exchange Commission

Washington D.C. and Appropriate

Regional Office

Designated Examining Authority

Dear Sirs:

Our most recent audit of the consolidated financial statements of Standard Stockbrokerage Co., Inc. and Subsidiaries was as of December 31, 19X0, and for the year then ended, which we reported on under date of February 15, 19X1. We have not audited any financial statements of the Company as of any date or for any period subsequent to December 31, 19X0. Although we are presently performing certain procedures as part of our audit of the consolidated financial statements of the Company as of December 31, 19X1, and for the year then ended, these procedures do not constitute all the procedures necessary in an audit conducted in accordance with generally accepted auditing standards or all procedures necessary to (1) consider the Company's internal control structure as required by generally accepted auditing standards or (2) study the Company's practices and procedures relevant to the objectives stated in rule 17a-5(g) of the Securities and Exchange Commission as required by rule 17a-5.

The management of Standard Stockbrokerage Co., Inc. is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the internal control structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

The purpose of performing certain procedures prior to the date of the financial statements is to facilitate the expression of an opinion on the Company's financial statements. It must be understood that the procedures performed would not necessarily disclose all material weaknesses in the internal control structure, including procedures for safeguarding securities.

However, pursuant to the requirements of rule 17a-5(h)(2), we are to call to the attention of the chief financial officer any weaknesses that we believe to be material and that were disclosed during the course of interim work. We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc. and we believe the following additional information is required pursuant to the requirements of rule 17a-11(f).

[*List and describe all instances where the independent auditor did not agree with the notification of the broker or dealer or where the required notification was not made.*]

Accounting Firm

New York, New York

[Source: AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*, Appendix A, Exhibit J.]

Notes: The issuance of Statement on Standards for Attestation Engagements No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting* (AT section 400), has not changed the reporting requirements under the Securities Exchange Act of 1934. This report would still be issued under Rule 17a-5.

AAM section 10,650 illustrates the auditor's reports on the financial statements of brokers and dealers in securities.

.170 Independent Auditor's Report on Internal Control Structure Required by Regulation 1.16 of the Commodity Futures Trading Commission

Board of Directors

ABC Commodities Corporation

In planning and performing our audit of the consolidated financial statements of ABC Commodities Corporation (the "Corporation") for the year ended December 31, 19X1, we considered its internal control structure, including procedures for safeguarding customer and firm assets, in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on the internal control structure.

Also, as required by Regulation 1.16 of the Commodity Futures Trading Commission, we have made a study of the practices and procedures (including tests of compliance with such practices and procedures) followed by the Corporation that we considered relevant to the objectives stated in the Regulation 1.16 in making (1) the periodic computations of minimum financial requirements pursuant to Regulation 1.17, (2) the daily computations of the segregation requirements of section 4d(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based on such computations, and (3) the daily computations of the foreign futures and foreign options secured amount requirements pursuant to Regulation 30.7 of the Commission.

The management of the Corporation is responsible for establishing and maintaining an internal control structure and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the Commission's above-mentioned objectives. Two of the objectives of an internal control structure and the practices and procedures are to provide management with reasonable, but not absolute, assurance that assets for which the Corporation has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles. Regulation 1.16 lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in any internal control structure or the practices and procedures referred to above, errors or irregularities may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure, including procedures for safeguarding customer and firm assets, that we consider to be material weaknesses as defined above.[1]

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[1] If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fifth paragraph of the report should be modified as follows:

> However, we noted the following matters involving the [(control environment, accounting system, control procedures, or procedures for safeguarding customer and firm assets)] and its [(their)] operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the consolidated financial statements of the Corporation for

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the Commission to be adequate for its purposes in accordance with the Commodity Exchange Act and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Corporation's practices and procedures were adequate at December 31, 19X1, to meet the Commission's objectives.[2]

This report is intended solely for the use of management, the Commodity Futures Trading Commission, and other regulatory agencies that rely on Regulation 1.16 of the Commodity Futures Trading Commission and should not be used for any other purpose.

Accounting Firm

New York, New York

February 15, 19X2

[Source: AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities,* Appendix A, Exhibit K.]

[*The next page is 10,521.*]

the year ended December 31, 19X1, and this report does not affect our report thereon dated February 15, 19X2.
[*A description of the material weaknesses that have come to the auditor's attention and corrective action would follow.*]

[2] Whenever inadequacies are described, the report should include the last sentence of the fifth paragraph as modified in the note above. The report should also describe material inadequacies the auditor becomes aware of that existed during the period but were corrected prior to the end of the period unless management already has reported them to the CFTC.

AAM Section 10,260
Special Reports

.010 Cash Basis Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of revenue collected and expenses paid for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19X2 and 19X1, and its revenue collected and expenses paid during the years then ended, on the basis of accounting described in Note X.

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 8, as amended by SAS No. 77 (AU section 623.08).]

Notes: If the report is a matter of public record, the following sentence may be added: "However, this report is a matter of public record and its distribution is not limited."

See the AICPA publication, *Preparing and Reporting on Cash- and Tax-Basis Financial Statements,* for further guidance on the unique recognition, measurement, and disclosure issues for OCBOA (other comprehensive basis of accounting) financial statements, including illustrative financial statements and notes.

.020 Income Tax Basis Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of assets, liabilities, and capital—income tax basis of ABC Partnership as of December 31, 19X2 and 19X1, and the related statements of revenue and expenses—income tax basis and of changes in partners' capital accounts—income tax basis for the years then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of accounting the Partnership uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and capital of ABC Partnership as of December 31, 19X2 and 19X1, and its revenue and expenses and changes in partners' capital accounts for the years then ended, on the basis of accounting described in Note X.

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 8, as amended by SAS No. 77 (AU section 623.08).]

Notes: If the report is a matter of public record, the following sentence may be added: "However, this report is a matter of public record and its distribution is not limited."

See the AICPA publication, *Preparing and Reporting on Cash- and Tax-Basis Financial Statements,* for further guidance on the unique recognition, measurement, and disclosure issues for OCBOA (other comprehensive basis of accounting) financial statements, including illustrative financial statements and notes.

.030 Regulatory (Statutory) Basis Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of admitted assets, liabilities and surplus—statutory basis of XYZ Insurance Company as of December 31, 19X2 and 19X1, and the related statements of income and cash flows—statutory basis and changes in surplus—statutory basis for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared in conformity with the accounting practices prescribed or permitted by the Insurance Department of [*State*], which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities and surplus of XYZ Insurance Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Insurance Company and for filing with the [*name of regulatory agency*] and should not be used for any other purpose.

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 8, as amended by SAS No. 77 (AU section 623.08).]

Note: If the report is a matter of public record, the following sentence may be added: "However, this report is a matter of public record and its distribution is not limited."

.040 Report Relating to Amount of Sales for the Purpose of Computing Rental

(Report on one or more specified elements, accounts, or items of a financial statement)

<u>Independent Auditor's Report</u>

Addressee:

We have audited the accompanying schedule of gross sales (as defined in the lease agreement dated March 4, 19XX, between ABC Company, as lessor, and XYZ Stores Corporation, as lessee) of XYZ Stores Corporation at its Main Street store, [*City*], [*State*], for the year ended December 31, 19X2. This schedule is the responsibility of XYZ Stores Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of gross sales is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of gross sales. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of gross sales referred to above present fairly, in all material respects, the gross sales of XYZ Stores Corporation at its Main Street store, [*City*], [*State*], for the year ended December 31, 19X2, as defined in the lease agreement referred to in the first paragraph.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Stores Corporation and ABC Company and should not be used for any other purpose.

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 18 (AU section 623.18).]

.050 Royalties

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor's Report

Addressee:

We have audited the accompanying schedule of royalties applicable to engine production of the Q Division of XYZ Corporation for the year ended December 31, 19X2, under the terms of a license agreement dated May 14, 19XX, between ABC Company and XYZ Corporation. This schedule is the responsibility of XYZ Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of royalties is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that, under XYZ Corporation's interpretation of the agreement referred to in the first paragraph, royalties were based on the number of engines produced after giving effect to a reduction for production retirements that were scrapped, but without a reduction for field returns that were scrapped, even though the field returns were replaced with new engines without charge to customers.

In our opinion, the schedule of royalties referred to above presents fairly, in all material respects, the number of engines produced by the Q Division of XYZ Corporation during the year ended December 31, 19X2, and the amount of royalties applicable thereto, under the license agreement referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Corporation and ABC Company and should not be used for any other purpose.

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 18 (AU section 623.18).]

.060 Profit Participation[1]

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor's Report

Addressee:

We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company for the year ended December 31, 19X1, and have issued our report thereon dated March 10, 19X2. We have also audited XYZ Company's schedule of John Smith's profit participation for the year ended December 31, 19X1. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit of the schedule in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of profit participation is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that the documents that govern the determination of John Smith's profit participation are *(a)* the employment agreement between John Smith and XYZ Company dated February 1, 19X0, *(b)* the production and distribution agreement between XYZ Company and Television Network Incorporated dated March 1, 19X0, and *(c)* the studio facilities agreement between XYZ Company and QRX Studios dated April 1, 19X0, as amended November 1, 19X0.

In our opinion, the schedule of profit participation referred to above presents fairly, in all material respects, John Smith's participation in the profits of XYZ Company for the year ended December 31, 19X1, in accordance with the provisions of the agreements referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Company and John Smith and should not be used for any other purpose.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 18 (AU section 623.18).]

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[1] If a specified element, account, or item is, or is based upon, an entity's net income or stockholder's equity or the equivalent thereof (e.g., profit participation), the auditor should have audited the complete financial statements to express an opinion on the specified element, account, or item.

.070 Report on Federal and State Income Taxes in Financial Statements[1]

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor's Report

Addressee:

We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company, Inc., for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX. We have also audited the current and deferred provision for the Company's federal and state income taxes for the year ended June 30, 19XX, included in those financial statements, and the related asset and liability tax accounts as of June 30, 19XX. This income tax information is the responsibility of the Company's management. Our responsibility is to express an opinion on it based on our audit.

We conducted our audit of the income tax information in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the federal and state income tax accounts are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures related to the federal and state income tax accounts. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the federal and state income tax accounts. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Company has paid or, in all material respects, made adequate provision in the financial statements referred to above for the payment of all federal and state income taxes and for related deferred income taxes that could be reasonably estimated at the time of our audit of the financial statements of XYZ Company, Inc., for the year ended June 30, 19XX.

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 18 (AU section 623.18).]

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[1] If a specified element, account, or item is, or is based upon, an entity's net income or stockholder's equity or the equivalent thereof (e.g., Federal and State Income Taxes), the auditor should have audited the complete financial statements to express an opinion on the specified element, account, or item.

.080 Proposed Acquisition

Independent Accountant's Report on Applying Agreed-Upon Procedures

To the Board of Directors and Management of X Company:

We have performed the procedures enumerated below, which were agreed to by the Board of Directors and Management of X Company, solely to assist you in connection with the proposed acquisition of Y Company as of December 31, 19XX. This engagement to apply agreed-upon procedures 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 Board of Directors and Management of X Company. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures and the associated findings are as follows:

Cash

1. We obtained confirmation of the cash on deposit from the following banks, and we agreed the confirmed balance to the amount shown on the bank reconciliations maintained by Y Company. We mathematically checked the bank reconciliations and compared the resultant cash balances per book to the respective general ledger account balances.

Bank	*General Ledger Account Balances as of December 31, 19XX*
ABC National Bank	$ 5,000
DEF State Bank	13,776
XYZ Trust Company—regular account	86,912
XYZ Trust Company—payroll account	5,000
	$110,688

We found no exceptions as a result of the procedures.

Accounts Receivable

2. We added the individual customer account balances shown in an aged trial balance of accounts receivable (identified as exhibit A) and compared the resultant total with the balance in the general ledger account.

   We found no difference.

3. We compared the individual customer account balances shown in the aged trial balance of accounts receivable (exhibit A) as of December 31, 19XX, to the balances shown in the accounts receivable subsidiary ledger.

   We found no exceptions as a result of the comparisons.

4. We traced the aging (according to invoice dates) for 50 customer account balances shown in exhibit A to the details of outstanding invoices in the accounts receivable subsidiary ledger. The balances selected for tracing were determined by starting at the eighth item and selecting every fifteenth item thereafter.

   We found no exceptions in the aging of the amounts of the 50 customer account balances selected. The sample size traced was 9.8 percent of the aggregate amount of the customer account balances.

5. We mailed confirmations directly to the customers representing the 150 largest customer account balances selected from the accounts receivable trial balance, and we received responses as indicated below. We also traced the items constituting the outstanding customer account balance to invoices and supporting shipping documents for customers from which there was no reply. As agreed, any individual differences in a customer account balance of less than $300 were to be considered minor, and no further procedures were performed.

   Of the 150 customer balances confirmed, we received responses from 140 customers; 10 customers did not reply. No exceptions were identified in 120 of the confirmations received. The differences disclosed in the remaining 20 confirmation replies were either minor in amount (as defined above) or were reconciled to the customer account balance without proposed adjustment thereto. A summary of the confirmation results according to the respective aging categories is as follows:

Accounts Receivable
December 31, 19XX

Aging Categories	*Customer Account Balances*	*Confirmations Requested*	*Confirmation Replies Received*
Current	$156,000	$ 76,000	$ 65,000
Past due:			
Less than one month	60,000	30,000	19,000
One to three months	36,000	18,000	10,000
Over three months	48,000	48,000	8,000
	$300,000	$172,000	$102,000

We were not engaged to, and did not, perform an audit, the objective of which would be the expression of an opinion on the specified elements, accounts, or items. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

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

[Source: SAS No. 75, Appendix A (AU section 622.49).]

.090 Claims of Creditors

Independent Accountant's Report
on Applying Agreed-Upon Procedures

To the Trustee of XYZ Company:

We have performed the procedures described below, which were agreed to by the Trustee of XYZ Company, with respect to the claims of creditors to determine the validity of claims of XYZ Company as of May 31, 19XX, as set forth in accompanying Schedule A. This engagement to apply agreed-upon procedures 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 Trustee of XYZ Company. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures and associated findings are as follows:

1. Compare the total of the trial balance of accounts payable at May 31, 19XX, prepared by XYZ Company, to the balance in the related general ledger account.

   The total of the accounts payable trial balance agreed with the balance in the related general ledger account.

2. Compare the amounts for claims received from creditors (as shown in claim documents provided by XYZ Company) to the respective amounts shown in the trial balance of accounts payable. Using the data included in the claims documents and in XYZ Company's accounts payable detail records, reconcile any differences found to the accounts payable trial balance.

   All differences noted are presented in column 3 of Schedule A. Except for those amounts shown in column 4 of Schedule A, all such differences were reconciled.

3. Examine the documentation submitted by creditors in support of the amounts claimed and compare it to the following documentation in XYZ Company's files: invoices, receiving reports, and other evidence of receipt of goods or services.

   No exceptions were found as a result of these comparisons.

   We were not engaged to, and did not, perform an audit, the objective of which would be the expression of an opinion on the specified elements, accounts, or items. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

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

[Source: SAS No. 75, Appendix A (AU section 622.49).]

.100 Compliance With Contractual Provisions (Separate Report)

We have audited, in accordance with generally accepted auditing standards, the balance sheet of XYZ Company as of December 31, 19X2, and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated February 16, 19X3.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to XX, inclusive, of the Indenture dated July 21, 19X0, with ABC Bank insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the boards of directors and management of XYZ Company and ABC Bank and should not be used for any other purpose.

[Source: SAS No. 62, paragraph 21 (AU section 623.21).]

Note: When this report is included in the auditor's standard report accompanying financial statements, the last two paragraphs are examples of the paragraphs that should follow the opinion paragraph of the auditor's report on the financial statements.

.110 Report on Financial Statements Prepared Pursuant to Loan Agreements That Results in a Presentation Not in Conformity With Generally Accepted Accounting Principles or an Other Comprehensive Basis of Accounting

Independent Auditor's Report

Addressee:

We have audited the accompanying special-purpose statement of assets and liabilities of ABC Company as of December 31, 19X1, and the related special-purpose statements of revenues and expenses and of cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The accompanying special-purpose financial statements were prepared for the purpose of complying with section 4 of a loan agreement between DEF Bank and the Company as described in Note X, and are not intended to be a presentation in conformity with generally accepted accounting principles.

In our opinion, the special-purpose financial statements referred to above present fairly, in all material respects, the assets and liabilities of ABC Company as of December 31, 19X1, and the revenues, expenses and cash flows for the year then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and DEF Bank and should not be used for any other purpose.

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 30 (AU section 623.30).]

.120 Report on a Schedule of Gross Income and Certain Expenses to Meet Regulatory Requirements and to be Included in a Document Distributed to the General Public

Independent Auditor's Report

Addressee:

We have audited the accompanying Historical Summaries of Gross Income and Direct Operating Expenses of ABC Apartments, City, State (Historical Summaries), for each of the three years in the period ended December 31, 19XX. These Historical Summaries are the responsibility of the Apartments' management. Our responsibility is to express an opinion on the Historical Summaries based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Historical Summaries are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Historical Summaries. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Historical Summaries. We believe that our audits provide a reasonable basis for our opinion.

The accompanying Historical Summaries were prepared for the purpose of complying with the rules and regulations of the Securities and Exchange Commission (for inclusion in the registration statement on Form S-11 of DEF Company) as described in Note X, and are not intended to be a complete presentation of the Apartments' revenues and expenses.

In our opinion, the Historical Summaries referred to above present fairly, in all material respects, the gross income and direct operating expenses described in Note X of ABC Apartments for each of the three years in the period ended December 31, 19XX, in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 26 (AU section 623.26).]

.121 Report on a Statement of Assets Sold and Liabilities Transferred to Comply With a Contractual Agreement

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of net assets sold of ABC Company as of June 8, 19XX. This statement of net assets sold is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the statement of net assets based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statement of net assets sold is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statement of net assets sold. We believe that our audit provides a reasonable basis for our opinion.

The accompanying statement was prepared to present the net assets of ABC Company sold to XYZ Corporation pursuant to the purchase agreement described in Note X, and is not intended to be a complete presentation of ABC Company's assets and liabilities.

In our opinion, the accompanying statement of net assets sold presents fairly, in all material respects, the net assets of ABC Company as of June 8, 19XX, sold pursuant to the purchase agreement referred to in Note X, in conformity with generally accepted accounting principles.

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and XYZ Corporation and should not be used for any other purpose.

[*Signature*]

[*Date*]

[Source: SAS No. 62, paragraph 26 (AU section 623.26).]

.130 Report on the Application of Accounting Principles

Introduction

We have been engaged to report on the appropriate application of generally accepted accounting principles to the specific (hypothetical) transaction described below. This report is being issued to the ABC Company (XYZ Intermediaries) for assistance in evaluating accounting principles for the described specific (hypothetical) transaction. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

Description of Transaction

The facts, circumstances, and assumptions relevant to the specific (hypothetical) transaction as provided to us by the management of ABC Company (XYZ Intermediaries) are as follows:

> Prior to 19X1, ABC Company used the accelerated cost recovery method (ACRS) to depreciate fixed assets for financial reporting and income tax purposes. The number of years specified by ACRS for recovery deductions of the fixed assets did not fall within a reasonable range of the asset's useful life. ABC Company switched to the straight-line method of depreciating its fixed assets in the current year.

Appropriate Accounting Principles

The change in depreciation methods should be accounted for as a prior period adjustment in the current year's financial statements in accordance with FASB Statement No. 16, *Prior Period Adjustments,* paragraph 11 [AC A35.103]. Since the number of years specified by ACRS for recovery deductions of the fixed assets did not fall within a reasonable range of the asset's useful life, the ACRS method would not be considered a generally accepted accounting principle. According to APB Opinion 20, *Accounting Changes,* paragraph 13, [AC A35.104], "A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error for purposes of applying this Opinion."

Concluding Comments

The ultimate responsibility for the decision on the appropriate application of generally accepted accounting principles for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountants. Our judgment on the appropriate application of generally accepted accounting principles for the described specific (hypothetical) transaction is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change.

[Source: SAS No. 50, paragraph 9 (AU section 625.09).]

Note: This illustrative report is intended for an accountant in public practice either in connection with a proposal to obtain a new client or otherwise, when: (1) preparing a written report on the application of accounting principles to specified transactions, either completed or proposed, (2) requested to provide a written report on the type of opinion that may be rendered on a specific entity's financial statements, or (3) preparing a written report to intermediaries on the application of accounting principles not involving facts or circumstances of a particular principal.

[Source: SAS No. 50, paragraph 2 (AU section 625.02).]

.140 Report on Financial Statements Presented in Conformity With a Prescribed Basis of Accounting (Property and Liability Insurance Company)

Independent Auditor's Report

Addressee:

We have audited the accompanying statutory-basis balance sheets of P and C Insurance Company as of December 31, 19X2 and 19X1, and the related statutory-basis statements of income, surplus, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to report on these financial statements based on our audits.

We conducted our audits of the accompanying statutory-basis financial statements in accordance with generally accepted auditing standards; however, as discussed in the following paragraph, we were not engaged to determine or audit the effects of the variances between statutory accounting practices and generally accepted accounting principles. Generally accepted auditing 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 on the accompanying statutory-basis financial statements.

The Company presents its financial statements in conformity with accounting practices prescribed or permitted by the [*name of state*] Insurance Department. When statutory-basis financial statements are presented for purposes other than for filing with regulatory agency, generally accepted auditing standards require that an auditor's report on them state whether they are presented in conformity with generally accepted accounting principles. The accounting practices used by the Company vary from generally accepted accounting principles as explained in Note X, and the Company has not determined the effects of these variances. Accordingly, we were not engaged to audit, and we did not audit, the effects of these variances. Since the financial statements referred to above do not purport to be a presentation in conformity with generally accepted accounting principles, we are not in a position to express and do not express an opinion on the financial statements referred to above as to fair presentation of financial position, results of operations, or cash flows in conformity with generally accepted accounting principles.

In our opinion, the statutory-basis financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and shareholders' (members') equity of P and C Insurance Company at December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting practices prescribed or permitted by the [*name of state*] Insurance Department.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*, paragraph 9.06]

[*The next page is 10,571.*]

AAM Section 10,270

Unaudited Financial Statements of a Public Entity

(When an accountant is associated with the financial statements but has not audited or reviewed such statements)

.01 Disclaimer

Addressee:

The accompanying balance sheet of X Company as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us, and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraph 5 (AU section 504.05).]

Notes: The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a privately held (nonpublic) company, this example is not appropriate. See AAM sections 2510 and 2520.

.02 Current Period Financial Statements Unaudited—Prior Period Financial Statements Audited

Addressee:

The accompanying balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

The financial statements for the year ended December 31, 19X1, were audited by us (other accountants) and we (they) expressed an unqualified opinion on them in our (their) report dated March 1, 19X2, but we (they) have not performed any auditing procedures since that date.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraphs 5 and 16 (AU section 504.05 and .16).]

Notes: The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a privately held (nonpublic) company, this example is not appropriate. See AAM sections 2510 and 2520.

.03 Disclaimer—Cash Basis Statements

(When an accountant is associated with unaudited financial statements of a public entity prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles)

Addressee:

The accompanying statement of assets and liabilities resulting from cash transactions of XYZ Corporation as of December 31, 19X1, and the related statement of revenues collected and expenses paid during the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraph 7 (AU section 504.07).]

Notes: A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.

The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a privately held (nonpublic) company, this example is not appropriate. See AAM sections 2510 and 2520.

.04 Disclaimer—Regulatory (Statutory) Basis Statements

(When an accountant is associated with unaudited financial statements of a public entity prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles)

Addressee:

The accompanying statement of admitted assets, liabilities, and surplus—statutory basis of XYZ Insurance Company as of December 31, 19XX, and the related statements of income—statutory basis, cash flows—statutory basis, and changes in surplus—statutory basis for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraph 7 (AU section 504.07).]

Notes: A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.

The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a privately held (nonpublic) company, this example is not appropriate. See AAM sections 2510 and 2520.

[*The next page is 10,621.*]

AAM Section 10,280
Lack of Independence

.01 Disclaimer

Addressee:

We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 19X1 and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: SAS No. 26, paragraph 10 (AU section 504.10).]

Notes: When an accountant is not independent, any procedures he or she might perform would not be in accordance with generally accepted auditing standards and he or she would be precluded from expressing an opinion on the financial statements. Accordingly, he or she should disclaim an opinion with respect to the financial statements and state specifically that he or she is not independent. The accountant should not include in his or her disclaimer the reasons for the lack of independence or any description of the procedures he or she has performed; including such matters might confuse readers concerning the importance of the lack of independence.

If the financial statements are those of a nonpublic entity, the guidance in Statements on Standards for Accounting and Review Services (SSARS) should be followed. (See AAM section 2510.03.)

[*The next page is 10,671.*]

AAM Section 10,300
Review of Interim Financial Information

.01 Independent Accountant's Report

Independent Accountant's Report

Addressee:

We have reviewed the accompanying [*describe the statements or information reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 19X1, and for the three-month and nine-month periods then ended. These financial statements (information) are (is) the responsibility of the company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements (information) for them (it) to be in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: SAS No. 71, paragraph 28 (AU section 722.28).]

Note: SAS No 71, *Interim Financial Information* (AU section 722), provides guidance for accountants engaged to review interim financial information of a public entity. SAS No. 71 (AU section 722) may also, in certain limited situations, apply to reviews of interim financial information for nonpublic entities. The accountant should refer to the SAS to determine its applicability.

[*The next page is 10,701.*]

AAM Section 10,400

Accountants' Reports on Condensed Financial Statements and Selected Financial Data

.01 Unqualified Opinion on Condensed Financial Statements[1]

Independent Auditor's Report

Addressee:

We have audited, in accordance with generally accepted auditing standards, the consolidated balance sheet of X Company and subsidiaries as of December 31, 19X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 19X1, we expressed an unqualified opinion on those consolidated financial statements.

In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

[*Signature*]

[*Date*]

[Source: SAS No. 42, paragraph 6 (AU section 552.06).]

[1] This report is appropriate when reporting in a client-prepared document on condensed financial statements (either for an annual or an interim period) that are derived from audited financial statements of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency (See SAS No. 42, paragraph 1a [AU section 552.01a].).

.02 Adverse Opinion on Condensed Financial Statements Due to Inadequate Disclosure[2]

Independent Auditor's Report

Addressee:

We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 19X0, and the related earnings and cash flows for the year then ended (not presented herein). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

The condensed consolidated balance sheet as of December 31, 19X0, and the related condensed consolidated statements of income, retained earnings, and cash flows for the year then ended, presented on pages XX-XX, are presented as a summary and therefore do not include all of the disclosures required by generally accepted accounting principles.

In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company and subsidiaries as of December 31, 19X0, or results of their operations and their cash flows for the year then ended.

[*Signature*]

[*Date*]

[Source: SAS No. 42, paragraph 7, footnote 6 (AU section 552.07).]

[2] This report is appropriate if a statement naming the auditor and stating that condensed financial statements have been derived from audited financial statements is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency at least annually (See SAS No. 42, paragraph 7, footnote 6 [AU section 552.07].).

.03 Review Report on Condensed Financial Statements

Independent Auditor's Report

Addressee:

We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 19X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 19X1 and 19X0. These financial statements are the responsibility of the company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with generally accepted accounting principles.

We have previously audited, in accordance with generally accepted auditing standards, the consolidated balance sheet as of December 31, 19X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 19X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 19X0, is fairly stated in all material respects, in relation to the consolidated balance sheet from which it has been derived.

[*Signature*]

[*Date*]

[Source: SAS No. 42, paragraph 8, as amended by SAS No. 71 (AU section 552.08).]

Note: This is an illustrative review report on a condensed balance sheet as of March 31, 19X1, and the related condensed statements of income and cash flows for the three-month periods ended March 31, 19X1 and 19X0, together with a report on a condensed balance sheet derived from audited financial statements as of December 31, 19X0, included in Form 10-Q.

[*The next page is 10,751.*]

AAM Section 10,500
Reports on Personal Financial Statements

.01 Auditor's Standard Report

Independent Auditor's Report

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audits in accordance with generally accepted auditing standards. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

In my (our) opinion, the financial statements referred to above present fairly, in all material respects, the financial condition of James and Jane Person as of [*date*] and the changes in their net worth for the [*period*] then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.13.]

.02 Audit Report—Statement of Financial Condition Only

Independent Auditor's Report

Addressee:

I (We) have audited the statement of financial condition of James and Jane Person as of [*date*]. This financial statement is the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on this financial statement based on my (our) audit.

I (We) conducted my (our) audit in accordance with generally accepted auditing standards. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting amounts and disclosures in the statements of financial condition. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall presentation of the statement of financial condition. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

In my (our) opinion, the financial statement referred to above presents fairly, in all material respects, the financial condition of James and Jane Person as of [*date*] in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.13.]

.03 Audit Report—Departure From GAAP—Inappropriate Valuation Methods—Adverse Opinion

Independent Auditor's Report

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with generally accepted auditing standards. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

As discussed in Note X to the financial statements, assets amounting to $XX,XXX (XX percent of total assets) as of [*date*] have been valued at estimated current value as determined by James Person. I (We) have reviewed the procedures applied by James Person in valuing the assets and have inspected the underlying documentation. In my (our) opinion those procedures are not appropriate to determine the estimated current values of the assets in conformity with generally accepted accounting principles. The effects on the financial statements of not applying appropriate procedures to determine the estimated current values of the assets are not reasonably determinable.

In my (our) opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial condition of James and Jane Person as of [*date*] and the changes in their net worth for the [*period*] then ended.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.18.]

.04 Audit Report—Departure From GAAP—Inappropriate Valuation Methods—Qualified Opinion

Independent Auditor's Report

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with generally accepted auditing standards. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

As discussed in Note X to the financial statements, assets amounting to $XX,XXX (XX percent of total assets) as of [*date*] have been valued at estimated current value as determined by James Person. I (We) have reviewed the procedures applied by James Person in valuing the assets and have inspected the underlying documentation. In my (our) opinion, those procedures are not appropriate to determine the estimated current values of the assets in conformity with generally accepted accounting principles. The effects on the financial statements of not applying appropriate procedures to determine the estimated current values of the assets are not reasonably determinable.

In my (our) opinion, except for the effects of the valuation of assets determined by James Person as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial condition of James and Jane Person as of [*date*], and the changes in their net worth for the [*period*] then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.17.]

.05 Audit Report—Disclaim Opinion Because of Scope Limitation—Inadequate Records

Independent Auditor's Report

Addressee:

I (We) was engaged to audit the accompanying statement of financial condition of James and Jane Person as of *[date]*, and the related statement of changes in net worth for the *[period]* then ended. These financial statements are the responsibility of James and Jane Person.

James and Jane Person do not maintain accounting records sufficient to assure that all transactions are recorded. Accordingly, it was not practicable for me (us) to extend my (our) auditing procedures sufficiently to determine that all of their assets and liabilities and the changes in their net worth are recorded in the financial statements referred to above.

Because James and Jane Person do not maintain certain accounting records and supporting documentation, and I was (we were) unable to apply adequate auditing procedures regarding the recording of transactions, the scope of my (our) work was not sufficient to enable me (us) to express, and I (we) do not express, an opinion on these financial statements.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.16.]

.06 Audit Report—Scope Limitation—Inadequate Records

Independent Auditor's Report

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

Except as explained in the following paragraph, I (we) conducted my (our) audit in accordance with generally accepted auditing standards. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

James and Jane Person do not maintain accounting records sufficient to assure that all transactions are recorded. Accordingly, it was not practicable for me (us) to extend my (our) auditing procedures sufficiently to determine that all of their assets and liabilities and the changes in their net worth are recorded in the financial statements referred to above.

In my (our) opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had I (we) been able to determine that all assets and liabilities and changes in net worth were recorded in the financial statements, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial condition of James and Jane Person as of [*date*], and the changes in their net worth for the [*period*] then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide,* paragraph 5.15.]

.07 Audit Report—Income Tax Basis

Independent Auditor's Report

Addressee:

I (We) have audited the accompanying statement of assets and liabilities—income tax basis of James and Jane Person as of [*date*], and the related statement of changes in net assets—income tax basis for the [*period*] then ended. These financial statements are the responsibility of James and Jane Person. My (Our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with generally accepted auditing standards. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

As described in Note X, these financial statements were prepared on the basis of accounting James and Jane Person use for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In my (our) opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities of James and Jane Person as of [*date*], and the changes in their net assets for the [*period*] then ended on the basis of accounting described in Note X.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.19.]

.08 Accountant's Standard Compilation Report

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide,* paragraph 5.03.]

.09 Compilation Report—Statement of Financial Condition Only

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [*date*], in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the accompanying statement of financial condition and, accordingly, do not express an opinion or any other form of assurance on it.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide,* paragraph 5.03.]

.10 Compilation Report—Omission of Substantially All Disclosures

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

James and Jane Person have elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the financial condition of James and Jane Person and changes in their net worth. Accordingly, these financial statements are not designed for those who are not informed about such matters.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.04.]

Note: When personal financial statements omit substantially all disclosures and do not disclose that the assets are presented at their estimated current values and that the liabilities are presented at their estimated current amounts, the accountant should include the following sentence at the end of the first paragraph of his or her report:

> The financial statements are intended to present the assets of James and Jane Person at estimated current values and their liabilities at estimated current amounts.

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.05.]

.11 Compilation Report—GAAP Departure—Material Assets at Cost

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, I (we) did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.

As disclosed in Note X to the financial statements, generally accepted accounting principles require that assets be presented at their estimated current values and that liabilities be presented at their estimated current amounts. James and Jane Person have informed me (us) that their investment in ABC Company is stated in the accompanying financial statements at cost and that the effects of this departure from generally accepted accounting principles on their financial condition and the changes in their net worth have not been determined.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.08.]

.12 Compilation Report—Income Tax Basis

Addressee:

I (We) have compiled that accompanying statement of asset and liabilities—income tax basis of James and Jane Person as of [*date*], and the related statement of changes in net assets—income tax basis for the [*period*] then ended, in accordance with Statement on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.19.]

Note: When personal financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the notes ordinarily would state the basis of presentation and describe how that basis differs from generally accepted accounting principles. [Source: Accounting and Review Services Interpretation No. 12 of SSARS 1 (AR section 9100.42).]

.13 Compilation Report—Financial Statements Included in a Prescribed Form

Addressee:

I (We) have compiled the [*identification of financial statements, including period covered and name of individual(s)*] included in the accompanying prescribed form, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

My (Our) compilation was limited to presenting in the form prescribed by [*name of body*] information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

These financial statements (including related disclosures) are presented in accordance with the requirements of [*name of body*], which differ from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such differences.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.08.]

.14 Accountant's Standard Review Report

Addressee:

I (We) have reviewed the accompanying statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of James and Jane Person.

A review of personal financial statements consists principally of inquiries of the individuals whose financial statements are presented and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.10.]

.15 Review Report—Statement of Financial Condition Only

Addressee:

I (We) have reviewed the accompanying statement of financial condition of James and Jane Person as of [*date*], in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in this financial statement is the representation of James and Jane Person.

A review of personal financial statements consists principally of inquiries of the individuals whose financial statements are presented and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying statement of financial condition in order for it to be in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.10.]

.16 Review Report—GAAP Departure—Failure to Include a Provision for Estimated Income Taxes on the Differences Between the Estimated Current Values of Assets and the Estimated Current Amounts of Liabilities and Their Tax Bases

Addressee:

I (We) have reviewed the accompanying statement of financial condition of James Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of James Person.

A review of personal financial statements consists principally of inquiries of the individual whose financial statements are presented and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, with the exception of the matter described in the following paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

Generally accepted accounting principles require that personal financial statements include a provision for estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases. The accompanying financial statements do not include such a provision and the effect of this departure from generally accepted accounting principles has not been determined.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.08.]

.17 Review Report—Historical Cost Basis

Addressee:

I (We) have reviewed the accompanying statement of assets and liabilities—historical cost basis of James and Jane Person as of [*date*], and the related statement of changes in net assets—historical cost basis for the [*period*] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of James and Jane Person.

A review of personal financial statements consists principally of inquiries of the individuals whose financial statements are presented and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the historical cost basis of accounting described in Note X.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide,* paragraph 5.19.]

[*The next page is 10,801.*]

AAM Section 10,600

Reports on Employee Benefit Plans

.01 Unqualified Opinion—Defined Benefit Plan Assuming End-of-Year Benefit Information Date

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits and of accumulated plan benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Plan as of December 31, 19X2 and 19X1, and the changes in its financial status for the year ended December 31, 19X2 in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.04.]

Note: Department of Labor Regulations, section 2520.103-1 requires the accountant's report to be dated, manually signed, indicate the city and state where issued and identify the financial statements and schedules covered by the report.

.02 Unqualified Opinion—Defined Benefit Plan Assuming Beginning-of-Year Benefit Information Date

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statements of changes in net assets available for benefits for the years then ended and the statement of accumulated plan benefits as of December 31, 19X1, and the related statement of changes in accumulated plan benefits for the year then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, information regarding the Plan's net assets available for benefits as of December 31, 19X2, and changes therein for the year then ended and its financial status as of December 31, 19X1, and changes therein for the year then ended in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.05.]

.03 Unqualified Opinion—Defined Contribution Profit-Sharing Plan

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of ABC Company Profit-Sharing Plan as of December 31, 19X1 and 19X0, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X1. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 19X1 and 19X0, and the changes in net assets available for benefits for the year ended December 31, 19X1 in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.06.]

.04 Unqualified Opinion—Employee Health and Welfare Benefit Plan* **[For those plans that have not yet adopted SOP 92-6]**

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets of Bizco Corporation Employee Health and Welfare Benefit Plan as of December 31, 19X1 and 19X0, and the related statement of changes in net assets for the year ended December 31, 19X1. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of the Plan as of December 31, 19X1 and 19X0, and the changes in net assets for the year ended December 31, 19X1 in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.07.]

* This is an illustration of an auditor's report with an unqualified opinion on the financial statements of an employee health and welfare plan prepared in accordance with chapter 4 of the AICPA Audit and Accounting Guide (the Guide) *Audits of Employee Benefit Plans*. Chapter 4 of the Guide has been superseded by AICPA Statement of Position (SOP) 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*. SOP 92-6 is effective for audits of financial statements of single-employer plans for plan years beginning after December 15, 1992, except that application of the SOP by single-employer plans with no more than 500 participants is effective for plan years beginning after December 15, 1994. SOP 92-6 is effective for audits of financial statements of multi-employer plans for plan years beginning after December 15, 1995. Earlier application is encouraged. When a plan adopts the SOP it must be adopted in its entirety.

An illustration of an auditor's report assuming the provisions of SOP 92-6 have been adopted is presented in AAM section 10.600.05.

.05 Unqualified Opinion—Employee Health and Welfare Benefit Plans* [SOP 92-6]

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits and of plan benefit obligations of Allied Industries Benefit Plan as of December 31, 19X2 and 19X1, and the related statements of changes in net assets available for benefits and of changes in plan benefits obligations for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Plan as of December 31, 19X2 and 19X1, and the changes in financial status for the year ended December 31, 19X2 in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.08.]

* This is an illustration of an auditor's report with an unqualified opinion on the financial statement of an employee health and welfare plan prepared in accordance with AICPA Statement of Position (SOP) 92-6, *Accounting and Reporting by Employee Health and Welfare Benefit Plans*. SOP 92-6 is effective for audits of financial statements of single-employer plans for plan years beginning after December 15, 1992, except that the application to single-employer plans with no more than 500 participants is effective for plan years beginning after December 15, 1994. SOP 92-6 is effective for audits of financial statements of multiemployer plans for plan years beginning after December 15, 1995. Earlier application is encouraged. When a plan adopts the SOP it must be adopted in its entirety.

An illustration of an auditor's report assuming the provisions of SOP 92-6 have not yet been adopted is presented in AAM section 10,600.04.

.06 Unqualified Opinion—Supplemental Schedules Required by ERISA and DOL Regulations

Independent Auditor's Report

Addressee:

Our audits were performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of (*identify*) are presented for the purpose of additional analysis and are not a required part of the basic financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans,* paragraph 13.11.]

Notes: This paragraph can be shown separately in the auditor-submitted document or as a separate paragraph, after the opinion paragraph, of the auditor's standard report, when the auditor's report covers additional information and the auditor has applied auditing procedures and is expressing an opinion on the additional information.

Examples of paragraphs that should be added to the standard auditor's report when the report on the supplemental schedules is modified because of omitted information or an omitted schedule required by DOL regulations are presented in AAM section 10,600.08, .09, and .18.

.07 Unqualified Opinion—Defined Benefit Pension Plan Prepared on the Modified Cash Basis

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits (modified cash basis) of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for benefits (modified cash basis) for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements and supplemental schedules were prepared on a modified cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits and the accumulated plan benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the changes in net assets available for benefits and changes in accumulated plan benefits for the year ended December 19X2, on the basis of accounting described in Note X.

Our audits were made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules (modified cash basis) of (1) assets held for investment purposes, (2) loans or fixed income obligations, (3) leases in default or classified as uncollectible, (4) reportable transactions, and (5) non-exempt transactions as of or for the year ended December 31, 19X2, are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplementary schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.21.]

Note: When reporting on financial statements prepared in conformity with a basis of accounting other than generally accepted accounting principles (OCBOA), the auditor should consider whether the financial statements and notes thereto include all informative disclosures that are appropriate for the basis of accounting used. Regardless of the basis of accounting used (GAAP or OCBOA), accumulated plan benefits disclosures should be made. If such disclosures are not made, the auditor should comment in his or her report on the lack of such disclosures and should express a qualified or adverse opinion on the financial statements. [Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.22.]

.08 Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations

Following are examples of paragraphs that should be added to the auditor's report when the auditor should modify his or her report on the supplemental schedules because of omitted information or an omitted schedule which is required under DOL regulations.

Independent Auditor's Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.* See AAM section 10,600.01–.04.]

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of *[identify]* are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations of Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The schedule of assets held for investment purposes that accompanies the Plan's financial statements does not disclose the historical cost of certain plan assets held by the Plan trustee [or custodian]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

or

The Plan has not presented the schedule of reportable transactions (transactions in excess of 5 percent of the current value of plan assets at the beginning of the year). Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans,* paragraph 13.16.]

.09 Qualified Opinion—Omitted or Incomplete Schedule or Material Inconsistency

The following paragraphs should be added to the auditor's report when the auditor concludes that his or her opinion on the supplemental schedules should be qualified because a schedule, or information thereon, was omitted (when the schedules are not covered by a trustee's certification as to completeness and accuracy), or because information in a required schedule is materially inconsistent with the financial statements.

Independent Auditor's Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.* See AAM section 10,600.01–.04.]

The schedule of assets held for investment purposes that accompanies the Plan's financial statements does not disclose that the Plan had loans to participants which are considered assets held for investment purposes. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of *[identify]* are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans,* paragraph 13.16.]

.10 Qualified Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted**

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor concludes that his or her opinion on the supplemental schedules should be qualified because disclosure of a material prohibited transaction with a party in interest is omitted.

Independent Auditor's Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.* See AAM section 10,600.01–.04.]

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the Plan [*describe prohibited transaction*]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.17.]

** *Note:* If a material party in interest transaction that is not disclosed in the supplementary schedule is also considered a related-party transaction and if that transaction is not properly disclosed in the notes to the financial statements, the auditor should express a qualified or adverse opinion on the financial statements as well as on the supplemental schedule. See AAM section 10,600.13.

.11 Adverse Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor decides that an adverse opinion should be expressed on the supplemental schedules because disclosure of a material prohibited transaction with a party in interest is omitted.

Independent Auditor's Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.* See AAM section 10,600.01–.04.]

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the Plan [*describe prohibited transaction*]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, because of the omission of the information discussed in the preceding paragraph are not fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.17.]

.12 Modified Report—Disclosure of Immaterial Prohibited Transaction With Party in Interest Omitted

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor decides to modify his or her report on the supplemental schedules because disclosure of a prohibited transaction with a party in interest that is not material to the financial statements has been omitted.

Independent Auditor's Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.* See AAM section 10,600.01–.04.]

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the Plan [*describe prohibited transaction*]. Disclosure of this information, which is not considered material to the financial statements taken as a whole, is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.17.]

.13 Qualified Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted—Related-Party Transaction

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of net assets available for benefits of XYZ Company Profit-Sharing Plan as of December 31, 19X1 and 19X0, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X1. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Plan's financial statements do not disclose that the Plan [*describe related-party transaction*]. Disclosure of this information is required by generally accepted accounting principles.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 19X1 and 19X0, and the changes in net assets available for benefits for the year ended December 31, 19X1 in conformity with generally accepted accounting principles.

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the plan [*describe prohibited transaction*]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans,* paragraph 13.18.]

.14 Limited-Scope Audits Under DOL Regulations

Independent Auditor's Report

Addressee:

We were engaged to audit the financial statements and schedules of XYZ Pension Plan as of December 31, 19X1 and 19X0, and for the year ended December 31, 19X1, as listed in the accompanying index. These financial statements and schedules are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing such information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of and for the years ended December 31, 19X1 (and 19X2) that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the trustee, have been audited by us in accordance with generally accepted auditing standards and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.25.]

Note: If the plan's financial statements are prepared on the cash basis or a modified cash basis of accounting, the auditor's report should also include a paragraph stating the basis of presentation and that cash basis is a comprehensive basis of accounting other than GAAP (see paragraph 13.21 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* for wording of such a paragraph). [Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.25, footnote 71.]

.15 Limited-Scope Audit in Prior Year

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X2, and the statements of accumulated plan benefits as of December 31, 19X2 and 19X1, and the related statement of changes in accumulated plan benefits for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, investment assets held by ABC Bank, the trustee (or custodian) of the Plan, and transactions in those assets were excluded from the scope of our audit of the Plan's 19X1 financial statements, except for comparing the information provided by the trustee (or custodian), which is summarized in Note X, with the related information included in the financial statements.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the Plan's financial statements as of December 31, 19X1. The form and content of the information included in the 19X1 financial statements, other than that derived from the information certified by the trustee (or custodian), have been audited by us and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

In our opinion, the financial statements, referred to above, of XYZ Pension Plan as of December 31, 19X2, and for the year then ended present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 19X2, and changes in its financial status for the year then ended in conformity with generally accepted accounting principles.

Our audit of the Plan's financial statements as of and for the year ended December 31, 19X2, was made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of (1) assets held for investment purposes, (2) loans or fixed income obligations, (3) leases in default or classified as uncollectible, (4) reportable transactions, and (5) non-exempt transactions as of or for the year ended December 31, 19X2, are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 19X2, and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.26.]

.16 Limited-Scope Audit in Current Year

Independent Auditor's Report

Addressee:

We were engaged to audit the accompanying statement of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X2 and the supplemental schedules of (1) assets held for investment purposes, (2) transactions in excess of 5 percent of the current value of plan assets, and (3) investments in loans and fixed income obligations in default or classified as uncollectible as of or for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing the information with the related information included in the 19X2 financial statements and supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of and for the year ended December 31, 19X2, that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information in the Plan's 19X2 financial statements that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules as of or for the year ended December 31, 19X2. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified by the trustee (or custodian), have been audited by us in accordance with generally accepted auditing standards and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

We have audited the statement of net assets available for benefits of XYZ Pension Plan as of December 31, 19X1 and, in our report dated May 20, 19X2, we expressed our opinion that such financial statement presents fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 19X1, in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.27.]

.17 Multiemployer Pension Plan Assuming Limited-Scope Audit

Independent Auditor's Report

Addressee:

We were engaged to audit the statements of (*identify*) of XYZ Multiemployer Pension Plan as of December 31, 19X2 and 19X1, and for the years then ended. These financial statements are the responsibility of the Plan's management.

The Plan's records and procedures are not adequate to assure the completeness of participants' data on which contributions and benefit payments are determined, and the Board of Trustees did not engage us to perform, and we did not perform, any other auditing procedures with respect to participants' data maintained by the sponsor companies or individual participants.

Because of the significance of the information that we did not audit, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.28.]

.18 Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations in a Limited Scope Engagement

Independent Auditor's Report

Addressee:

[*Same first and second paragraphs as the limited-scope report.* See AAM section 10,600.14.]

The schedule of assets held for investment purposes that accompanies the Plan's financial statements does not disclose that the Plan has loans to participants which are considered assets held for investment purposes. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

or

The Plan has not presented the schedule of reportable transactions (transactions in excess of 5 percent of the current value of plan assets at the beginning of the year). Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the trustee, have been audited by us in accordance with generally accepted auditing standards and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.16.]

.19 Trust Established Under an Employee Benefit Plan

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of net assets of ABC Pension Trust as of December 31, 19X2, and the related statement of changes in net assets and trust balance for the year then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. 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 evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of ABC Pension Trust as of December 31, 19X2, and the changes in its net assets and trust balance for the year then ended in conformity with generally accepted accounting principles.

The accompanying statements are those of ABC Pension Trust, which is established under XYZ Pension Plan; the statements do not purport to present the financial status of XYZ Pension Plan. The statements do not contain certain information on accumulated plan benefits and other disclosures necessary for fair presentation of the financial status of XYZ Pension Plan in conformity with generally accepted accounting principles. Furthermore, these statements do not purport to satisfy the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 relating to the financial statements of employee benefit plans.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.29.]

.20 Defined Benefit Plan Assuming Inadequate Procedures to Value Investments

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1 and of accumulated plan benefits as of December 31, 19X2, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note X, investments amounting to $______ (______ percent of net assets available for benefits) as of December 31, 19X2, have been valued at estimated fair value as determined by the Board of Trustees. We have reviewed the procedures applied by the trustees in valuing the securities and have inspected the underlying documentation. In our opinion, those procedures are not adequate to determine the fair value of the investments in conformity with generally accepted accounting principles. The effect on the financial statements and supplemental schedules of not applying adequate procedures to determine the fair value of the securities is not determinable.

In our opinion, except for the effects of the procedures used by the Board of Trustees to determine the valuation of investments as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 19X2, and information regarding the plan's net assets available for benefits as of December 31, 19X1, and the changes in its financial status for the year ended in December 31, 19X2 in conformity with generally accepted accounting principles.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of (1) assets held for investment purposes, (2) loans or fixed income obligations, (3) leases in default or classified as uncollectible, (4) reportable transactions, and (5) non-exempt transactions as of or for the year ended December 31, 19X2, are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. That additional information has been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 19X2; and in our opinion, except for the effects of the valuation of investments, as described above, the additional information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.32.]

.21 Defined Benefit Plan Assuming Nonreadily Marketable Investments

Independent Auditor's Report

Addressee:

[*Same first and second paragraphs as the standard report.* See AAM section 10,600.01–.04.]

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 19X1 and 19X0, and the changes in net assets available for benefits for the year ended December 31, 19X1 in conformity with generally accepted accounting principles.

As explained in note 2, the financial statements include securities valued at $______ (______ percent of net assets), whose values have been estimated by the Board of Trustees in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Trustees in arriving at its estimate of value of such securities and have inspected underlying documentation, and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

____

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.31.]

.22 Savings Plan Containing Separate Investment Fund Option Information

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits* of XYZ Employee Savings Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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 of disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 19X2 and 19X1, and the changes in net assets available for benefits for the year ended December 31, 19X2, in conformity with generally accepted accounting principles.

Our audits were performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of [*insert titles of DOL required schedules*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The Fund Information in the [statement of net assets available for benefits and the] statement of changes in net assets available for benefits is presented for purposes of additional analysis rather than to present the [net assets available for plan benefits and] changes in net assets available for plan benefits of each fund. The supplemental schedules and Fund Information have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans,* paragraph 13.36.]

[*The next page is 10,851.*]

* If the financial statements are included in an SEC filing not subject to ERISA, the words "including the schedules of investments" would be added here. Additionally, the report would cover the required statements of changes in net assets available for plan benefits for each of the three years in the period ended December 31, 19X2.

AAM Section 10,650

Reports on Financial Statements of Brokers and Dealers in Securities

.01 Unqualified Opinion on Financial Statements and Supplementary Schedules Required by the SEC

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated statement of financial condition of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the related consolidated statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the results of their operations and their cash flows for the year then ended in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 under the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*, Appendix B.]

Notes: SEC Regulation S-X section 210.2-02 requires the accountant's report to be dated, signed manually, indicate the city and state where issued, and identify without detailed enumeration the financial statements covered by the report.

AAM section 10,250.150 and .160 contain illustrative reports on internal control required by SEC Rule 17a-5.

.02 Qualified Opinion—Departure From GAAP

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated statement of financial condition of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the related consolidated statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X to the financial statements, investment securities not readily marketable amounting to $XX,XXX (XX percent of stockholders' equity) as of December 31, 19X1, have been valued at fair value as determined by the Board of Directors. We have reviewed the procedures applied by the directors in valuing such securities and investments and have inspected underlying documentation. In our opinion, those procedures are not reasonable, and the documentation is not appropriate to determine fair value of securities in conformity with generally accepted accounting principles. The effect on the financial statements of not applying adequate valuation procedures is not readily determinable.*

In our opinion, except for the effects on the financial statements of the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Standard Stockbrokerage Co., Inc. and Subsidiaries as of December 31, 19X1, and the results of their operations and their cash flows for the year then ended in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, except for the effects on [*identify the schedules affected*] of the valuation of investment securities determined by the Board of Directors, as described in the second preceding paragraph, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*, Appendix B.]

* SEC regulations require auditors to state if they have reviewed the procedures applied by the directors in valuing the securities, if they have inspected the underlying documentation, and if they believe the procedures are reasonable and documentation appropriate.

Notes: In certain circumstances, depending on materiality, the qualification could apply only to the income statement.

AAM section 10,250.150 and .160 contain illustrative reports on internal control required by SEC Rule 17a-5.

.03 Separate Report on Supplementary Schedules

Independent Auditor's Report on Supplementary Information Required by Rule 17a-5 of the Securities and Exchange Commission

Addressee:

We have audited the accompanying consolidated financial statements of Standard Stockbrokerage Co., Inc. and Subsidiaries as of and for the year ended December 31, 19X1, and have issued our report thereon dated February 15, 19X2. Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*, Appendix B.]

Note: This paragraph can be shown separately in the auditor-submitted document or as a separate paragraph, after the opinion paragraph, of the auditor's standard report.

[*The next page is 10,901.*]

AAM Section 10,700
Reports for Investment Companies

.01 Unqualified Opinion on the Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of portfolio investments, as of December 31, 19X4, and the related statements of operations and cash flows* for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows* for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 9.03.]

Note: The reference to "and brokers" in the fourth sentence of the scope paragraph is not normally required if the investment company's financial statements do not show an amount payable for securities purchased. Also, if securities were "verified by examination," the report should be modified to state that.

* FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Held for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

.02 Unqualified Opinion on the Financial Statements for a Multicolumnar Presentation of the Portfolios Constituting the Series

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of assets and liabilities, including the schedules of investments, of XYZ Series Investment Company (comprising, respectively, the Foreign, Domestic Common Stock, Long-Term Bond, and Convertible Preferred Portfolios) as of December 31, 19X4, and the related statements of operations and cash flows* for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of each of the respective portfolios constituting the XYZ Series Investment Company as of December 31, 19X4, the results of their operations and their cash flows* for the year then ended, the changes in their net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 9.06.]

* FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Held for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

.03 Unqualified Opinion on the Financial Statements Presenting One of the Portfolios or Entities Constituting the Series

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of assets and liabilities, including the schedule of portfolio investments, of the Convertible Preferred Portfolio (one of the portfolios constituting the XYZ Series Investment Company) as of December 31, 19X4, and the related statements of operations and cash flows* for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of the Convertible Preferred Portfolio of the XYZ Series Investment Company as of December 31, 19X4, and the results of its operations and cash flows* for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 9.07.]

* FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Held for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

.04 Unqualified Opinion on the Financial Statements With an Explanatory Paragraph Due to Absence of Ascertainable Market Values (Documentation Supports Valuation)

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of portfolio investments, as of December 31, 19X4, and the related statements of operations and cash flows* for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows* for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

As explained in Note 2, the financial statements include securities valued at $____ (____% of net assets), whose values have been estimated by the Board of Directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of value of such securities and have inspected underlying documentation, and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

____

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 9.08.]

* FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Held for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

.05 Qualified Opinion on the Financial Statements Due to Absence of Ascertainable Market Values (Documentation Does Not Support Valuation)

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of portfolio investments, as of December 31, 19X4, and the related statements of operations and cash flows* for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As explained in Note 2, the financial statements include securities valued at $____ (____% of net assets), whose values have been estimated by the Board of Directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of value of such securities and have inspected underlying documentation. In our opinion, those procedures are not reasonable, and the documentation is not appropriate to determine the value of the securities in conformity with generally accepted accounting principles. The effect on the financial statements of not applying adequate valuation procedures is not readily determinable.

In our opinion, except for the effects on the financial statements and selected per share data and ratios of the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, that financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows* for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 9.09.]

[*The next page is 11,001.*]

* FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Held for Resale,* amends FASB Statement No. 95, *Statement of Cash Flows,* to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

AAM Section 11,000
Quality Control Forms and Aids

> These sample quality control documents are presented for illustrative purposes only. They are intended as an aid for users of this Manual who may want points of departure when establishing their own quality control policies and procedures. These illustrations are neither all inclusive nor are they prescribed minimums. Auditors and accountants should rely on professional standards and their individual professional judgment in determining what may be needed in individual circumstances.

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AAM Section 11,100
Quality Control—General

AICPA Requirements

.01 Article VI—*Scope and Nature of Services*—of the AICPA's *Principles of Professional Conduct* (ET section 57), requires that members in the practice of public accounting "practice in firms that have in place internal quality control procedures to ensure that services are competently delivered and adequately supervised."

.02 As this edition of the manual went to print, the AICPA had just issued Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (QC section 20), and SQCS No. 3, *Monitoring a CPA Firm's Accounting and Auditing Practice* (QC section 30). SQCS No. 2 (QC section 20) supersedes SQCS No. 1, *System of Quality Control for a CPA Firm* (QC section 10), and its interpretations (QC section 10-1). Both standards are effective as of January 1, 1997.

.03 SQCS No. 2 (QC section 20) redefines a firm's accounting and auditing practice to include all audit, attest, and accounting and review services for which professional standards have been established by the AICPA Auditing Standards Board (ASB) and Accounting and Review Services Committee under rules 201 (ET section 201.01) and 202 (ET section 202.01) of the AICPA Code of Professional Conduct. The definition of a firm's accounting and auditing practice includes engagements performed under Statements on Standards for Attestation Engagements issued by the ASB. These standards had not been issued when SQCS No. 1 (QC section 10) was promulgated. Also, the new standard replaces the nine specific elements discussed in SQCS No. 1 (QC section 10) with five broad elements. SQCS No. 3 (QC section 30) provides guidance on how a firm can implement the new monitoring element of a quality control system in its accounting and auditing practice. Firms will need to modify their quality control systems to comply with the new standards. To order SQCS Nos. 2 (QC section 20) and 3 (QC section 30), call the AICPA Order Department at 800-862-4272 and ask for product numbers 067018 and 067019.

.04 The sample quality control documents included in sections 11,200 through 11,400 are prepared in accordance with SQCS No. 1 (QC section 10) and do not incorporate the requirements of SQCS Nos. 2 (QC section 20) and 3 (QC section 30), which are effective January 1, 1997. Sample quality control documents in accordance with the new standards will be included in a future 1996 update to the looseleaf service and in the 1997 annual paperback edition of this Manual. If you have purchased the annual paperback edition, you may wish to purchase the AICPA's *Guide for Establishing and Maintaining Quality Control for a CPA's Accounting and Auditing Practice* (available Fall 1996), which will include sample quality control documents for various size firms. For information on the status of this publication, call the AICPA Technical Hotline at 800-862-4272.

Quality Control System

.05 A system of quality control for a firm encompasses the firm's organization structure and the policies adopted and procedures established to provide the firm with reasonable assurance of conforming with professional standards. The system of quality control should be appropriately comprehensive and suitably designed in relation to the firm's organizational structure, its policies, and the nature of its practice.

.06 The nature and extent of a firm's quality control policies and procedures depend on a number of factors, such as its size, the nature of its practice, its organization and appropriate cost-benefit considerations.

.07 In developing a quality control system, a firm shall consider each on the nine elements of quality control discussed below, to the extent applicable to its practice.

a. **Independence.** The firm should be assured that persons at all levels maintain independence to the extent required by the rules of conduct of the AICPA.

Forms which may assist you are:

Section	Form Name
11,500.01	Independence Checklist for Employees
11,500.02	Independence and Representation Checklist for Other Auditors

b. **Assigning Personnel to Engagements.** The firm should be assured that work will be performed by persons having the degree of technical training and proficiency required in the circumstances.

Forms which may assist you are:

Section	Form Name
11,500.03	Scheduling Request
11,500.04	History of Staff Assignments
11,500.05	Client History of Personnel Assigned
11,500.06	Scheduling Master Plan

c. **Consultation.** The firm should be assured personnel will seek assistance, to the extent required, from persons having appropriate levels of knowledge, competence, judgment, and authority.

Forms which may assist you are:

Section	Form Name
11,500.07	Consultation Log
11,500.08	Consultation Worksheet

d. **Supervision.** The firm should be assured that work at all organizational levels is supervised to ascertain that the work performed meets the firm's standards of quality.

Forms which may assist you are:

Section	Form Name
3170.01-.02	Audit Time Budget
3170.03-.04	Audit Time Analysis
3170.05	Weekly Progress Report
3165.01-.12	Illustrative Planning Checklist
3175.01-.12	Sample Engagement Letters
2200.21	Illustrative Engagement Letter for a Compilation
2200.22	Illustrative Engagement Letter for a Review
5400	Illustrative Audit Programs for Corporations
9100.01-.14	Supervision and Review Procedures
11,500.04	History of Staff Assignments

e. **Hiring.** The firm should be assured that those employed possess the appropriate characteristics to enable them to perform competently.

Forms which may assist you are:

Section	Form Name
11,500.09	Pre-Employment Application
11,500.10	Interview Report

f. **Professional Development.** The firm should be assured that personnel will have the knowledge required to enable them to fulfill responsibilities assigned and to comply with applicable (state) Board of Accountancy requirements.

Forms which may assist you are:

Section	Form Name
11,500.11	Record of Professional Development
11,500.12	Professional Development Summary (in hours)
11,500.13	Professional Development Summary (in dollars)

g. **Advancement.** The firm should be assured that those selected for advancement will have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.

Forms which may assist you are:

Section	Form Name
11,500.14	Performance Evaluation
11,500.15	Job Evaluation Report
11,500.16	Knowledge and Skill Form
11,500.17	Employee Annual Performance Appraisal

h. **Acceptance and Continuation of Clients.** The firm should be assured that the decision to accept or continue a client is in the best interest of the firm as well as the client.

Forms which may assist you are:

Section	Form Name
11,500.18	New Client Acceptance Checklist
2200.20	Client Acceptance and Continuance Form

i. **Inspection.** The firm should be assured that the procedures relating to other elements of quality control are being effectively performed.

Forms which may assist you are:

Section	Form Name
11,500.19	Summary Inspection Report
11,500.20	Inspection of Compliance With Policies and Procedures Relating to Elements of Quality Control

The elements are interrelated. For example, a firm's hiring practices affect its policies as to training, training affects policies as to promotion, etc. The system should be designed to function together to maintain a firm's quality. (This section does not specifically cover services for OCBOA, Agreed-Upon Procedures, Prospective Financial Statements, Internal Control Reports or Attest Engagements. A firm may want to develop alternative Quality Control checklists for these engagements.)

.08 Although firms are not required to have a formal quality control document, many firms find preparation and dissemination to their staff of such a document useful. The sample quality control documents for local CPA firms and sole practitioners presented in the following sections have been prepared using the information contained in Statement on Quality Control Standards, *System of Quality Control for a CPA Firm* (QC section 10), the interpretations of this statement (QC section 10-1), and the guide entitled, "Quality Control Policies and Procedures for CPA Firms (QC section 90)," which was prepared by the Quality Control Review Committee for use in establishing guidance for the implementation of this statement. The publications are included in the Quality Control section of *Professional Standards*, volume 2.

[*The next page is 11,201.*]

AAM Section 11,200

Sample Quality Control Document for a Multi-Partner Local CPA Firm—Prior to 1/1/97 Effective Date of SQCS Nos. 2 and 3

.01 Firm Background Information

Our firm has ______ partners, nine professional staff, and four clerical staff—a total of ______ people. One partner has been designated as the executive partner and another as administrative partner. (A copy of our organization chart follows on the next page.)

Our executive partner founded the firm in 19XX, and our growth has been derived entirely from internal expansion. All of the other partners joined the firm as staff assistants and were promoted to partner level.

Our objective is to provide quality accounting, auditing, tax, and management advisory services to our clients.[1] To this end we expect to limit our practice to those clients we can properly serve. We intend to further develop expertise that will enable us to increase the number of clients that are municipalities and auto dealerships. Therefore, we plan to hire and train professional personnel who will be able to function to meet these goals.

We expect our growth to continue to be internal and to be limited to our present geographic practice area; a community we have served for nearly 35 years. We hope to retain our local identity and personal relationship with clients that are the foundations of our practice.

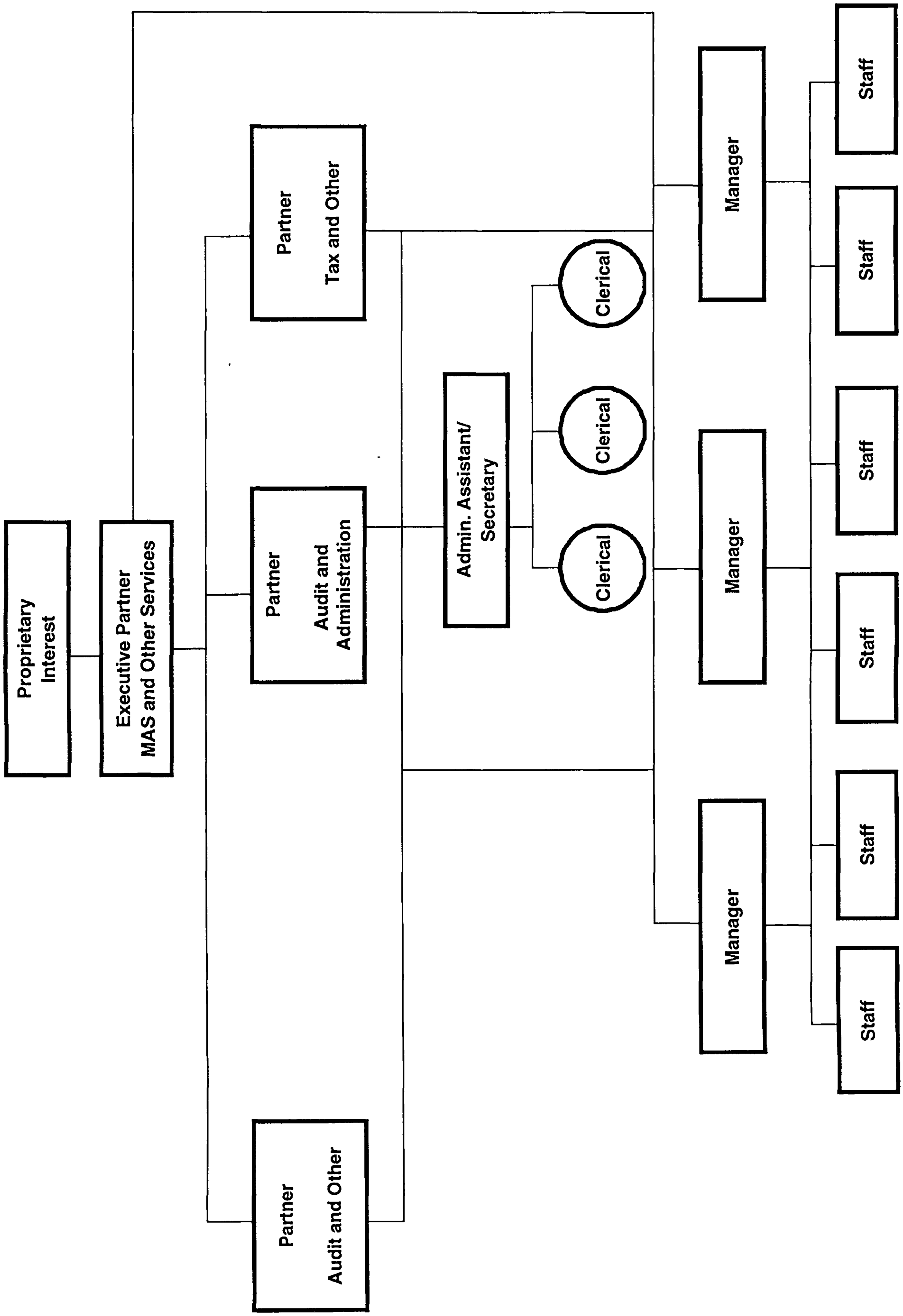
We hope to be a firm that is enjoyable and rewarding to work for. We intend to continue our involvement in and contribution to community and professional activities and organizations.

Our practice breakdown is as follows:

Auditing	33%
Reviews	10
Compilations	15
Taxes	25
Management advisory services	9
Other accounting services	8
	100%

[1] Additional considerations for establishing a firm's stated objectives are discussed in AAM section 11,200.12.

Organization Chart



Our practice is conducted from one office and is basically a general practice composed of the following types of clients:

Audit engagements
- Publicly held corporations
- Manufacturing companies
- Retail establishments
- Auto dealerships
- Municipalities

Unaudited statement engagements
Other accounting services

For the benefit of our professional personnel, an accounting and auditing manual and a personnel manual are maintained. Both manuals are referred to in this document and are, in effect, an integral part of our quality control system.

November 1, 19XX

.02 Independence

a. **All personnel are required to adhere to the independence rules, regulations, interpretations, and rulings of the AICPA, (state) CPA Society, (state) Board of Accountancy, state statutes, and for applicable engagements, the Securities and Exchange Commission and other regulatory agencies under which we practice.**

1. The executive partner is responsible for resolving questions relating to independence matters and is available to provide guidance when required.

2. The executive partner communicates with the AICPA and/or the (state) CPA Society for assistance in resolving independence questions that are not satisfactorily resolved within the firm. (See AAM section 11,500.07 for an example of a log which can be utilized to document all communication with parties outside the firm, also see AAM section 11,500.08 for a Consultation Worksheet, which can be used to document the subject matter as well as the response from the consultant.)

3. A memo documenting the resolution of independence questions is prepared and retained by the executive partner. The other firm personnel involved in the questions review and initial the memo.

b. **Policies and procedures relating to independence are communicated to all personnel.**

1. The personnel manual is used to inform personnel of the firm's independence policies and procedures and advise them that they are expected to be familiar with these policies and procedures. Rulings and interpretations of the AICPA, (state) CPA Society, (state) Board of Accountancy, state statutes, the Securities and Exchange Commission and other regulatory agencies under which we practice are referred to in the personnel manual.

2. Independence of mental attitude is emphasized during training sessions and in the supervision and review of engagements.

3. Our client list, which is periodically updated, is reviewed by all partners and professional employees to ensure that they are aware of those entities to which our independence policies apply. The executive partner is responsible for maintenance and distribution of the list.

4. The firm's library contains professional, regulatory, and firm literature relating to independence matters.[2]

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[2] The appropriate information may be found in *AICPA Professional Standards*, volume 2, in regulation S-X and Accounting Series Releases of the Securities and Exchange Commission, rulings and interpretations of the state CPA societies, the state boards of accountancy, and state statutes.

c. **Independence is confirmed when another firm is engaged to perform a segment of an engagement for which we are the principal auditor.**

1. The form and content of the independence representation that is to be obtained from a firm that has been engaged to perform segments of an engagement is part of the firm's accounting and auditing manual. (See AAM section 11,500.02.)

2. An annual representation of independence should be obtained from an affiliate or associate firm on a repeat engagement.

d. **Compliance with policies and procedures relating to independence is monitored.**

1. Confirmations are obtained annually (See AAM section 11,500.01 for an example of an Independence Checklist for Employees.) by the administrative partner from personnel and upon employment from newly hired personnel confirming that—
   (i) They are familiar with our firm's independence policies and procedures.
   (ii) Prohibited investments are not held and were not held during the period.
   (iii) Prohibited relationships do not exist.
   (iv) Transactions prohibited by the firm have not occurred.
2. The executive partner is responsible for the resolution of exceptions to the firm's independence policies and procedures.

3. The executive partner designates a partner to perform an annual review each July of the independence compliance files for completeness and the firm's independence policies and procedures for compliance with professional standards. A report of findings is presented to all the partners.

4. Accounts receivable that are past due are reviewed monthly by the executive partner to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

.03 Assigning Personnel to Engagements

a. **Our firm's approach to assigning personnel includes the planning of overall firm needs and the measures employed to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization.**

1. On a quarterly basis all partners submit to the administrative partner a projection containing anticipated manpower requirements for engagements during the coming quarter for which they have client responsibilities. (See AAM section 11,500.03 for an example of a form which may be used for this purpose.) Such projections are detailed as to number and classification of individuals required and are supported by preliminary engagement time estimates. The administrative partner prepares a summary schedule of assignments to be made for approval by the partners.

2. For every engagement where the anticipated time exceeds ten man-days, a time budget is normally prepared under the direction of the engagement partner at least a month prior to the scheduled commencement of field work. Time budgets for smaller engagements are prepared as considered necessary by the engagement partners. The budgets provide detail as to appropriate staff level and time required by function such as cash, accounts receivable, inventory, and so forth.

3. The engagement partner considers the following factors to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization:
   (i) Engagement size and complexity

(ii) Personnel availability

(iii) Special expertise required

(iv) Timing of the work to be performed

(v) Continuity and periodic rotation of personnel

(vi) Opportunities for on-the-job training

b. **The administrative partner is responsible for assigning personnel to engagements.**

1. Before the assignment of a professional employee to an engagement, the following criteria are considered:

   (i) Staffing and timing requirements of the specific engagement.

   (ii) Evaluation of the qualifications of personnel as to experience, position, background, and any special expertise possessed. (See AAM section 11,500.04.)

   (iii) The planned extent of supervision and involvement by managers and partners.

   (iv) Projected time availability of individuals assigned.

   (v) Situations where possible independence problems and conflicts of interest may exist, such as assignment of personnel to engagements for clients who are former employers or employers of certain kin.

2. The administrative partner attempts to achieve a balance between the need for continuity and for periodic rotation of personnel.

c. **The engagement partner approves the scheduling and staffing of the engagement.**

1. The names of personnel assigned to an engagement are submitted to the engagement partner for approval.

2. The engagement partner considers the experience and training of the assigned personnel in relation to complexity or other engagement requirements, and the extent of supervision to be provided.

3. Unresolved assignment conflicts between an engagement partner and the administrative partner are resolved by the executive partner.

.04 Consultation

a. **Areas and specialized situations where consultation is required are identified, and personnel are encouraged to consult with or use authoritative sources on complex or unusual matters.**

1. All personnel are advised of our firm's consultation policies and procedures. These policies and procedures are incorporated into the firm's accounting and auditing manual.

2. A listing of certain areas or specialized situations, which because of the nature or complexity of the subject have been identified as requiring consultation, is updated semiannually by the administrative partner for inclusion in the accounting and auditing manual. The following areas and situations receive special consideration in preparing the list:

   (i) Application of newly issued technical pronouncements.

   (ii) Industries with special accounting, auditing, or reporting requirements.

   (iii) Emerging practice problems.

   (iv) Choices among alternative generally accepted accounting principles when an accounting change is to be made.

   (v) Filing requirements of regulatory agencies.

3. A technical reference library is maintained to assist personnel in resolving practice problems. The administrative partner is charged with the responsibility of reviewing semiannually the library contents and making necessary additions.

4. Supervisory personnel are encouraged to seek advice from partners and managers the firm has designated as specialists in particular areas when confronted with a situation in the specialist's area of expertise.

5. When expertise is not available within the firm, a practice question or problem is referred by the engagement partner to the Technical Information Service of the AICPA or the (state) CPA Society established to handle technical inquiries.

6. We maintain a consultation agreement with the local office of (firm name) CPAs to provide our firm with additional expertise. Inquiries to that firm are channeled through the administrative partner.

7. The results of outside consultation are reviewed by the engagement partner and the executive partner before a decision is reached on the matter in question.

8. An example of a log which can be utilized to maintain a listing of consultations is shown in AAM section 11,500.07. This log can be put in the workpapers to document consultants utilized on the engagement as well as to maintain control for follow-up documentation from the specific consultant used.

9. An example of a worksheet which can be used to document the consultations with specialists is shown in AAM section 11,500.08.

b. **Specific individuals are designated as having specialized experience and expertise in certain technical areas. These individuals are available for consultation to all personnel.**

1. A listing of firm designated specialists together with their particular expertise is updated semiannually and included in the accounting and auditing manual.

2. The following procedures are used to resolve differences of opinion on practice problems:
   (i) Differences of opinion between a professional employee and an engagement partner are brought before the appropriate designated specialist.
   (ii) If the specialist agrees with the engagement partner, the matter is considered resolved.
   (iii) If the specialist disagrees with the engagement partner and they are unable to agree on an appropriate resolution, the executive partner is consulted.

3. The engagement partner is responsible for the preparation of a memorandum documenting the considerations involved in the resolution of differences of opinion. The original of the memorandum is filed with the engagement working papers and a reference copy without identification of the client is placed in the subject file maintained in the library. Any party to the discussion who disagrees with the conclusion has the option of preparing a memorandum and filing it with the working papers.

c. **In situations where firm policy requires consultation with specialists, a summary of the consultation conclusions and the reasons for the conclusions is required.**

1. The accounting and auditing manual is used to inform personnel of the extent of documentation required and the responsibility for its preparation. (See AAM section 11,500.07.)

2. Consultation worksheets (see AAM section 11,500.08) are filed with the engagement working papers, and a copy is placed in the subject file maintained in the library under the supervision of the administrative partner. The subject file is maintained in the event that similar questions arise in connection with the same topics.

.05 Supervision

a. **All engagements are adequately planned by persons knowledgeable about the client and/or the type of engagement.** (For additional information on planning, review AAM section 3000.)

1. For all annual recurring audit and accounting engagements where the anticipated manpower requirement is in excess of ten man-days, the in-charge accountant or manager reviews with the engagement partner the following documents from the prior year's files (as applicable) to determine if modifications are appropriate:
   (i) Engagement letter
   (ii) Time budget completed with actual time expended
   (iii) Evaluation of the internal control structure
   (iv) Audit or work program
   (v) Engagement memorandums
   (vi) Financial statements and accountant's report
   (vii) Management letters
   (viii)Planning memorandum
2. On all engagements in excess of ten man-days, new engagements, and special engagements, the in-charge accountant or manager submits to the engagement partner the following, where applicable, for his written approval:
   (i) Engagement letter
   (ii) Time budget
   (iii) Preliminary evaluation of the internal control structure
   (iv) Audit or work program
   (v) A memorandum stating the manpower requirements (including the need for specialized knowledge), current economic conditions affecting the client or its industry, and any other special problems that may have an impact on the conduct of the engagement
   (vi) Planning memorandum

b. **Procedures are provided for maintaining the firm's standards of quality for the work performed.**

1. Depending upon each individual's background in relationship to his assignment, varying degrees of supervision are provided by proper engagement staffing. (See AAM section 11,500.04.)
2. Each staff member receives an accounting and auditing manual upon joining the firm and is responsible for the proper filing of updates as they are issued.
3. Differences of opinion among staff members working on an engagement are brought to the attention of the engagement partner. If the partner agrees with the senior party in the dispute, the matter is considered resolved. If no resolution is made, the executive partner is consulted. Any party to the discussion who disagrees with the conclusion has the option of preparing a memorandum and filing it with the working papers.

c. **All engagement working papers and reports are reviewed by appropriate supervisory personnel prior to issuance of the report.** (For additional information on Supervision, review AAM section 9000.)

1. The in-charge accountant and/or manager reviews and initials all working papers he did not prepare (including those prepared by a partner). The engagement partner reviews the overall

engagement (initialing all working papers not reviewed by a manager and working papers dealing with difficult and complex subjects) including financial statements and accountant's report, and discusses with the in-charge accountant or manager any critical audit areas and unusual accounting matters encountered during the course of the engagement. This discussion is documented by a memorandum when appropriate.

2. In certain circumstances (as enumerated at AAM section 11,200.09 item *a*.4 prior to the issuance of the financial statements and the auditor's report thereon, a second partner not otherwise associated with the engagement evaluates the appropriateness of financial statement disclosures and the auditor's report in relation to the material discussed in the engagement partner's memorandum.

.06 **Hiring**

a. **The firm maintains a program designed to obtain qualified personnel by planning for personnel needs, establishing hiring objectives, and setting qualifications for those involved in the hiring function.**

1. The administrative partner and the executive partner plan (at least annually) the firm's long-range personnel objectives. Current clientele, anticipated growth, personnel turnover, individual advancement, and retirement are among the factors considered. This plan considers the number and qualifications of personnel as well as the sources and methods for obtaining personnel who meet the requirements and guidelines set by the firm.

2. The administrative partner is responsible for employment decisions.

b. **Our firm has established qualifications and guidelines for evaluating potential hirees at each professional level.** (See AAM section 11,500.09 for an example of a Pre-Employment Application which can be used to determine the individual's qualifications and AAM section 11,500.10 for an example of an Interview Report which can be used to document the interviewer's comments about individuals interviewed for positions within the firm.)

1. Our firm seeks to employ individuals who possess high levels of intelligence, integrity, honesty, motivation, and aptitude for the profession.

2. Our firm normally employs college and business college graduates with a concentration in accounting as full-time permanent members of our professional and paraprofessional staff.

3. Newly employed staff members are from the top half of their college class, unless other factors such as personal achievements, work experience, and personal interests indicate the likelihood of adequate professional development.

4. Our firm requires that a professional staff applicant have the academic background that will enable him to meet the academic requirements to sit for the CPA examination as administered by the (state) Board of Accountancy.

5. The approval of the executive partner is required before making an employment offer in atypical situations, such as hiring relatives of personnel or clients, rehiring former employees, or hiring clients' employees.

6. The background of new employees is appropriately investigated to reasonably assure hiring persons with acceptable qualifications, by obtaining completed application forms, college transcripts, and personal references.

7. Applicants for positions above entry level are interviewed and approved by the executive partner in addition to the administrative partner before an employment decision is made.

c. **Applicants and new personnel are informed of the firm's policies and procedures relevant to them.**

1. The firm's personnel policies and procedures relevant to applicants are communicated to them before offers of employment are extended.

2. The administrative partner maintains and distributes to all personnel a personnel manual describing policies and procedures.

3. The administrative partner discusses the firm's personnel policies and procedures with new employees.

.07 Professional Development

a. **Guidelines and requirements have been established for the firm's professional development program and are communicated to all personnel.**

1. The administrative partner is responsible for the formulation and implementation of firm policy regarding the guidelines and requirements for the firm's professional development programs.

2. As part of their orientation, newly employed personnel are informed of their professional responsibilities and opportunities by the administrative partner.

3. Newly employed personnel with limited experience are sent to introductory level training sessions of the AICPA or the (state) CPA Society during their first year of employment with our firm.

4. Each partner and professional employee is required to complete a minimum of 40 hours of continuing professional education each year. (Firms should determine the specific requirements of their State Board of Accountancy.) Personnel complete the record of professional development form and forward it to the administrative partner. (See AAM section 11,500.11.) The administrative partner is responsible for having the personnel files of each partner and professional employee updated to include a current record of hours of professional development completed. (See AAM section 11,500.12 and .13.) The types of programs qualifying for the fulfillment of the 40-hour requirement include—
   (i) Continuing professional education programs of the AICPA and the (state) Society of CPAs. This includes both sessions attended and cassette/workbook or workbook programs, as long as there is written evidence of completion.
   (ii) College courses related to the profession.

5. Personnel are reimbursed for membership dues paid to the AICPA, the (state) Society of CPAs and our local chapter of the state society.

6. Personnel are encouraged to serve on state society or AICPA committees, write articles for professional publications, serve as discussion leaders at professional development seminars, give speeches, and so forth.

7. The executive partner annually reviews the firm's professional development program (including personnel participation records) to determine whether it is adequately meeting the firm's needs, providing for the professional growth of individuals, and meeting mandatory continuing education requirements. An annual report is made to the partners.

b. **Information about current developments in professional technical standards and materials containing the firm's technical policies and procedures are made available to personnel. Personnel are encouraged to engage in self-development activities.**

1. It is the responsibility of the administrative partner to distribute information about current developments in accounting and auditing to all personnel who do not receive them directly. This

distribution includes statements and interpretations issued by the Financial Accounting Standards Board, Governmental Accounting Standards Board, the AICPA Auditing Standards Board, and other AICPA technical committees.

2. Pronouncements relating to areas of specific interest, such as those issued by the Securities and Exchange Commission, Internal Revenue Service, and other regulatory agencies are distributed by the appropriate specialist to persons who have responsibilities in such areas.

3. The administrative partner, as the firm's lead technician, is responsible for maintaining an accounting and auditing manual containing firm policies and procedures on technical matters. Updates are prepared and issued to the staff as new developments and conditions arise.

4. The firm does not, at present, conduct formal in-house training programs other than in specialized areas. However, from time to time personnel participate in the training programs of the AICPA and (firm name) CPAs.

5. A library of staff training cassette/workbook programs published by the AICPA and (state) Society of CPAs is maintained by the administrative partner for self-study and reference purposes and is available to all personnel.

c. **The firm provides programs to fill its needs for personnel with expertise in specialized areas and industries.**

1. The administrative partner is responsible for arranging in-house programs on SEC matters, cost accounting, and municipal accounting for personnel involved in these areas.

2. Individuals designated as having specialized experience and expertise are encouraged to maintain their proficiency by joining appropriate professional associations and attending external professional education programs.

3. The firm will pay for memberships in organizations concerned with specialized areas or industries in which the firm is engaged or intends to become engaged.

4. The administrative partner is responsible for maintaining technical literature on specialized areas and industries.

d. **The firm recognizes that on-the-job training accounts for a significant part of professional development.**

1. Personnel with in-charge responsibility on engagements—
   (i) Discuss with assistants the relationship of the work they are performing to the engagement as a whole.
   (ii) Permit assistants, when practicable, to become involved in areas of the engagement other than those previously assigned.
   (iii) Explain to assistants the reasons for any additional work requirements discovered through the review process.

2. Personnel are evaluated in part on their effectiveness to properly train and develop subordinates.

3. The administrative partner monitors assignments to determine that personnel are—
   (i) Fulfilling, where applicable, the experience requirement of the (state) Board of Accountancy.
   (ii) Gaining experience in various areas of engagements and varied industries.
   (iii) Working under different supervisory personnel.

.08 **Advancement**

a. **Our firm has established qualifications deemed necessary for the various levels of responsibility within the firm.**

1. The levels of responsibility that are inherent in the various staff classifications are clearly defined. Our firm has provided for the following staff classifications.[3]
   (i) Manager
   (ii) In-charge accountant
   (iii) Staff assistant
2. The criteria which are considered in evaluating individual performance and expected proficiency are enumerated in our staff classification guidelines contained in the personnel manual.
3. Our firm's personnel manual provides the staff with information regarding the firm's advancement policies and procedures. The administrative partner issues updates from time to time to reflect changes made by the partnership in the policies and procedures.

b. **The performance of our personnel is continuously evaluated, and personnel are periodically advised of their progress. Personnel files are maintained containing documentation relating to the evaluation process.**

1. Professional employees assigned to an engagement for a period in excess of five days must be evaluated by their immediate superior on the engagement by use of an evaluation form. (See AAM section 11,500.14 and .15 for examples of Evaluation Forms, which may be used for periodic evaluation of staff members. The differences in the forms relate to the amount of time spent on a particular engagement. For example, if a staff member spends 40 or more hours on an engagement a more thorough evaluation can usually be performed (AAM section 11,500.14). AAM section 11,500.16 would be utilized to evaluate the management skills of the individual being evaluated and therefore does not include specific duties relating to the assignment of work performed.) These evaluation forms are reviewed with the employee at the end of the engagement and are approved by the engagement partner.
2. Personnel are assigned to engagements in a manner that assures they will be reviewed by several people during the course of a year.
3. Personnel with the responsibility for the preparation of evaluations are counseled (at least annually) by the administrative partner to ensure that they understand the firm's objectives.
4. All professional employees receive an evaluation of their performance at least once a year. Such counseling interviews are conducted by the administrative partner. These evaluations summarize the evaluations received on engagements during the year. The individual's progress, strengths, weaknesses, future objectives, and the firm's future objectives are among the items discussed. The interviews are documented in each individual's personnel file.
5. Annually, each partner completes a partner evaluation form evaluating each of the partners, including himself. The completed forms are submitted to the executive partner who summarizes and reviews them with each partner.
6. The executive partner or his designee reviews (each August) the system of personnel evaluation and counseling to ascertain that—
   (i) Procedures for evaluation and documentation are being followed on a timely basis.
   (ii) Requirements established for advancement are being met.
   (iii) Personnel decisions are consistent with evaluations.
   (iv) Recognition is given to outstanding performance.

   At the completion of the review, a report is made to the partners.

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[3] The description of the firm's professional levels, with the responsibilities for each level and the general length of time required for advancement to the next position, can be found in AAM section 11,200.11.

c. **Responsibility for making advancement decisions is assigned to specific individuals.**

1. The administrative partner is responsible for making advancement and termination recommendations, conducting the evaluation interviews, documenting the results of the interviews, and maintaining appropriate records.

2. The partners evaluate the above data and, after giving appropriate recognition to the quality of the work performed, make advancement decisions. The executive partner has the ultimate responsibility for making advancement decisions.

3. The executive partner studies the firm's advancement experience annually to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility. A report is made to the partners. This report includes the executive partner's opinion of the capabilities and progress of the staff.

.09 **Acceptance and Continuance of Clients**

a. **Our firm has established procedures for evaluation of prospective clients and for their acceptance as clients.** (See AAM section 11,500.18 for a New Client Acceptance Checklist, which can be used for prospective clients.)

1. Available financial information regarding the prospective client, such as annual reports, interim financial statements, reports to regulatory agencies, and income tax returns is obtained and reviewed. Registration statements and 10-K forms are obtained for public companies.

2. Inquiries about potential clients are made to bankers, attorneys, credit services, and others having business relationships with the company.

3. Predecessor auditors (if applicable) are contacted and inquiries are made in accordance with generally accepted accounting standards.

4. Consideration is given to circumstances that would cause the firm to regard the engagement as one requiring special attention or presenting unusual risks. These circumstances include—
   - (i) Audits of publicly held corporations
   - (ii) Audits where the expected man-hour requirement exceeds 300 hours
   - (iii) Audits of firms operating in high-risk industries, such as those industries where it is difficult to establish an adequate internal control structure or those industries whose operations are especially sensitive to general economic conditions
   - (iv) Audits of firms in the development stage
   - (v) Audits of firms in serious financial difficulty
   - (vi) Any of the conditions enumerated in *b.*1(iii)

5. The firm's independence and ability to adequately serve a potential client are evaluated prior to acceptance. In evaluating the firm's ability, consideration is given to the requirements for technical skills, knowledge of the industry, and availability of qualified personnel.

6. A review is made to ensure that acceptance of the client would not violate applicable regulatory agency requirements and the code of professional conduct of the AICPA and/or the (state) CPA Society.

7. Procedures for acceptance of a new engagement are as follows:
   - (i) The engagement partner assembles the information and evaluates all matters described in the previous paragraphs.
   - (ii) For all audit engagements, or engagements described in paragraph 4 above, the acceptance is to be approved in writing by the engagement partner and the executive partner.

(iii) All other engagements are to be approved in writing by the engagement partner and the administrative partner.

8. The administrative partner is responsible for administering the procedures for acceptance of clients. The executive partner performs an annual review for compliance with the firm's policies and procedures for acceptance of clients and makes a report to the partners.

b. **Clients are evaluated at the end of specific periods or upon the occurrence of certain events to determine whether the relationship should be continued.** (See AAM section 11,200.19 for a Client Evaluation Questionnaire which can be used for evaluating existing clients.)

1. Reevaluations are made of existing clients—
   (i) Annually, if any of the conditions mentioned in *a*.4 above exist.
   (ii) Every three years if none of the conditions mentioned in *a*.4 above exist.
   (iii) If there is a significant change in one or more of the following:
   - Management
   - Directors
   - Ownership
   - Legal counsel
   - Financial condition
   - Litigation status
   - Nature of client's business
   - Scope of the auditor's work

   (iv) Upon the emergence of conditions that would have caused the firm to reject a client had such conditions existed at the time of the initial acceptance.

2. The administrative partner is responsible for evaluating the information obtained, making continuance recommendations, and administering firm procedures for continuance of clients. If the administrative partner recommends discontinuance or if any of the conditions enumerated in *b*.1(iii) above or (iv) above exist, all partners participate in the continuance decision.

3. The executive partner performs an annual review to test for compliance with the firm's policies and procedures for continuance of clients and makes a report to the partners.

.10 Inspection

a. **The firm conducts an inspection program regarding its quality control policies and procedures.** (See AAM section 11,500.20 for a Summary Inspection Report, which can be used to document the results of a firm's yearly quality review inspection and AAM section 11,500.21 for an Inspection of Compliance with Policies and Procedures Relating to Elements of Quality Control.)

1. Each year a partner and a manager not otherwise directly involved in firm administration are appointed by the executive partner as an inspection team to evaluate the firm's quality control policies and procedures for compliance with professional standards.

2. The appointed partner and manager obtain reasonable assurance that quality control policies and procedures are being complied with by—
   (i) Inquiring of persons responsible for a function or activity.
   (ii) Reviewing selected administrative and personnel files.
   (iii) Reviewing selected engagement working paper files and reports (described below).
   (iv) Reviewing other evidential matter.

3. A sample of engagements is selected annually from each partner's and manager's client listing and is given an in-depth review by the inspection team. The administrative partner reviews engagements of the partner and manager involved in the inspection process to ensure that a representative sample of engagements from all partners and managers has been selected. The working papers and reports are reviewed for compliance with professional standards, including generally accepted auditing standards, generally accepted accounting principles, and the firm's quality control policies and procedures.

4. The executive partner annually selects a representative report to be submitted for review to the practice review committee of the (state) Society and/or the AICPA.

5. Every third year the firm has a quality review. The executive partner is responsible for scheduling this review. This review takes the place of the firm's annual inspection.

b. **Provision is made for reporting inspection findings to the appropriate management levels and for monitoring actions taken or planned.**

1. The results of engagement reviews are discussed with the supervisory personnel responsible for the engagement.

2. Inspection findings and recommendations are reported to the partners by the inspection team together with corrective actions taken or planned. A memo outlining the findings and recommendations is prepared by the inspection team and is retained by the executive partner.

3. The executive partner has the responsibility to determine that planned corrective actions were taken and to report the extent of compliance to all the partners.

.11 Description of the Firm's Professional Levels

Level	*Approximate Time Frame*
Staff Assistant	
Level 1	First year (0 to 1)
Level 2	Second year (1 to 2)
In-Charge Accountant	Third, fourth, fifth (3 to 5)
Audit Manager	Sixth through tenth year (6 to 10)
Partner	After the tenth year

Staff Assistant (Level 1). A Level 1 staff assistant is expected to—

- Work on portions of audit and accounting engagements.
- Become familiar with the contents of the firm manuals.
- Know the rules, regulations, and code of conduct of the AICPA and the (state) Society of CPAs.
- Be familiar with the pronouncements of the Financial Accounting Standards Board (FASB) and the AICPA, such as the Statements on Auditing Standards (SASs) and Accounting Principles Board Opinions (APBs).
- Progress professionally by working toward passing the CPA examination as soon as possible.

Staff Assistant (Level 2). A Level 2 staff assistant should be able to—

- Assume full responsibility under supervision for small accounting engagements involving unaudited financial statements.
- Work on more involved portions of large audit and accounting engagements.
- Prepare financial statements.

In-Charge Accountant. An in-charge accountant is expected to—

- Assume full responsibility for small and medium-size audit engagements requiring the services of one or two people and large accounting engagements involving unaudited financial statements.
- Work on (and research) assignments involving "theory" and such "conceptual" areas as materiality and interrelationships of accounts.
- Review and analyze internal control.
- Prepare audit programs and time budgets.
- Prepare management letters.
- Train and supervise the staff assistants assigned to the engagement.
- Recognize, in advance, the possible problem areas of an engagement.
- Pass the CPA examination, if not already certified.

Manager. A manager is a CPA and is expected to—

- Assume full responsibility for large audit assignments falling within his expertise.
- Supervise the assignment of duties to, and the training of, personnel assigned to the engagement.
- Supervise a number of engagements at one time.
- In connection with engagements, be responsible for personnel scheduling, compliance with due dates, and monitoring time budgets.
- Adequately review all working papers and the completed reports to ascertain that both meet firm standards.
- Resolve all problems prior to the submission of the report for final partner review.
- Communicate firm policies and technical information to accounting and auditing personnel through individual or group meetings.
- Motivate and assist staff in their professional development.
- Represent the firm in professional and service organizations.
- Develop the firm's reputation and his own through conducting seminars, making speeches, and the like.
- Assist partners with practice development and practice management.

.12 Stated Objectives of Firm (Philosophy)

A particular firm's stated objectives may include items such as the following:

a. Concern for the general public interest.

b. Concern for the financial well-being of clients.

c. Reinvestment of the firm's profits in the training and advancement of the firm's partners and staff.

d. Growth plans for the firm, including opening of branch offices, annual billings, and staff size.

e. Development of specialties such as auditing governmental units or concentration in particular fields— agriculture, retail, and so forth.

f. Development of other services, such as a computer data processing center.

g. Centralization (or decentralization) of authority for issuance of reports.

h. Degree of operating autonomy for individual practice offices.

i. Extent of autonomy for partners.

j. Pattern for firm growth—internal growth through acquisitions of clients and growing apace with them or growth through mergers with other accounting firms.

[*The next page is 11,301.*]

AAM Section 11,300

Sample Quality Control Document for a Sole Practitioner CPA Firm Without Full-Time Staff—Prior to 1/1/97 Effective Date of SQCS Nos. 2 and 3

.01 Firm Background Information

My firm was founded in 19XX after I had gained several years' experience with a local CPA firm. A secretary and a student from the local university are employed on a part-time basis during the busy season.

My objective is to provide quality service in accounting, auditing, income tax, and financial advisory capacities to small businesses in my community. I do not serve publicly held companies, nor do I plan to do so. It is anticipated that the firm's future growth will be through expanded service to present clients and the addition of new clients.[1] I intend to hire and train personnel as needed.

My practice is conducted from one office and consists of five audit engagements, for which we are the sole auditors, twelve unaudited financial statement engagements, and fifteen clients for which my firm provides other accounting services.

May 31, 19XX

.02 Independence

Any part-time staff and I are required to adhere to the independence rules, regulations, interpretations, and rulings of the AICPA, (state) CPA Society, (state) Board of Accountancy, and state statutes.

a. I communicate with the AICPA and/or the (state) CPA Society for assistance, if needed, in resolving independence questions. (See AAM section 11,500.07 for an example of a log which can be utilized to document all communication with parties outside the firm. Also, see AAM section 11,500.08 for a Consultation Worksheet, which can be used to document the subject matter as well as the response from the consultant.

b. My part-time staff complete an independence checklist for employees when they are hired. The purpose of the checklist is to determine the part-time staff member's independence and to document the same.

c. A memorandum documenting the resolution of independence questions is prepared and retained. My part-time employee reviews and initials the memorandum if the question relates to his independence.

d. Accounts receivable that are past due are reviewed monthly to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

e. Our library contains professional, regulatory, and firm literature relating to independence matters.[2]

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[1] Additional considerations for establishing a firm's stated objectives are discussed in AAM section 11,300.11.

[2] The appropriate information may be found in *AICPA Professional Standards*, volume 2, and in rulings and interpretations of the state CPA societies, the state boards of accountancy, and state statutes.

.03 Assigning Personnel to Engagements

Assignment of personnel includes the planning of overall firm needs and the measures employed to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization.

On an annual basis, normally in October of each year, I develop a projection of anticipated manpower requirements to determine if I will need additional staff during the coming year. This is performed by utilizing a "Client History of Staff Assignments" (AAM section 11,500.05) which lists by client the amount of time expended in prior years. (It should be noted that the form in AAM section 11,500.05 can be adapted to be used for a sole practitioner as well as a large firm.)

.04 Consultation

a. **Areas and specialized situations where consultation is required are identified, and personnel are encouraged to consult with or use authoritative sources on complex or unusual matters.**

1. A technical reference library is maintained, and I have made arrangements to use the libraries of other practicing CPAs. The AICPA library is also used on a frequent basis.

2. When presented with a practice question or problem that I may lack the particular expertise to resolve, I refer to the Technical Information Service of the AICPA or the (state) CPA Society established to handle technical inquiries, or I may confer with another CPA who has expertise in the area.

b. **In those areas and specialized situations where firm policy requires consultation with specialists, a summary of the consultation conclusions and the reasons for the conclusions is required.** (See AAM section 11,500.08.)

Consultation summaries are filed with the engagement working papers. (See AAM section 11,500.07.)

.05 Supervision

a. **All engagements are adequately planned, and procedures are provided for maintaining the firm's standards of quality for the work performed.** (For additional information on Planning, review AAM section 3000.)

1. On all recurring engagements, I annually review the following documents from the prior year's files, as applicable, to determine if modifications are appropriate:

   (i) Engagement letter

   (ii) Time budget compared with actual time expended

   (iii) Evaluation of the internal control structure

   (iv) Audit or work program

   (v) Engagement notes and memorandums

   (vi) Financial statement and accountant's report

   (vii) Management letters

   (viii) Planning memorandum

   The foregoing items are prepared, where applicable, for new and special engagements, and a memorandum is prepared stating special problems, if any, that have an impact on the conduct of the engagement.

2. Copies of forms, checklists, and questionnaires are available for use on engagements.

b. **All engagement working papers and reports are reviewed prior to issuing the report.** (For additional information on Supervision, see AAM section 9000.)

1. I review and initial the work of my part-time employee.

2. I review and initial my own work after waiting at least until the following day.

3. Checklists are utilized for reviewing engagement working papers and reports.

.06 Hiring

a. **The firm endeavors to obtain qualified personnel and has established qualifications and guidelines for evaluating potential hirees.** (See AAM section 11,500.09 for an example of a Pre-Employment Application which can be used to determine the individual's qualifications and AAM section 11,500.10 for an example of an Interview Report which can be used to document the interviewer's comments about individuals interviewed for positions within the firm.)

1. During my busy season, I normally employ a college senior who has completed substantially all of the accounting curriculum course requirements for graduation.

2. I interview potential employees and appropriately investigate their backgrounds to reasonably assure my hiring persons with acceptable qualifications.

b. **New personnel are informed of the firm's policies and procedures relevant to them.**

A copy of this quality control document is presented to newly hired personnel.

.07 Professional Development

a. **I have an annual professional development requirement.**

1. I am a member of the AICPA and the (state) CPA Society and participate in professional activities.

2. I complete a minimum of 40 hours of formal continuing professional education each year in areas related to my practice. (Firms should determine the specific requirements of their State Board of Accountancy.) A record of professional development hours is maintained, updated, and periodically reviewed. (See AAM section 11,500.11.) The types of programs qualifying for the fulfillment of the forty-hour requirement include—

   (i) Continuing professional education programs of the AICPA and the (state) CPA Society. These include sessions attended and, with written evidence of completion, cassette/workbook, or workbook programs.

   (ii) College courses related to the profession.

b. **Information about current developments in professional technical standards and materials containing the firm's technical policies and procedures are made available to personnel.**

I receive and review statements relating to current developments in accounting and auditing including statements and interpretations issued by the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the AICPA Auditing Standards Board, and other AICPA technical committees.

c. **On-the-job training accounts for a significant part of professional development.**

I provide for on-the-job training by discussing with my part-time employee the relationship of his work to the engagement as a whole. Also, during my review of working papers prepared by my part-time employee, I explain the need for any additional work requirements discovered through the review process.

.08 Advancement

The element of advancement is inapplicable because the firm uses only part-time staff.

.09 Acceptance and Continuance of Clients

a. **Procedures are established for evaluation of prospective clients and for their acceptance as clients.** (See AAM section 11,500.18 for a New Client Acceptance Checklist which can be used for prospective clients.)

1. I obtain and review available financial information regarding the prospective client (such as annual and interim financial statements and income tax returns).

2. I make inquiries about potential clients to bankers, attorneys, credit services, and others having business relationships with the company.

3. I contact predecessor auditors, where applicable, and make inquiries in accordance with generally accepted auditing standards.

4. I consider circumstances that would cause the firm to regard the engagement as one requiring special attention or presenting unusual risks. These circumstances include the following:
   (i) Audits where the expected man-hour requirement exceeds seventy-five hours
   (ii) Audits of firms operating in high-risk industries, such as those industries where it is difficult to establish an adequate internal control structure or those industries whose operations are especially sensitive to general economic conditions
   (iii) Audits of firms in the development stage
   (iv) Audits of firms in serious financial difficulty
   (v) Audits of firm's experiencing change in any of the following: management or ownership, legal counsel, financial condition, litigation status, nature of business, or scope of engagement

5. I evaluate the firm's independence and ability to adequately serve a potential client. In evaluating the firm's ability, I give consideration to the requirements for technical skills, knowledge of the industry, and personnel.

6. A review is made to ensure that acceptance of the client would not violate applicable regulatory agency requirements and the code of professional conduct of the AICPA and/or the (state) CPA Society.

7. I assemble, evaluate, and document the items listed above before making an acceptance decision.

b. **Clients are evaluated at the end of specific periods or upon the occurrence of certain events to determine whether the relationship should be continued.** (See AAM section 11,500.19 for a Client Evaluation Questionnaire, which can be used for evaluating existing clients.)

1. Reevaluations of existing clients are made—
   (i) Annually, if any of the conditions mentioned in *a*.4 above exist.
   (ii) Every three years if none of the conditions mentioned in *a*.4 above exist.
   (iii) Upon the emergence of conditions that would have caused me to reject a client had such conditions existed at the time of the initial acceptance.

2. I prepare an annual memorandum documenting the evaluations.

.10 Inspection

a. **The firm conducts an inspection program regarding its quality control policies and procedures.** (See AAM section 11,500.20 for a Summary Inspection Report, which can be used to document the results of a firm's yearly quality review inspection, and AAM section 11,500.21 for an Inspection of Compliance With Policies and Procedures Relating to Elements of Quality Control.)

Each year, I evaluate the firm's quality control policies and procedures for compliance with professional standards by use of AICPA and/or (state) Society checklists. This procedure includes a review of administrative, personnel, and engagement files sufficient to obtain reasonable assurance that quality control policies and procedures are being complied with. An inspection program is not conducted during the year in which the firm has a quality review.

b. **The firm adheres to the quality control standards that have been established by the AICPA.**

Every three years there is a quality review of the firm's accounting and auditing practice. This review is performed by either a peer firm qualified to perform the review or a team assembled by the AICPA or state society of CPAs.

c. **Provision is made for reporting inspection findings and for monitoring actions taken or planned.**

I evaluate inspection findings and recommendations together with suggested corrective actions and prepare and retain a memorandum documenting that the inspection has been performed. Appropriate corrective actions, if any, are taken.

.11 Stated Objectives of Firm (Philosophy)

A particular firm's stated objectives may include items such as the following:

a. Concern for the general public interest.

b. Concern for the financial well-being of clients.

c. Reinvestment of the firm's profits in the training and advancement of personnel.

d. Growth plans including opening of branch offices, annual billings, and staff size.

e. Development of specialties such as auditing governmental units or concentration in particular fields—agriculture, retail, and so forth.

f. Development of other services such as a computer data processing center.

g. Pattern for firm growth—internal growth through acquisitions of clients and growing apace with them or growth through mergers with other accounting firms.

[*The next page is 11,401.*]

AAM Section 11,400

Sample Quality Control Document for a Sole Practitioner CPA Firm With Full-Time Staff—Prior to 1/1/97 Effective Date of SQCS Nos. 2 and 3

.01 Firm Background Information

The firm was founded in 19XX after the proprietor gained several years' experience with a local CPA firm. Presently, our full-time staff consists of two professional employees and a secretary. One per diem accountant is hired during the busy season. An accounting student and a secretary are available on a part-time basis, as needed.

The firm's objectives are to—

- Provide high-quality accounting, auditing, tax, and management advisory services to growth-oriented companies in our geographic area.
- Serve clients with outstanding business potential and to help each company reach its maximum potential through sound and efficient accounting, financial, and management advice.
- Be actively involved in professional, business, community, and civic affairs.
- Offer close, personalized service on a timely basis.

In order to achieve these goals and objectives, the firm seeks to grow through a combination of expanded service to present clients and the addition of new clients on a regular basis.[1]

Our practice is conducted from one office, and our clientele, consists of retail establishments, manufacturing companies, service companies, and nonprofit organizations.

May 31, 19XX

.02 Independence

a. **All personnel are required to adhere to the independence rules, regulations, interpretations, and rulings of the AICPA, (state) CPA Society, (state) Board of Accountancy, and state statutes.**

1. Mr. (practitioner) is responsible for resolving questions relating to independence matters and is available to provide guidance when required.
2. Mr. (practitioner) communicates with the AICPA and/or the (state) CPA Society for assistance in resolving independence questions that are not satisfactorily resolved within the firm. (See AAM section 11,500.07 for an example of a log, which can be utilized to document all communication with parties outside the firm. Also see AAM section 11,500.08 for a Consultation Worksheet, which can be used to document the subject matter, as well as the response from the consultant.)

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[1] Additional considerations for establishing a firm's stated objectives are discussed in AAM section 11,400.11.

3. A memorandum documenting the resolution of independence questions is prepared and retained by Mr. (practitioner); the other firm personnel review and initial the memorandum if the question relates to their independence.

b. **Policies and procedures relating to independence are communicated to all personnel.**

1. Memorandums are used to inform personnel of the firm's independence policies and procedures and advise them that they are expected to be familiar with those policies and procedures. Rulings and interpretations of the AICPA, (state) CPA Society, (state) Board of Accountancy, and state statutes are also made available to personnel.
2. An independent mental attitude is emphasized during the conduct of engagements.
3. I review the current client listing with each new employee to ensure that the employee is aware of those entities to which independence policies apply. During the monthly staff meeting, the staff is informed of any changes in the listing.
4. Our library contains professional, regulatory, and firm literature relating to independence matters.[2]

c. **Compliance with policies and procedures relating to independence is monitored.**

1. Annually, all staff members are required to complete a questionnaire (see AAM section 11,500.01), indicating that—
   (i) They are familiar with the firm's independence policies and procedures.
   (ii) They are not now nor have been holding prohibited investments.
   (iii) They are not now nor have been involved in relationships or transactions that are prohibited.
2. Mr. (practitioner) is responsible for the resolution of exceptions to the firm's policies and procedures relating to independence.
3. Accounts receivable that are past due are reviewed monthly by Mr. (practitioner) to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

.03 Assigning Personnel to Engagements

a. **Our firm's approach to assigning personnel includes the planning or overall firm needs and the measures employed to achieve a balance or engagement manpower requirements, personnel skills, individual development, and utilization.**

1. On an annual basis, normally in September of each year, Mr. (practitioner) develops a projection containing anticipated manpower requirements for the next year. (See AAM section 11,500.06.)
2. In scheduling assignments, Mr. (practitioner) strives to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization, taking into consideration—
   (i) Engagement size and complexity
   (ii) Personnel availability
   (iii) Special expertise required
   (iv) Timing of the work to be performed

[2] The appropriate information may be found in *AICPA Professional Standards*, volume 2, and in rulings and interpretations of the state CPA societies, the state boards of accountancy, and state statutes.

b. **Mr. (practitioner) is responsible for assigning personnel to engagements.** (See AAM section 11,500.04 and .05 for examples of forms which can be used to facilitate assigning personnel to specific engagements.)

1. Before the assignment of a professional employee to an engagement, Mr. (practitioner) considers the nature of the engagement, personnel availability, extent of supervision required, and possible independence problems or conflicts of interest.

2. To the extent practicable, Mr. (practitioner) attempts to achieve a balance between the need for continuity and for periodic rotation of staff.

.04 Consultation

a. **Areas and specialized situations where consultation is required are identified, and personnel are encouraged to consult with or use authoritative sources on complex or unusual matters.**

1. All personnel are advised of our firm's consultation policies and procedures. These policies and procedures are set forth in a memorandum.

2. Certain areas or specialized situations have been identified as requiring consultation because of their nature or complexity. They include the following:
   (i) Application of newly issued technical pronouncements.
   (ii) Industries with special accounting, auditing, or reporting requirements.
   (iii) Emerging practice problems.
   (iv) Choices among alternative generally accepted accounting principles when an accounting change is to be made.

3. A technical reference library is maintained, and arrangements have been made to use the libraries of other practicing CPAs. The resources of the AICPA library are drawn upon when needed.

4. When expertise is not available within the firm, practice questions and problems are referred by Mr. (practitioner) to the Technical Information Service of the AICPA or the (state) CPA Society established to handle technical inquiries.

5. We maintain a consultation agreement with the local office of (firm name) CPAs, to provide us with additional expertise. Inquiries to that firm are channeled through Mr. (practitioner).

b. **In those areas and specialized situations where firm policy requires consultation with specialists, a summary of the consultation conclusions and the reasons for the conclusions are required.**

1. The consultation policy memorandum is used to inform personnel of the consultation procedures, the extent of documentation required, and the responsibility for its preparation.

2. Consultation worksheets (see AAM section 11,500.08) are filed with the engagement working papers.

.05 Supervision

a. **All engagements are adequately planned.** (For additional information on Planning, review AAM section 3000.)

1. On all annual recurring engagements, the staff accountant reviews with Mr. (practitioner) (or Mr. (practitioner) reviews alone) the following documents from the prior year's files, as applicable, to determine if modifications are appropriate:
   (i) Engagement letter

(ii) Time budget compared with actual time expended

(iii) Evaluation of the internal control structure

(iv) Audit or work program

(v) Engagement notes and memorandums

(vi) Financial statements and accountant's report

(vii) Management letters

(viii) Planning memorandum

2. For all engagements (including annual recurring engagements, new engagements, and special engagements), the staff accountant submits to Mr. (practitioner) the following, where applicable, for his written approval, or Mr. (practitioner) prepares, where applicable, the following:

(i) Engagement letter

(ii) Time budget

(iii) Preliminary evaluation of the internal control structure

(iv) Audit or work program

(v) A memorandum stating the special problems, if any, that may have an impact on the conduct of the engagement

(vi) Planning memorandum

b. **Procedures are provided for maintaining the firm's standards of quality for the work performed.**

1. Depending upon each individual's background in relation to his assignment, varying degrees of supervision are provided.

2. Copies of forms, checklists, and questionnaires are available for use on engagements.

3. Differences of opinion among staff members working on an engagement are resolved by Mr. (practitioner). Any party to the discussion who disagrees with the conclusion has the option of preparing a memorandum and filing it with the working papers.

c. **All engagement working papers and reports are reviewed prior to issuance of the report.** (For additional information on Supervision, review AAM section 9000.)

1. The staff accountant reviews and initials all working papers he did not prepare (excluding those prepared by Mr. (practitioner)).

2. Mr. (practitioner) reviews the overall engagement (including his own working papers after waiting at least one day following their preparation) by completing a review checklist.

.06 **Hiring**

a. **The firm endeavors to obtain qualified personnel by planning for personnel needs and establishing hiring objectives.**

1. Mr. (practitioner) annually plans the firm's long-range personnel objectives. Current clientele, anticipated growth, personnel turnover, individual advancement, and retirement are among the criteria considered.

2. Mr. (practitioner) makes the employment decisions.

b. **Our firm has established qualifications and guidelines for evaluating potential hirees.** (See AAM section 11,600.09 for an example of a Pre-Employment Application which can be used to determine the individual's qualifications and AAM section 11,500.10 for an example of an Interview Report which can be used to document the interviewer's comments about individuals interviewed for positions within the firm.)

1. Our firm seeks to employ individuals with high levels of intelligence, integrity, honesty, motivation, and aptitude for the profession.

2. Our firm normally employs college and business college graduates with a concentration in accounting as full-time permanent members of its professional and paraprofessional staff. The following general criteria are considered in hiring decisions:

    (i) Academic background

    (ii) Personal achievements

    (iii) Work experience

    (iv) Personal interests

3. Our firm normally expects that a professional staff applicant have the academic background that will enable him to meet the academic requirements to sit for the CPA examination as administered by the (state) Board of Accountancy.

4. The backgrounds of potential employees are appropriately investigated to reasonably assure our hiring persons with acceptable qualifications by obtaining completed application forms, college transcripts, personal references, and employment references.

5. Potential employees are interviewed by Mr. (practitioner) who informs them about the firm.

c. **New personnel are informed of the firm's policies and procedures relevant to them.**

1. Mr. (practitioner) discusses the firm's personnel policies and procedures with new employees.

2. A copy of this quality control document is presented to newly hired personnel.

.07 Professional Development

a. **Guidelines and requirements have been established for the firm's professional development program and are communicated to all personnel.**

1. Mr. (practitioner) and any eligible staff members of the AICPA and the (state) CPA Society; they also participate in professional activities.

2. Mr. (practitioner) is responsible for the formulation and implementation of guidelines and requirements for professional development.

3. As part of their orientation, new employees are informed of professional responsibilities and opportunities by Mr. (practitioner).

4. Mr. (practitioner) and the full-time professional employees are required to complete a minimum of 40 hours of formal continuing professional education each year. (Firms should determine the specific requirements of their State Board of Accountancy.) Personnel complete the record-of-professional-development form (see AAM section 11,500.11) and forward it to Mr. (practitioner). He reviews the form and has it filed in the individual's personnel file. The types of programs qualifying for the fulfillment of the 40-hour requirement include—

    (i) Continuing professional education programs of the AICPA and the (state) CPA Society. This includes sessions attended and, with written evidence of completion, cassette/workbook or workbook programs.

(ii) College courses related to the profession.

5. Mr. (practitioner) annually reviews and approves the firm's professional development program (including personnel participation records) to determine whether it is adequately meeting the firm's needs, providing for the professional growth of individuals, and meeting mandatory continuing education requirements. (See AAM section 11,500.12 and .13.)

b. **Information about current developments in professional technical standards and materials containing the firm's technical policies and procedures are made available to personnel. Personnel are encouraged to engage in self-development activities.**

It is the responsibility of Mr. (practitioner) to distribute statements relating to current developments in accounting and auditing to all personnel not receiving them directly. This includes statements and interpretations issued by the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the AICPA Auditing Standards Board, and other AICPA technical committees.

c. **The firm recognizes that on-the-job training accounts for a significant part of professional development.**

1. Mr. (practitioner) provides for on-the-job training by discussing with the engagement staff the relationship of the work they are performing to the engagement as a whole. Also, during the review of working papers prepared by staff members, the proprietor explains the need for any additional work requirements discovered through the review process.

2. When practicable, professional employees are assigned to varying engagement areas.

3. Assignments are monitored to determine that personnel are fulfilling, where applicable, the experience requirements of the (state) Board of Accountancy.

.08 **Advancement**

a. **The performance of our personnel is continuously evaluated, and personnel are periodically advised of their progress. Personnel files are maintained containing documentation of the evaluation process.**

1. At least annually, all professional employees receive an evaluation of their performance. (See AAM section 11,500.14 and .15 for examples of Evaluation Forms which may be used for periodic evaluation of staff members. The differences in the forms relate to the amount of time spent on a particular engagement. For example, if a staff member spends 40 or more hours on an engagement a more thorough evaluation can usually be performed (AAM section 11,500.14). AAM section 11,500.16 would be utilized to evaluate the management skills of the individual being evaluated and therefore does not include specific duties relating to the assignment of work performed.) Such counseling interviews are conducted by Mr. (practitioner). These evaluations summarize performance on engagements during the year. The individual's progress, strengths, weaknesses, future objectives, and the firm's future objectives are among the items discussed.

2. Results of evaluations are documented in the individual's personnel file.

b. **Mr. (practitioner) makes advancement and termination decisions and documents the results.**

.09 **Acceptance and Continuance of Clients**

a. **Our firm has established procedures for evaluation of prospective clients and for their acceptance as clients.** (See AAM section 11,500.18 for a New Client Acceptance Checklist which can be used for prospective clients.)

1. Available financial information regarding the prospective client (such as annual and interim financial statements and income tax returns) is obtained and reviewed.

2. Inquiries about potential clients are made to bankers, attorneys, credit services, and others having business relationships with the company.

3. Where applicable, predecessor auditors are contacted, and inquiries are made in accordance with generally accepted auditing standards.

4. Consideration is given to circumstances that would cause the firm to regard the engagement as one requiring special attention or presenting unusual risks. These circumstances include the following:

   (i) Audits where the expected man-hour requirement exceeds ninety hours

   (ii) Audits of firms operating in high-risk industries, such as those industries where it is difficult to establish an adequate internal control structure or those industries whose operations are especially sensitive to general economic conditions

   (iii) Audits of firms in the development stage

   (iv) Audits of firms in serious financial difficulty

   (v) Audits of firms experiencing change in any of the following: management or ownership, legal counsel, financial condition, litigation status, nature of business, or scope of engagement

5. The firm's independence and ability to adequately serve a potential client are evaluated prior to its acceptance. In evaluating the firm's ability, consideration is given to the requirements for technical skills, knowledge of the industry, and personnel.

6. A review is made to ensure that acceptance of the client would not violate applicable regulatory agency requirements and the codes of professional conduct of the AICPA and/or the (state) CPA Society.

7. Mr. (practitioner) assembles, evaluates, and documents the applicable foregoing considerations before making an acceptance decision.

b. **Clients are evaluated at the end of specific periods or upon the occurrence of certain events to determine whether the relationship should be continued.** (See AAM section 11,500.19 for a Client Evaluation Questionnaire which can be used for evaluating existing clients.)

1. Reevaluations of existing clients are made—

   (i) Annually, if any of the conditions mentioned in *a*.4 above exist.

   (ii) Every three years if none of the conditions mentioned in *a*.4 above exist.

   (iii) Upon the emergence of conditions that would have caused the firm to reject a client had such conditions existed at the time of the initial acceptance.

2. Based on the information obtained, Mr. (practitioner) makes the continuance decision and documents it with a memorandum.

.10 Inspection

a. **The firm conducts an inspection program regarding its quality control policies and procedures.** (See AAM section 11,500.20 for a Summary Inspection Report, which can be used to document the results of a firm's yearly quality review inspection, and AAM section 11,500.21 for an Inspection of Compliance With Policies and Procedures Relating to Elements of Quality Control.)

Using AICPA and/or (state) Society checklists, Mr. (practitioner) annually evaluates the firm's quality control policies and procedures for compliance with professional standards. This procedure includes a review of administrative, personnel, and engagement files sufficient to obtain reasonable assurance that quality control policies and procedures are being compiled with. An inspection program is not conducted during the year in which the firm has a quality review.

b. **The firm adheres to the quality control standards that have been established by the AICPA.**

Every three years there is a quality review of the firm's accounting and auditing practice. This review is performed by either a peer firm qualified to perform the review or a team assembled for the review purpose.

c. **Provision is made for reporting inspection findings and for monitoring actions taken or planned.**

Mr. (practitioner) evaluates the inspection findings and recommendations together with suggested corrective actions and prepares and retains a memorandum documenting that the inspection has been performed. Appropriate corrective actions, if any, are taken.

.11 Stated Objectives of Firm (Philosophy)

A particular firm's stated objectives may include items such as the following:

a. Concern for the general public interest.

b. Concern for the financial well-being of clients.

c. Reinvestment of the firm's profits in the training and advancement of personnel.

d. Growth plans including opening of branch offices, annual billings, and staff size.

e. Development of specialties such as auditing governmental units or concentration in particular fields—agriculture, retail, and so forth.

f. Development of other services such as a computer data processing center.

g. Pattern for firm growth—internal growth through acquisitions of clients and growing apace with them or growth through mergers with other accounting firms.

[*The next page is 11,501.*]

AAM Section 11,500
Sample Quality Control Forms

.01 Independence Checklist for Employees

Office ______________________________

Employee name ______________________

In order to determine that the firm and its employees are in compliance with the independence rules, regulations, interpretations and rulings of the AICPA, the (name of State) CPA Society, the (name of State) Board of Accountancy, and state statutes the following must be completed by _______ (date) and returned to _______ as noted at the end of the form. If there are any questions you have related to the completion of the form, or if there is a matter that has come to your attention which may impair the firm's independence, please contact (name of Partner) to resolve the problem.

	Yes	*No*
1. Do you have a direct or indirect material financial interest in a client* or its subsidiaries and affiliates?	____	____
2. Do you have a financial interest in any major competitors, investees, or affiliates of a client*?	____	____
3. Do you have any outside business relationship with a client* or an officer, director, or principal stockholder having the objective of financial gain?	____	____
4. Do you owe any client* an amount, except a normal consumer note payable or home mortgage made by a financial institution under normal lending procedures, terms, and requirements?	____	____
5. Do you have a note or account receivable from a client*, except for a deposit in a financial institution?	____	____
6. Do you have the authority to sign checks for a client*?	____	____
7. Are you connected with a client* as a promoter, underwriter or voting trustee, director, officer or in any capacity equivalent to a member of management or an employee?	____	____
8. Do you serve as a director, trustee, officer, or employee of a nonprofit organization that is a present client*?	____	____
9. Has your spouse or minor child been employed by a client*?	____	____
10. Has anyone in your legal family, or any blood relative, been employed in any type of managerial position by a client*?	____	____
11. Are any billings delinquent for clients* that are your responsibility?	____	____

* Client. The enterprise with whose financial statements the member is associated.

I have read the Firm's Independence Policy and AICPA standards. I believe I understand the independence policy and standards. I am in compliance except for the exceptions listed below. (Exceptions to policies: A "Yes" answer to the independence checklist is an exception. Give details as to names, addresses, amounts (relationships of amounts to your net worth is relevant), etc. Leaving the space blank indicates you have no exceptions.)

Arrangements made to dispose of above exceptions to comply with policies:

Signature	Date Reviewer's initials
Exceptions approved by	Location

Instructions: Sign and return to _______ within one week after starting work. Annually, a new form must be completed during the first week of September.

.02 Independence and Representation Checklist for Other Auditors

Office ______________________________

Firm name ______________________________

In order to determine that your firm is in compliance with the independence standards, regulations, interpretations and rulings of the AICPA, the (name of State) CPA Society, the (name of State) Board of Accountancy, and (name of State) statutes the following must be completed by _______ (date) and returned to _______ as noted. If there are any questions you have related to the completion of the form, or if there is a matter that has come to your attention which may impair your firm's independence, please contact (name of Partner) to resolve the problem.

		Yes	*No*
1.	We are aware that [Name of primary auditor] has been engaged to audit the financial statements of [Name of parent] as of [Date] and for the [period, e.g., year] then ended.	____	____
2.	We are aware that [Name of primary auditor] plans to rely on our audit of the financial statements of [Name of subsidiary or component] as of [Date] and for the [period, e.g., year] then ended.	____	____
3.	[We are aware that the primary auditor will refer to our report in their report.]	____	____
4.	We are independent with respect to [Name of both the parent and subsidiary or component.]	____	____

______________________________ ______________________________

Partner of other audit firm Date

Reviewed by:

____

Partner of primary audit firm

.03 Scheduling Request

Client ______________________ Engagement No. __________ Year End __________

Partner ______________________ Manager ______________ Tax Ptr/Mgr ________

Personnel Requested	Experience Level	Interim From	Interim Thru	Interim Hours	Year End From	Year End Thru	Year End Hours	Total Hours

Audited? Yes _____ No _____
SEC? Yes _____ No _____
Reviewed? Yes _____ No _____
Compiled? Yes _____ No _____

Industry ______________________

Estimated total hours:
Partner ______________
Manager ______________
Staff ______________
Total

Can dates be adjusted? Yes _____ No _____ Explain ______________

Can personnel be changed? Yes _____ No _____ Explain ______________

Comments ____

Requested by ______________ Date __________ Scheduled __________ Date _______
Assignment Manager

.04 History of Staff Assignments

NAME ______________________

	DATES			ASSIGNMENT DESCRIPTION				
CLIENT/ LOCATION	INTERIM	YEAR END	RESPONSIBILITY LEVEL	TOTAL HOURS	INDUSTRY	SEC	AUDIT AREAS PERFORMED	REPORTED TO

.05 Client History of Personnel Assigned

CLIENT ______________________________ LOCATION ______________

YEAR ENDING ____________ AUDITED? YES ______ NO ______ SEC? YES ______ NO ______

FISCAL YEAR	HOURS		ENTER NAMES AND CHARGEABLE HOURS FOR THE YEAR							
	INTERIM	YEAR END	PARTNER	MANAGER	SENIOR	IN-CHARGE	STAFF	STAFF	STAFF	STAFF

.06 Scheduling Master Plan

MONTH OF _____

Staff member	Carry forward	Month assignments	Nonworking hours: Vacation	Holiday	Prof dev.	Comp time	CPA exam	Admin	Other	Nonrecurring assignments: Tax dept	Review dept	Other: client #	Other: hr	Hours for month: Total assign	Available	(Over) under
Aston	XX	XX	XX	X	X		X					XXXXXX	X	XXX	X	XX
Barry	XX	X	XX	X	X			X	X					XXX	XX	X
Casey	X	X	X	X					X	X				XXX	XX	XX
Davis	XX	X	X	X	X	X	X	X	X	X	X	XXXXXXX	XX	XXXX	XX	(XX)
Evans	X	X	X	X	X	X						XXXXXXX	XX	XXXX		(XX)
Frank	XX	X	X	X	X	X	X	X	X	X	X	XXXXXXX	XX	XXXX	X	(XX)
Louis	XX	X	XX	X	X	X		X		X				XXX	XX	XX
Miceli	XX	X	XX	XX	X	X	X	X						XXX	XX	XX
Total	XXXX	XX	XXX	XXX	XX	XX	XX	XX	XX	XX	XX		XXX	XXX	XXX	XXX

.07 Consultation Log

						Memorandum	
DATE	MODE OF COMMUNICATION	CLIENT	OFFICE	REQUEST	RESPONSE	REQUIRED YES/NO	DATE REC'D

.08 Consultation Worksheet

DATE ______________________________

CLIENT NAME ______________________________

LOCATION ______________________________

ENGAGEMENT (TYPE) ______________________________

SUBJECT (QUESTION) ______________________________

CONSULTANT'S RESPONSE: (Cite Professional literature discussed and conclusion of consultant) ______

FINAL RESOLUTION ______________________________

______________________ Senior/Manager ______________________ Date

______________________ Partner ______________________ Date

.09

PRE-EMPLOYMENT APPLICATION

NAME	DATE
ADDRESS	
TELEPHONE NUMBER	SOCIAL SECURITY NUMBER

POSITION APPLIED FOR

FIRST CHOICE	SECOND CHOICE	MINIMUM SALARY REQUIRED: $

☐ Full Time ☐ Permanent Part Time ☐ Temporary ☐ Summer Temporary

REFERRED BY
☐ Newspaper ad ________ ☐ Agency ________ ☐ Friend ________ ☐ Other ________
NAME NAME NAME NAME

EDUCATIONAL BACKGROUND — ☐ See Below ☐ See Attached Resume

	NAME & LOCATION OF SCHOOL	MAJOR COURSE	YEARS ATTENDED		YEAR GRAD.
			FROM	TO	
Elementary					
High or Vocational					
Business or Technical					
College					
Graduate					

ADDITIONAL SKILLS OR MACHINE KNOWLEDGE ☐ See Below ☐ See Attached Resume

Note: See exhibit 304-3 of the AICPA MAP Handbook for an alternative.

EMPLOYMENT HISTORY — ☐ See Below ☐ See Attached Resume List present (or if currently unemployed, most recent) position first.

FROM	TO	EMPLOYER'S NAME	EMPLOYER'S ADDRESS	POSITION OR TITLE	SUPERVISION	REASON FOR LEAVING

USE THIS SPACE TO ACCOUNT FOR PERIODS NOT WORKED	ADDITIONAL INFORMATION HELPFUL IN CONSIDERING EMPLOYMENT

AGREEMENT

"I certify that the information given by me in this application is true in all respects, and I agree that if employed and it is found to be false in any way, that I may be subject to dismissal without notice, if and when discovered. I authorize the use of any information in this application to enable to verify my statements, and I authorize , past employers, doctors, all references and any other persons to answer all questions asked by concerning my ability, character, reputation, and previous employment record. I release all such persons from any liability or damages on account of having furnished such information. I further agree, if employed, that (i) I am to work faithfully and diligently, to be careful and avoid accident, to come to work promptly, and I am not to be absent for any reason without prior notice to my supervisor, (ii) upon termination of employment, may answer all questions asked of any prospective employer concerning my ability, character, reputation and employment record. I agree to submit to a physical examination whenever requested by and, if employed, I agree to abide by all present and subsequently issued personnel policies and rules of

APPLICANT'S SIGNATURE: ______________________ DATE: ______________

.10 Interview Report

DAY ____________

DATE ____________

TIME ____________

NAME OF APPLICANT ____

POSITION APPLIED FOR ____

COMMENTS BY INTERVIEWER:

RECOMMENDED ACTION:

INTERVIEWED BY: ______________________ TITLE: ______________________

PLEASE RETURN TO HUMAN RESOURCES AS SOON AS POSSIBLE

Note: See exhibit 303-6 of the AICPA MAP Handbook for an alternative.

.11 Record of Professional Development

Name ______________________ Employee No. ______________

Out-of-Office Courses:

	Sponsor	Course description	No. of hours	Date completed
1.				
2.				
3.				
4.				
5.				
6.				
7.				
8.				
9.				
10.				

In-House Programs:

	Instructor	Course description	No. of hours	Date completed
1.				
2.				
3.				
4.				
5.				
6.				
7.				
8.				
9.				
10.				

.12 19XX Professional Development

Summary *(in hours)*

	In-house presentations			
	Developed in-house	Purchased programs	Outside courses	Total
Partners/Owners				
1.				
2.				
3.				

	In-house presentations			
	Developed in-house	Purchased programs	Outside courses	Total
Professional staff				
1.				
2.				
3.				
4.				
5.				
6.				
7.				
8.				
Paraprofessionals				
1.				
2.				
3.				
4.				

.13 19XX Professional Development

Summary *(in dollars)*

	Purchased programs for in-house use	Outside courses	Total
Partners/Owners			
1.	$	$	$
2.			
3.			
Professional staff			
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
Paraprofessionals			
1.			
2.			
3.			
4.			

.14 Performance Evaluation

[To be completed after each engagement of forty hours or more.]

Name ______________________________ Classification ______________

Client ______________________________ From __________ To __________

Describe work assigned: ______________________________

____

____

In your opinion based on the staff member's classification, should this assignment be considered:

Demanding ☐ Routine ☐

This individual is ☐ is not ☐ ready for increased responsibility. Explain ______________

____

Rating: Enter comments which describe the staff member's performance on this engagement. Rate the staff member on each of the items below as Outstanding (O), Very High (VH), Good (G), Below Normal (BN), or Not Applicable (NA).

[Support each caption with specific incidents or remarks.]

Technical Knowledge: Did the staff member possess adequate knowledge to function effectively at the level assigned? Did this knowledge encompass accounting principles, auditing standards, and tax accounting? Has the staff member kept current on recent developments and new pronouncements on professional practice matters as they affected this engagement?

O VH G BN NA
Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

Analytical Ability and Judgment: How well did the staff member recognize problems, develop relevant facts, formulate alternative solutions, and decide on appropriate conclusions? Did the staff member distinguish between material and immaterial items? Was the staff member practical in adapting theory and experience to the individual circumstances of this client?

O VH G BN NA
Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

Written and Oral Expression: Evaluate the effectiveness of the staff member's letters, memoranda, and other forms of written communication. In conversation, did the staff member communicate intentions effectively? Were instructions understood the first time? Did the staff member sell ideas, obtain acceptance and action?

O VH G BN NA
Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

Note: See chapter 307 of the AICPA MAP Handbook for alternatives.

Performance: Can you depend on the staff member for sustained, productive work? Were assignments organized and completed accurately in a reasonable amount of time? Did the staff member readily assume responsibility? Did the staff member meet time estimates and document work papers properly?

O VH G BN NA
Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

Development of Personnel: In assigning work, did the in-charge member make the most effective use of available talent in terms of getting the work done and in terms of developing staff members performing the work? Did the in-charge staff member tend to make assignments which were either too easy or too hard for his subordinates? Was the staff member readily accepted as a leader? Was the staff member effective in on-the-job coaching?

O VH G BN NA
Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

Client Relations: How well did the staff member relate to this client and gain his acceptance? How well did the staff member recognize and take advantage of practice development opportunities, through extension of services to this client?

O VH G BN NA
Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

Attitude: Did the staff member demonstrate a positive and professional approach to the assignment? Was this demonstrated by sustained effort in completing work? Was the assignment undertaken with enthusiasm and zest? Did the staff member respond in a positive way to suggestions and guidance from superiors? To what degree did the staff member make personal sacrifices to meet client requirements? Was the staff member a helpful member of the team? Did the staff member go out of his way to help an associate?

O VH G BN NA
Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

Personal Characteristics: Did the staff member possess self-confidence and was this confidence projected in an acceptable way? Were positive impressions created with this client and with associates? Did the staff member have a keen sense of what to do or say (tact)? Were clothes appropriate to professional work? Was the staff member well groomed?

O VH G BN NA
Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

Strong points which were evident: ______________________________

____

____

____

____

Recommendations for improvement: ______________________________

____

____

____

____

Comments of Staff Member Being Evaluated: ______________________________

____

____

____

____

Signatures:

Evaluated staff member ______________________________ Date__________

Evaluator ______________________________ Title ______________ Date__________

Engagement manager ______________________________ Date__________

Partner ______________________________ Date__________

.15

JOB EVALUATION REPORT
[For Assignments of Thirty (30) Hours or More]

Name ____________________

Location ____________________

Engagement ____________________

Assistant ____________________ In-Charge ____________________

	Compared to Others in Peer Group							
	A	A-	B+	B	B-	C+	C	
	SUPERIOR	EXCELLENT	ABOVE AVERAGE	SATISFACTORY	IMPROVEMENT DESIRED	IMPROVEMENT REQUIRED	UNSATISFACTORY	NOT APPLICABLE
A. PERFORMANCE ON THE JOB								
1. *Technical Ability Demonstrated*								
a) The purpose of the audit procedures planned was understood								
b) Materiality was neither underestimated nor overestimated								
c) Accounting theory and current releases of the profession were applied correctly								
d) Federal and state income tax regulations were applied correctly								
2. *Working Paper Evidence*								
a) Documentation of work performance, including adequate indexing and cross referencing								
b) Sound explanations and conclusions								
c) Use of standard work papers								
d) Legibility								
e) Accuracy — absence of mathematical errors								
3. *Completing This Job*								
a) Meeting planned time estimates								
b) Completing reports and tax returns								
c) Following up the reviewer's comments and making the necessary changes								
4. *Client Reaction on This Job*								
a) Getting along with the client's employees								
b) Interest in the client's business								
B. ENGAGEMENT ADMINISTRATION — (For In-Charge Accountants Only)								
1. *Effectiveness of Proper Planning*								
a) Extent that the scope of the work related to internal control								
b) Developing the work program								
2. *Utilizing Staff Effectively and Efficiently*								
a) Advance planning to minimize crises								
b) Efficient use of staff on the job								
c) On-the-job training of assistants								
3. *Meeting Deadlines*								
a) Completing the engagement in the planned time								
b) Delivering completed pencil copies of the report and tax returns to the supervisor as agreed								
4. *The Product*								
a) Quality of report preparation, including adequate and informative disclosures								
b) Quality of the management advice recommendations								
5. *Practice Management*								
a) Extending service								
b) Ease of collecting for services performed								

.16

Knowledge and Skill Form

(and Profile of Management Role Performance)

______________________________ Staff member evaluated

______________________________ Date

______________________________ Evaluator

Indicate most effective and least effective roles by placing a check in the far left or right hand column (maximum of two each). For the other five traits, indicate relative strength of staff member by placing a check in columns 2, 3, or 4.

(Circle at least two but not more than four in each section and indicate the effectiveness of each trait.)

			If you wish, add your own words.	Effectiveness: Least 1	2	3	4	Most 5
Planner								
Careful	Sloppy	Thorough						
Imaginative	Foresighted	Infrequent						
Routine	Erratic	Last-minute						
Constant	Cautious	Meticulous						
Problem solver								
Analytical	Consistent	Superficial						
Critical	Faulty	Routine						
Hasty	Creative	Reliable						
Slow	Quick	Successful						
Communicator								
Warm	Sloppy	Cold						
Inhibited	Weak	Unstructured						
Thorough	Receptive	Patient						
Expressive	Efficient	Precise						
Leader								
Dominating	Excitable	Partial						
Uncertain	Permissive	Energetic						
Weak	Fair	Heavy-handed						
Loose	Amiable	Sure						
Decision maker								
Decisive	Lone	Delayer						
Slow	Avoider	Reliable						
Quick	Seldom	Participative						
Frequent	Rash	Dependent						
Trainer								
Systematic	Unprepared	Conscientious						
Patient	Efficient	Knowledgeable						
Sloppy	Diligent	Disinterested						
Off-on	Slow	Enthusiastic						
Team member								
Cooperative	Unreliable	Independent						
Influential	Divisive	Undisciplined						
Conformist	Reliable	Contributing						
Forceful	Reluctant	Welcome						
Innovator								
Original	Appropriate	Consistent						
Infrequent	Clever	Sensible						
Unnecessary	Creative	Unimaginative						
Constant	Disruptive	Rash						
Job expertise								
Amateur	Improving	Too technical						
Obsolete	Mediocre	Disinterested						
Masterful	Balanced	Lagging						
Versatile	Up-to-date	Thorough						

(Complete Annually)

.17 Employee Annual Performance Appraisal

Time Period Involved			
From	To		☐ EXEMPT ☐ NON-EXEMPT

Name	Position Title	Number

Hire Date	Present Position Date	Days Absent From: ____ To: ____ Charged To Sick Time: ____ Disability: ____

Strengths	Development Needs
	Suggested Plan for Performance Improvement

Summary

Overall Rating on Having Met Job Requirements	
Non-Exempt - Circle One	Exempt - Circle One
1 2 3 1 = Did Not Meet Job Requirements 2 = Met All 3 = Exceeded	1 2 3 4 5 1 = Did Not Meet Job Requirements 2 = Met Most 3 = Met All 4 = Exceeded 5 = Far Exceeded

Review the following questions before answering them, using the following criteria:

- A "yes" answer should be considered for possible mention as a "strength". If so, refer to it on the first page of this evaluation.
- A "no" answer should be considered for possible mention as a "development need". If so, refer to it on the first page of this evaluation.

All answers should be considered in arriving at an overall rating on having met job requirements.

	CHECK AS APPROPRIATE				
	Strength	Yes	N/A	No	Development Need
Quality of Work					
Is work accurate, neat and clearly presented?	( )	( )	( )	( )	( )
Carefully planned, well organized and thorough?	( )	( )	( )	( )	( )
Productivity					
Is a good level of production maintained?	( )	( )	( )	( )	( )
Are deadlines met?	( )	( )	( )	( )	( )
Are pressure situations handled effectively?	( )	( )	( )	( )	( )
Knowledge of Job					
Does the individual know where to get information?	( )	( )	( )	( )	( )
Is the individual used as a source of information by others?	( )	( )	( )	( )	( )
Communication					
Does the individual ask for clarification when necessary?	( )	( )	( )	( )	( )
Does the individual respond to others in a manner that indicates understanding?	( )	( )	( )	( )	( )
Are ideas expressed so that others are able to understand them?	( )	( )	( )	( )	( )
Human Relations					
Does the individual cooperate with others to get the job done?	( )	( )	( )	( )	( )
Does the individual demonstrate tact and courtesy in dealing with others?	( )	( )	( )	( )	( )
Does the individual maintain a good working relationship with all others?	( )	( )	( )	( )	( )
Are questions and requests dealt with in a helpful manner?	( )	( )	( )	( )	( )
Need for Supervision					
Can the individual be relied upon to get work done without close supervision?	( )	( )	( )	( )	( )
Does the individual take the initiative when appropriate?	( )	( )	( )	( )	( )
Problem Solving					
Does the individual collect the data needed to solve problems?	( )	( )	( )	( )	( )
Are problems solved quickly?	( )	( )	( )	( )	( )
Are solutions reasonable and accurate?	( )	( )	( )	( )	( )

	CHECK AS APPROPRIATE				
	Strength	Yes	N/A	No	Development Need
Problem Solving—cont'd					
Does the individual know when to ask for advice and whom to ask?	( )	( )	( )	( )	( )
Does the individual seek out methods to do work more efficiently?	( )	( )	( )	( )	( )
Are alternate solutions generated when appropriate?	( )	( )	( )	( )	( )
Work Habits					
Does the individual comply with the Institute's established work hours?	( )	( )	( )	( )	( )
Does the individual provide proper notification when absent from work?	( )	( )	( )	( )	( )
Personal Development					
Does the individual try to expand on required knowledge and skills?	( )	( )	( )	( )	( )
Does the individual readily grasp and master the new job requirements?	( )	( )	( )	( )	( )
Does the individual show ambition by building on strengths and working on deficiencies?	( )	( )	( )	( )	( )
Is the individual a good candidate for promotion?	( )	( )	( )	( )	( )
Is the individual ready for promotion at this time?	( )	( )	( )	( )	( )
Supervisory Capabilities					
Does the individual demonstrate the ability to direct and be responsible for the performance of others?	( )	( )	( )	( )	( )
Does the individual effectively evaluate and develop subordinates?	( )	( )	( )	( )	( )
Are subordinates properly motivated?	( )	( )	( )	( )	( )
Are subordinates given reasonable goals and aided in meeting them?	( )	( )	( )	( )	( )
Does the individual comply with administrative and policy guidelines of _______?	( )	( )	( )	( )	( )
Is good judgment exercised in observing budget constraints?	( )	( )	( )	( )	( )
Does the individual maintain adequate discipline in regard to subordinates attendance and punctuality?	( )	( )	( )	( )	( )
Does the individual provide a good example for peers and subordinates to follow?	( )	( )	( )	( )	( )

INCUMBENT REVIEW COMMENTS & ACKNOWLEDGEMENT
I acknowledge that: (1) I have reviewed and discussed this performance appraisal with the preparer. My signature means that I have been advised of my performance evaluation but does not necessarily imply that I agree with it; (2) I have received a copy of the goals/duties that will be used to evaluate my performance during the coming year; and (3) I have reviewed my job description and do ☐ do not ☐ feel it should be revised. My signature and the date I discussed this with the preparer appears below.

Employee	Date

Evaluator/Title	Date

.18 New Client Acceptance Checklist

Name of prospective client: ____________________

Address and Phone No.: ____________________

____

Name and title of contact at prospective client: ____________________

____

Form completed by: ____________________ Date: ____________

Instructions

This form provides for information necessary to assess whether to accept a prospective client. The information should be obtained from discussions with the prospective client's management, banker, attorney, and if applicable current or former independent CPA, from reviewing the client's financial statements and tax returns, and from other sources such as industry or accounting journals, etc. As much information as possible should be obtained before visiting the potential client. Depending on the type of engagement involved, some information requested on this form may not be applicable, or additional information may be necessary and should be attached.

Services and Reports Required

1. Describe the service and reports requested. ____________________

2. Describe the reason the service is needed, including any regulatory requirements or third parties for which the service or report is intended. ____________________

3. What is the required completion date? ____________________

4. Describe any other services not requested for which there appears to be a need. ____________________

Industry Practices and Conditions

5. In what industry does the company operate? ____________________

6. Describe any specialized tax or accounting practices applicable to the industry. ____________________

7. Describe any economic, technological or competitive conditions or other recent developments in the industry that may affect the company's operations. ____________________

8. Describe any special regulatory requirements applicable to the industry. ____________________

Organization and Personnel

9. Company's Legal Name: ____________________ Fiscal Year End: ____________

10. Type of legal entity (Corporation, S Corporation, partnership, proprietorship, etc.): ____________

11. List the major stockholders (partners or owners) of the company and their percentage of ownership. If applicable, obtain and attach a copy of the company's organization chart.

Name and (if applicable) Title	% Ownership

12. List the principal members of management.

Name and Title	Stated Qualifications (education, training, and experience)

13. Briefly describe any existing or contemplated employee bonus arrangement (individual, title, method of computation), stock option, or pension (profit sharing) plans that may affect the engagement.

14. List each location maintained by the company (including foreign locations, if any), the nature of the activity performed at each, and the approximate number of employees at each, i.e., plant, sales office, executive offices, etc.

Location	Activity	No. of Employees

15. Inquire about possible transactions with related parties that may affect the engagement.

Name of Related Party	**Relationship**	**Type of Transaction**

Operations

16. Describe the nature of the company's major assets and liabilities.

17. What are the company's sources of revenue and marketing methods? Describe major products, customers, etc.).

18. If the company is economically dependent on a major customer, name the customer and approximate percentage of total revenue generated by this customer. ______

19. Describe the components of cost of goods sold and the company's production process. ______

20. What are the major expenses of the company other than cost of goods sold? ______

21. Describe the company's compensation methods, i.e., salary , hourly wage, commissions, piece work, union scale, etc. ______

22. What are the company's major sources of financing, i.e., working capital loans, long term debt, leasing, equity, etc. Describe restrictive covenants on any loan agreements. ______

Accounting

23. Does the company maintain the following items? [Attach description, if appropriate.]
    a. Accounting manual? ______
    b. Budget? ______
    c. Cost accounting system? ______
    d. EDP equipment? (indicate type of equipment and software) ______
    e. Written credit policy? ______

24. Briefly describe the accounting system and accounting responsibilities.

Description of Accounting Record	Name of person who is responsible	EDP	MANUAL	N/A
General Ledger	____	____	____	____
Subsidiary Ledgers:				
Accounts receivable	____	____	____	____
Fixed assets	____	____	____	____
Loans payable	____	____	____	____
Accounts payable	____	____	____	____
Perpetual inventory	____	____	____	____
Physical inventory summarization	____	____	____	____
____	____	____	____	____
____	____	____	____	____
____	____	____	____	____
Journals:				
Cash receipts	____	____	____	____
Cash disbursements	____	____	____	____
Sales/purchase/voucher	____	____	____	____
Payroll	____	____	____	____
General journal entries	____	____	____	____
____	____	____	____	____
____	____	____	____	____
____	____	____	____	____
Financial Reporting [Indicate basis of accounting]:				
Annual financial statements	____	____	____	____
Monthly financial statements	____	____	____	____
Management reports	____	____	____	____
____	____	____	____	____
Other:				
Bank reconciliations	____	____	____	____
____	____	____	____	____

25. Describe the company's completeness procedures and methods to insure that accounting transactions enter into the accounting system, i.e., that all shipments or services are invoiced, that all cash sales are recorded, and that all disbursements are recorded. ____________

____

____

____

____

____

____

26. Describe any unusual features of the accounting system. ____________

____

____

____

27. For audit engagements does it appear that the accounting system provides accounting records sufficient to permit the application of audit procedures on a cost-effective basis? [If no, attach a memo explaining the possible scope limitation, its potential effect on the auditor's report, and the potential management's reaction.] ________________

Tax Matters

28. Who prepares the tax returns? ________________

29. Describe major differences between book and tax income, unusual tax elections, carry forwards or IRS examinations in process. If possible, review copies of the most recent 3 years of tax returns and attach them to this form. ________________

Other Matters

30. Describe any significant problems that could affect the engagement, such as litigation or other contingencies, unusual agreements, and plans to acquire or dispose of significant assets, merge with another entity, enter a new area of business, convert to or expand use of EDP equipment, etc.________________

31. Give the name of a current or former independent CPA.________________

    a. Describe any disputes over accounting matters.________________

32. Describe any apparent problems or areas for improvement that were noted where our firm could provide additional service or recommendations.________________

Independence

33. Would service to this client cause problems of independence or conflicts of interest because of relationships with other clients or members of the staff? ________________

Fees

34. Based on inquiries with a current or former independent CPA, if applicable, indicate the amount of any unpaid fees and the reason for nonpayment. ________________

35. If possible indicate the amount of fees charged by an existing or former independent CPA for the service being proposed. (The CPA or the potential client may be willing to furnish this information, or it might be obtainable from the financial statements or tax return.)________________

36. Describe any other indications that our firm might have a problem billing or collecting our fees. ________________

Management Integrity

37. Have any of the following sources raised any concerns about management's integrity?
    a. Difficulty in obtaining information from management, or evasive, guarded or glib responses to inquiries. ______

    ______

    b. Apparent difficulty in meeting financial operations or a deteriorating financial position that might predispose management to make an intentional error, irregularity or misrepresentation.

    c. Disputes about accounting principles, engagement procedures or similarly significant matters with an existing or former accountant, or doubts of the predecessor accountant about management's integrity. ______

    ______

    d. Comments by bankers, attorneys, creditors, or others having a business relationship with a potential client. ______

    ______

38. If management is changing accountants, why is the change being made? ______

    ______

39. Is there any reason to suspect that management would be uncooperative, unreasonable or otherwise unpleasant to work with? ______

    ______

Other Comments or Observations

40. Give any other comments or observations that might affect our decision whether to prepare a proposal letter or its contents. Add attachments to this form, if necessary. ______

    ______

.19 Summary Inspection Report

I. *Planning the Inspection*

A. Inspection period ____________________

B. Composition of Inspection Team:

1. Captain ____________________ Position ____________________
2. Team Member ____________________ Position ____________________
3. Team Member ____________________ Position ____________________

C. Indicate matters that may require additional emphasis in the inspection and explain why.

____
____
____
____
____

D. Development of Inspection Program:

1. Describe programs used and indicate any deviations therefrom.

____
____
____
____

2. Describe basis for selection of engagements:

____
____
____

E. Timing of Inspection:

Commencement ____________________
Completion of work ____________________
Issuance of report ____________________

II. *Scope of Work Performed*

A. Indicate elements of quality control not addressed and give reasons.

____
____
____
____

B. Engagements Reviewed:

	Firm Totals		Engs. Reviewed	
	Hrs.	No. of Engs.	Hrs.	No. of Engs.
Audits:				
SEC Clients				
Government[1]				
Other				
Reviews				
Compilations				
Other Accounting Services	______	______	______	______
	______	______	______	______
	______	______	______	______
Percentage of A&A Practice Reviewed			______	______
			______	______

Comments: ____

____

____

____

III. *Engagement Conclusions*

A. Did the inspection disclose any situation that led the reviewers to conclude that the firm or office should consider:

1. Taking action to prevent future reliance on a previously issued report, pursuant to SAS No. 1 (AU section 561)? Yes ______ No ______
2. Performing additional auditing procedures to provide a satisfactory basis for a previously expressed opinion, pursuant to SAS No. 46 (AU section 390)? Yes ______ No ______

B. Did the inspection team conclude in any instances that the firm or office lacked a reasonable basis under the standards for accounting and review services for the report issued? Yes ______ No ______

If any of the answers above are yes, attach a description of such situations, including actions the firm or office has taken or plans to take.

IV. *Findings and Recommendations:*

Attach a copy of any reports issued, including a summary of any inspection findings and recommendations for improvement or list such findings and recommendations below.

____

____

____

____

____

____

____

Supervisory Partner ______________________

Date ______________________

[1] Includes only audits conducted pursuant to the *Government Auditing Standards*, issued by the Comptroller General of the United States ("yellow book").

.20 Inspection of Compliance With Policies and Procedures Relating to the Elements of Quality Control

Period Covered	*Yes*	*No*	*N/A*	*Extent of Testing*
INDEPENDENCE				
1. Have memorandums of inquiry, written representations, or other appropriate documentation been obtained, evidencing:				
a) Communication of firm policies and procedures relating to independence?	___	___	___	___
b) Monitoring of compliance with those policies and procedures?	___	___	___	___
2. Have independence questions which have arisen been appropriately resolved and, where necessary, have appropriate authorities been consulted?	___	___	___	___
ASSIGNING PERSONNEL TO ENGAGEMENTS				
1. Have the firm's policies and procedures been followed to provide reasonable assurance that personnel are assigned to engagements in a manner that attempts to achieve a balance between the complexity to the engagement, the qualifications of the staff and individual development?	___	___	___	___
CONSULTATION				
1. Does the firm's reference library contain technical manuals, and recent pronouncements, including those relating to particular industries and other specialties, that meet the needs of the practice?	___	___	___	___
2. On engagements reviewed, was consultation performed and documented in accordance with firm policy?	___	___	___	___
3. If sufficient testing of consultation policies and procedures was not performed in 2 above, were consultations that took place appropriately and correctly applied? (This may be accomplished through inquiry or review of the subject files.)	___	___	___	___
SUPERVISION				
1. On engagements reviewed, have the required technical materials (audit manuals, standardized forms, checklists and questionnaires), been used?	___	___	___	___
2. Based on the engagements reviewed:				
a) Are the technical materials sufficiently comprehensive and up-to-date?	___	___	___	___
b) Are the firm's policies and procedures for the review of engagement working papers, reports and financial statements appropriate?	___	___	___	___
c) Are the firm's procedures for resolving differences of opinion among members of the engagement team appropriate?	___	___	___	___

Period Covered	*Yes*	*No*	*N/A*	*Extent of Testing*
PROFESSIONAL DEVELOPMENT				
1. Do the firm's professional development records meet the requirements of the firm and of the Section?	___	___	___	___
2. Has the professional development program for the last year been reviewed to determine if it fulfills the firm's needs for personnel with expertise in specialized areas and industries?	___	___	___	___
HIRING				
1. Has the firm planned for its personnel needs in accordance with its policies and procedures?	___	___	___	___
2. Does the firm's hiring program satisfy its needs?	___	___	___	___
3. Do personnel files of recently hired employees contain appropriate evidence that the individuals meet the firm's personal, educational, and experience requirements?	___	___	___	___
4. Have new personnel been notified of the policies and procedures that apply to them?	___	___	___	___
ADVANCEMENT				
1. Based on a review of personnel files, personnel evaluations, or other documentary evidence, have personnel been evaluated and promoted in accordance with the firm's policies and procedures?	___	___	___	___
ACCEPTANCE AND CONTINUANCE OF CLIENTS				
1. Do new client files contain documentation of compliance with the firm's policies and procedures for acceptance of clients?	___	___	___	___
2. On engagements reviewed, was the firm's policy for continuance of clients, including required documentation, complied with?	___	___	___	___
INSPECTION				
1. Were appropriate corrective actions taken, including effective follow-up, with respect to the prior period's inspection findings?	___	___	___	___

Reviewer ______________________ Date ______________

Supervisory Partner ______________________ Date ______________

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AAM Section 12,000
State and Local Governments

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AAM Section 12,010

*Illustrative Internal Control Structure Questions—State and Local Governmental Units**

.010 The following is a list of illustrative internal control structure questions an auditor might raise concerning a state or local governmental unit. The extent of internal control structure policies and procedures that an organization should establish is a judgment that must be made by the management of the entity. The judgment is affected by circumstances, such as the size of the organization and the number of personnel available, and by conclusions about the relationship of costs and benefits. These illustrative questions are numbered merely for organization purposes. The numbers are in no way intended to infer completeness or a preferred sequence. A firm that believes the questionnaire approach is appropriate for its practice should develop its own internal control structure questionnaires based on its own needs and preferences. In any event, users of checklists and questionnaires should recognize that important matters in a particular set of circumstances may not be covered in a standard checklist.

* SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, revises the definition and description of internal control and makes conforming changes to relevant terminology. SAS No. 78 was issued in December 1995 and is effective for audits of financial statements for periods beginning on or after January 1, 1997. This section will be amended to conform to SAS No. 78 nearer to the pronouncement's effective date.

I. Control Environment*

.020 The control environment represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include the following:

- Management's philosophy and operating style
- The entity's organizational structure
- Personnel policies and practices
- Methods of assigning authority and responsibility
- Management's control methods for monitoring and following-up on performance, including internal auditing and budgeting
- Various external influences that affect an entity's operations and practices

.030 The control environment reflects the overall attitude, awareness, and actions of the legislative, management, staff, and others concerning the importance of the control and its emphasis in the entity.

.040 The following questions are to assist the auditor in obtaining an understanding of the control environment and assessing the control risk.

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
.050 **A. Management's Philosophy and Operating Style**							
1. Does management often enter into particularly high-risk ventures, or is extremely conservative in accepting risks?	—	—	—		—		
2. Does management conduct business on a high ethical plane and insist that others do so, or pay little attention to ethical issues?		—			—		
3. Does management have to meet rigid targets to receive a portion of their compensation (e.g., bonus), particularly when such targets are considered unreasonably difficult?		—		—	—		
4. What is management's attitude and actions toward financial reporting, including disputes over application of accounting treatment (e.g., selection of conservative versus liberal accounting policies; whether accounting principles have been misapplied, important financial information not disclosed, or records manipulated or falsified)?					—		
5. Is management conscientious and applies integrity with the judgmental aspects of reporting, when developing estimates?				—	—		
6. Is there frequent interacting between senior management and operating management, particularly for geographically removed units?	—	—					
7. What is management's attitude toward the data processing and accounting functions, and their concerns about the reliability of financial reporting and safeguarding assets?	—				—		
8. Has management communicated a commitment to a strong internal control structure to employees during the past year?	—	—			—		
9. Does management periodically review the internal control structure to ensure that it is being enforced?	—	—					

* The control environment questions in AAM section 12,010.020–.100 specifically apply to governmental entities and are not intended to be all inclusive. The auditor should also consider the illustrative control environment inquiries in AAM section 4400.14, which may apply to governmental entities.

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
10. What is management's attitude towards overriding or bypassing established controls?	—	—					
11. Has management conveyed the message that ethics cannot be compromised and have employees received and understood that message?	—						
12. Does the "tone at the top" include explicit moral guidance about what is right and what is wrong, and is it established and communicated throughout the organization?	—				—		
.060 **B. Organizational Structure**							
1. Is the organizational structure so simple that it cannot adequately monitor the organization's activities, or so complex that it inhibits the necessary flow of information?	—	—					
2. Does management fully understand their control responsibilities and possess the requisite experience and levels of knowledge commensurate with their positions?	—						
3. Is there an adequate definition of key managers' responsibilities and an appropriate understanding of those responsibilities?	—	—					
4. Do key managers possess the appropriate knowledge and experience in light of their responsibilities?	—	—					
5. Is the entity's organizational structure appropriate so as to provide the necessary information flow to manage its activities?	—	—					
6. Are the reporting relationships appropriate?	—	—					
7. To what extent are organizational modifications made in light of changing conditions?	—	—					
8. Are there sufficient quantities of employees, particularly in management and supervisory capacities?	—	—					
9. Is the organization chart current?	—	—					
10. Is the organization properly synchronized for the program/budget structure?	—	—			—		
11. Are goals and objectives for the organization current and in writing?	—	—					
12. Are functional statements current and in writing and consistent with organization chart?	—	—					
.070 **C. Personnel Policies and Procedures**							
1. Do personnel practices include:							
a. A code of conduct?	—						
b. Provisions for conflict of interest disclosure?	—						
2. Are there accurate and up-to-date performance standards?	—	—					
3. Are the performance standards consistent with the operating plan?	—	—					
4. Is there periodic performance review (appraisal) of all employees?	—						
5. Are there sufficient training opportunities to ensure all employees are competent to perform work assigned?	—	—					
6. To what extent are policies and procedures for hiring, training, promoting, and compensating employees in place?	—	—					
7. To what extent are employees made aware of their responsibilities and expectations of them?	—	—					
8. Is there appropriate remedial action taken in response to departures from approved policies and procedures and violations of the code of conduct?	—						

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
9. Are there adequate employee candidate background checks, particularly with regard to prior actions or activities considered to be unacceptable by the entity?	—						
10. Are there adequate employee retention and promotion criteria, and related information gathering techniques, related to compliance with the code of conduct or other behavioral guidelines?	—						
11. Do management performance standards include provisions for maintaining adequate internal controls?	—						
12. Are employees adequately supervised?	—	—					
13. Are staffing levels adequate?	—	—					
14. Is turnover low?	—	—					
15. Do employees have copies of their current position description?	—	—					
16. Is orientation training conducted for new employees?	—						
17. Are employees aware of their rights to communicate with any official of rank higher than their immediate supervisor?	—	—			—		
.080 D. Authority and Responsibility							
1. Are delegations of authority and responsibility current and in writing?	—						
2. Do the delegations of authority and responsibility reflect the segregation of duties concept?	—	—					
3. Are the job descriptions descriptive of the jobs actually performed?	—	—					
4. Do the delegations of authority and responsibility grant officials necessary authority to carry out functions for which they are responsible?	—	—					
5. Are employees held accountable for performance and results achieved?	—	—					
6. Do managers routinely follow-up on delegations of authority and responsibility to subordinates?	—	—					
.090 E. Mangement Control Methods							
1. Is there a long-range planning process?	—	—					
2. Is the budgeting system integrated with the planning process?	—	—			—		
3. Are plans and budgets effectively communicated throughout the organization?	—	—			—		
4. Are responsibilities for budget preparation, adoption, execution, and reporting segregated?	—	—			—		
5. Is a budget calendar used for the orderly submission and approval of the budget?	—	—					
6. Are budgets prepared for all significant activities regardless of whether mandated by law?	—	—					
7. Is the budget prepared in sufficient detail providing a meaingful tool with which to monitor subsequent performance?	—	—			—		
8. Is citizen input obtained through budget hearings?	—	—	—				
9. Has the budget been submitted to the legislative body for approval and is there clear communication to operation departments or agencies of the effects of legislatively mandated budget modifications, either increases or decreases?	—						
10. Are interfund and interdepartmental transfers included in the budget?	—	—			—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
11. Is the type of budgeting performed compatible with the accounting system?	—	—			—		
12. Are budgets published if required by law?	—				—		
13. Are estimated revenues and appropriations recorded in the accounting records for later comparison to actual amounts realized or incurred?	—	—		—	—		
14. Have procedures been adopted and communicated establishing authority and responsibility for transfers between budget categories?	—	—	—		—		
15. Is the flow of expenditures or commitments controlled through the use of an allotment system?	—	—	—				
16. Does the accounting department submit approval as to availability of funds before the issuance of a purchase order or expenditure commitment?	—	—	—				
17. Are requests for supplemental appropriations or budget changes processed and approved in the same manner as the original budget is processed and approved?	—	—	—		—		
18. If liabilities and expenditures are recorded on an encumbrance or obligation basis, are there controls to ensure knowledge of outstanding commitments?	—	—	—		—		
19. Are actual expenditures compared to budget with reasonable (monthly) frequency and on a timely basis?		—		—	—		
20. Are reports discussed with departmental personnel and are there explanations for significant variations from budget?		—		—	—		
21. Are executive and legislative branches notified of expenditures in excess of appropriations or budgets?	—		—		—		
22. Are actual results of operations against budget published if required by law?	—	—		—	—		
23. Are the adequacy and effectiveness of the internal control structure policies and procedures relevant to the entity's transaction classes and are account balances periodically evaluated?	—	—			—		
24. Are measures implemented to correct weaknesses?	—						
25. Are there clearly established levels of operational and financial accountablility?	—	—					
26. Are program evaluations/management reviews routinely performed?	—	—			—		
27. Are audits routinely performed?	—	—			—		
28. Are procedures in place and adhered to which require prompt implementation of resolved audit findings or program/management review results?	—	—			—		
29. Are policies and procedures current and in writing?	—						
30. Are policies and procedures consistent with statutory authorities?	—	—	—				
31. Are all policies and procedures clearly stated and systematically communicated (manuals, handbooks, etc.)?	—	—					
32. Do the policies and procedures support the internal control structure?	—	—					
33. Are there channels of communication for people to report suspected improprieties?							
a. Ability to contact someone other than a direct supervisor?	—	—					
b. Anonymity permitted?	—						
34. Is feedback provided to people who report suspected improprieties and do they have immunity from reprisals?	—	—					
a. Is management receptive to such reports?	—						
35. Are outside parties made aware for the entity's ethical standards?	—						
36. Is there timely and appropriate follow-up action by management resulting from external party communications, such as:							
a. Customer complaints?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
b. Notification of errors in billings?	—	—		—	—		
c. Notification of inappropriate behavior by an employee?	—						
37. Are there mechanisms to identify and react to changes that can have a more dramatic and pervasive effect on the entity, and may demand the attention of senior management? Some examples include:							
a. New laws or regulations that affect the entity or its activities,	—	—					
b. New or redesigned information systems,	—	—			—		
c. New technology incorporated into the information systems.	—	—			—		
.100 **F. External Influences**							
1. Is the organization subject to external forces or pressures which make it vulnerable to errors?	—	—			—		
2. Does the public perceive this organization to be adequately controlled?	—				—		
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

II. Accounting System

.110 The accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. The auditor should obtain knowledge of the accounting system to understand:

- The classes of transactions in the entity's operations that are significant to the financial statements.
- How those transactions are initiated.
- The accounting records, supporting documents, computer media, and specific accounts in the financial statements involved in the processing and reporting of transactions.
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

.120 The following questions are to assist the auditors in obtaining an understanding of the accounting system and assessing the control risks.

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
.130 A. General							
1. Does the entity have adequate written statements and explanations of its accounting policies and procedures? (Written accounting policies and procedures may include such matters as: (*i*) Chart of accounts accompanied by explanations of the items to be included in the various accounts. (*ii*) Identification and description of the principal accounting records, recurring standard entries, and requirements for supporting documentation. For example, this may include information about the general ledger, source journals, subsidiary ledgers, and detail records for each significant class of transactions. (*iii*) Expression of the assignment of responsibilities and delegation of authority including identification of the individuals or positions that have authority to approve various types of recurring and non-recurring entries. (*iv*) Explanations of documentation and approval requirements for various types of recurring and non-recurring transactions and journal entries. Documentation requirements, for example, would include the basis and supporting computations required for adjustments and write-offs. (*v*) Instructions for determining an adequate cutoff and closing of accounts for each reporting period.)	—	—					
2. Are accounting policy and procedure manuals updated as necessary?	—	—					
3. Are manuals distributed to appropriate personnel?		—					
4. Do procedures exist to ensure that only authorized persons can alter or establish a new accounting principle, policy, or procedure to be used by the entity?	—	—	—	—	—		
5. Does the principal accounting officer of the entity have adequate authority over accounting employees and principal accounting records at all locations?	—	—					
6. Are the principal accounting, treasury, and custody functions segregated?	—	—					
7. Are the responsibilities for maintaining the general ledger segregated from those for maintaining subsidiary ledgers?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
8. Are the responsibilities for maintaining the general ledger and custody of assets segregated?	—						
9. Is access to the general ledger and related records restricted to those who are assigned general ledger responsibilities?	—						
10. Are there adequate facilities for custody of the general ledger and related records? (Examples of such facilities include fire-resistant locked cabinets, vaults, physical barriers, separate rooms, limited access to work areas, alarms, and other detection devices.)	—						
11. Is appropriate insurance coverage maintained in amounts required by statutes or entity policy? (Such insurance may include loss of records coverage and fidelity bonding of employees in positions of trust.)	—			—			
12. Are the preparation and approval functions for journal entries segregated?	—	—		—			
13. Are all journal entries reviewed and approved by designated individuals at appropriate levels in the entity? (The levels at which journal entries are reviewed and approved will usually vary depending on whether the entries are recurring, or non-recurring, routine or unusual, accumulations of routine transactions, or adjustments of balances requiring estimates and judgments.)	—	—		—			
14. Are all journal entries adequately explained and supported? (Explanation and support for an entry should be sufficient to enable the person responsible for its review and approval to reasonably perform this function.)	—	—					
15. Do all journal entries include approval in accordance with management's general or specific authorization?	—	—					
16. Are all journal entries subject to controls over completeness of processing? (Examples of controls over completeness of processing include pre-numbering of journal vouchers and accounting for all numbers used, accumulation of control totals of dollar amounts debited and credited, and standard identification numbers for recurring entries.)	—	—					
17. Do all journal entries include adequate identification of the accounts in which they are to be recorded?	—	—		—	—		
.140 **B. Electronic Data Processing**							
Segregation of Duties							
1. Is the EDP department independent from the accounting and operating departments for which it processes data?	—						
2. Does appropriate segregation of duties exist within the data processing function for (*a*) systems development (design and programming), (*b*) technical support (maintenance of systems software), and (*c*) operations?	—	—					
3. In smaller and minicomputer installations with limited opportunities for segregation of duties, do procedures exist for user departments to— • Utilize batch or other input controls? • Control master file changes? • Balance master files between processing cycles?	—	—		—			
4. Do the personnel policies of the EDP function include such procedures as reference checks, security statements, rotation of duties, and terminated employee security measures that enhance segregation of duties and otherwise improve controls?	—						
Procedural Controls							
User Controls							
5. Do controls exist over preparation and approval of input transactions outside the EDP department and is the department prohibited from initiating transactions?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
6. Does the user exercise control procedures over input to ensure that all approved input is processed correctly through the system and only once?	—	—		—			
7. Do controls exist over entry of data in on-line systems to restrict access to terminals and data entry to authorized employees?	—	—					
8. Do on-line systems controls exist that prevent documents from being keyed into the system more than once and that permit tracing from computer output to data source and vice versa?	—	—					
9. Do controls exist over changes to master files, such as requiring preparation of specific forms indicating data to be changed, approval by a supervisor in the user department, and verifying against a printout of changes?	—	—					
10. Do user controls exist over rejected transactions through the use of a computerized suspense file of rejected transactions or an auxiliary manual system?	—	—					
11. Does user department management reconcile output totals to input totals for all data submitted, reconcile the overall file balances, and review outputs for reasonableness?	—	—		—			
Application Controls							
12. Do procedures exist within the data processing control function that provide that data is properly controlled between the user and the EDP department?	—	—					
13. Do controls exist over data entry, for example, that include adequate supervision, up-to-date instructions, key verification of important fields, and self-checking digits?	—	—					
14. Do program controls exist over entry of data into on-line systems?	—	—					
15. Is input data edited and validated?	—	—					
16. Do data processing controls exist over rejected transactions?	—	—					
17. Do controls exist for balancing transactions and master files?	—	—		—			
18. Do procedures exist within the data processing control function concerning review and distribution of output?	—	—					
General Controls							
19. Do controls exist over changes to system software?	—	—					
20. Do controls exist over use and retention of tape and disk files, including provisions for retention of adequate records to provide backup capabilities?	—	—					
21. Do controls exist that limit access to data processing equipment, tapes, disks, system documentation, and application program documentation to authorized employees?	—	—					
22. Is a job accounting system (or console logs) used to ensure that scheduled programs are processed and proper procedures followed and that supervisory personnel know that only required programs have been processed?	—	—					
23. Are EDP department employees supervised for all shifts?	—	—					
24. Are procedures to be followed by computer operators documented?	—	—					
25. Is the data processing system documented such that the organization could continue to operate if important data processing employees leave?	—						
26. Do procedures exist to protect against a loss of important files, programs, or equipment?	—	—					
27. Are equipment, programs, and data files covered by insurance?	—						
28. Are there user-approved written specifications for new systems and modifications to existing application systems?	—	—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
29. Are there written procedures to test and implement new systems and modifications to existing application systems?	—	—					
.150 **C. Financial Reporting**							
Segregation of Duties							
1. Is the final review and approval of financial reports segregated from the responsibility for preparation of the reports?	—	—					
Procedural Controls							
General Ledger							
2. Is there a formal plan of organization for the unit of government under which reporting responsibilities are clearly defined and reasonably aligned?	—	—					
3. Is the principal accounting officer over accounting records and accounting employees supervised at all locations?	—	—					
4. Is there general ledger control over all assets and transactions of all departments of the organization?	—	—		—			
Closing							
5. Are procedures and policies for closing the accounts for a reporting period sufficient to ensure that accounts are closed, adjusted, and reviewed on a timely basis?	—	—		—			
6. Do procedures exist to ensure that all accounting systems have included all transactions applicable to the reporting period?		—					
7. Are valuation reserves or other account balances based on estimates reviewed and approved?	—			—			
8. Are all journal entries reviewed, approved, and supported by adequate descriptions or documentation?	—	—					
9. Do controls exist that ensure that only authorized individuals can initiate entries?	—						
Combining							
10. Do procedures exist to ensure the orderly and effective accumulation of financial data?	—	—			—		
11. Do procedures exist for the orderly processing of financial data received from departments and other accounting units?	—	—			—		
12. Do procedures exist to permit the recording and review of special entries generated in the combining process?	—	—			—		
Preparation, Review and Approval							
13. Do procedures exist to ensure that financial reports are supported by either underlying account records or other documentation?	—						
14. Do procedures exist providing reasonable assurances that all data required to be included in legal as well as public reports are properly disclosed?		—			—		
15. Do procedures exist to ensure that financial reports are prepared on a consistent basis?	—	—			—		
16. Are financial reports reviewed and approved at appropriate levels of management and, if appropriate, by the legislature before public release?	—				—		
17. Are there procedures to ensure that all requirements for filing of financial reports are met (for example, senior levels of government, bondholders, and the public)?	—	—		—			
.160 **D. Identified Significant Account Balances and Transaction Classes**							
1. Cash?	—						
2. Investments?	—						
3. Revenues and Receivables?	—						
4. Capital Assets?	—						
5. Procurement and Payables?	—						
6. Employee Compensation?	—						

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

III. Control Procedures

.170 Control procedures are those policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures have various objectives and are applied at various organizational and data processing levels. They may also be integrated into specific components of the control environment and the accounting system. Generally, they may be categorized as procedures that pertain to—

- Proper authorization of transactions and activities.
- Segregation of duties that reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties—assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records to help ensure the proper recording of transactions and events, such as monitoring the use of pre-numbered shipping documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.
- Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparison of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the detail of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

.180 Questions for the following functional areas have been included to assist the auditor in obtaining an understanding of the control procedures and assessing the control risk:

- Cash
- Investments
- Revenues and Receivables
- Capital Assets
- Procurement and Payables
- Employee Compensation

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
.190 A. Cash							
Segregation of Duties							
1. Are responsibilities for collection and deposit preparation functions segregated from those for recording cash receipts and general ledger entries?		—					
2. Are responsibilities for cash receipts functions segregated from those for cash disbursements?		—					
3. Are responsibilities for disbursement preparation and disbursement approval functions segregated from those for recording or entering cash disbursements information on the general ledger?	—	—		—			
4. Are responsibilities for the disbursement approval function segregated from those for the disbursement, voucher preparation, and purchasing functions?	—			—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
5. Are responsibilities for entries in the cash receipt and disbursement records segregated from those for general ledger entries?	—	—					
6. Are responsibilities for preparing and approving bank account reconciliations segregated from those for other cash receipt or disbursement functions?	—	—			—		
7. If EDP is used, is the principle of segregation of duties within processing activities maintained?	—	—					
Procedural Controls							
Collections							
8. Are all receipts deposited on a timely basis (preferably daily)?		—					
9. Do controls exist over the collection, timely deposit, and recording of collections in the accounting records in each collection location?		—					
10. Is the general accounting department notified on a timely basis of cash receipts from separate collection locations?		—					
11. Are daily reported receipts compared on a test basis to bank statements to verify timeliness of deposits?	—						
12. Is a restrictive endorsement placed on each incoming check upon receipt?		—					
13. Are "not sufficient funds" checks delivered to someone independent of processing and recording of cash receipts?		—					
14. Do procedures exist for follow-up of "not sufficient funds" checks?		—					
15. Do controls exist to ensure that checks are returned promptly for deposit if checks received are forwarded to be used as posting media to taxpayers' or customers' accounts?		—					
16. Are receipts controlled by cash register, pre-numbered receipts, or other equivalent means if payments are made in person (over the counter)?		—					
17. Are receipts accounted for and balanced to collections on a daily basis?	—	—					
18. Do facilities exist for protecting undeposited cash receipts?	—	—					
Disbursements							
19. Does control exist over warrant or check-signing machines as to signature plates and usage?	—	—					
20. Are procedures provided for immediate notification to banks when warrant or check signers leave the unit or are otherwise no longer authorized to sign?	—	—					
21. Are invoices and supporting documents furnished to the signer prior to signing the warrant or check?	—	—		—			
22. Are reasonable limits set on amounts that can be paid by facsimile signatures?	—						
23. Are two signatures required on warrants or checks over a stated amount?	—						
24. Are signature plates maintained in the custody of the person whose facsimile signature is on the plate when not in use?	—						
25. Are signature plates under the signer's control when in use?	—	—					
26. Is the recording machine read by the signer or an appropriate designee to ascertain that all checks or warrants signed are properly accounted for by comparison to document control totals?	—	—					
27. Are signed warrants or checks delivered directly to the mailroom making them unaccessible to persons who requested, prepared, or recorded them?	—						
28. Is the drawing of warrants or checks to cash or bearer prohibited?	—						
Custody							
29. Are controls maintained over the supply of unused and voided warrants or checks?	—	—					
30. Are bank accounts properly authorized?		—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
31. Are depositories periodically reviewed and formally reauthorized?		—					
32. Do controls and physical safeguards exist surrounding working (petty cash) funds?	—						
33. Is adequate fidelity insurance maintained?	—	—	—				
34. Are separate bank accounts maintained for each fund, or if not, is there adequate fund control over pooled cash?			—		—		
Detail Accounting							
35. Do procedures exist to ensure that collections and disbursements are recorded accurately and promptly?		—		—	—		
36. Do procedures exist for authorizing and recording interbank and interfund transfers and for providing for proper accounting for those transactions?	—	—		—	—		
General Ledger							
37. Does general ledger control exist over all bank accounts?	—	—					
38. Are bank statements and paid warrants or checks delivered in unopened envelopes directly to the employee preparing the reconciliation?	—	—			—		
39. Do procedures exist for steps essential to an effective reconciliation, particularly—							
• Comparison of warrants or checks in appropriate detail with disbursement records?		—		—			
• Examination of signature and endorsements, at least on a test basis?	—		—				
• Accounting for numerical sequence of warrants or checks used?		—		—			
• Comparison of book balances used in reconciliations with general ledger accounts?	—	—		—	—		
• Comparison of deposit amounts and dates with cash receipt entries?		—		—			
• Footing of cash books?		—		—			
40. Are all reconciliations and investigations of unusual reconciling items reviewed and approved by an official who is not responsible for receipts and disbursements, including recording evidence of the review and approval by signing the reconciliation?	—	—		—			
41. Are checks outstanding for a considerable time periodically reviewed for propriety?	—						
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of contols	L M H	L M H	L M H	L M H	L M H		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
.200 **B. Investments**							
Segregation of Duties							
1. Are responsibilities for initiating, evaluating, and approving transactions segregated from those for detail accounting, general ledger, and other related functions?	—	—		—			
2. Are responsibilities for initiating transactions segregated from those for final approvals that commit government resources?	—			—			
3. Are responsibilities for monitoring investment market values and performance segregated from those for investment acquisition?	—			—			
4. Are responsibilities for maintaining detail accounting records segregated from those for general ledger entries?	—			—			
5. Are custodial responsibilities for securities or other documents evidencing ownership or other rights assigned to an official who has no accounting duties?	—		—	—			
6. If EDP is used, is the principle of segregation of duties within processing activities maintained?	—	—					
Procedural Controls							
Approval							
7. If applicable, are procedures adequate to ensure that only investments that are permitted by law are acquired?	—			—	—		
8. Are investment policy guidelines formally established and periodically reviewed?	—				—		
9. Is the investment program integrated with the cash management program and expenditure requirements?	—	—		—			
10. Have authority and responsibility been established for investment opportunity evaluation and purchase?	—			—			
11. Is the performance of the investment portfolio periodically evaluated by persons independent of investment portfolio management activities?	—	—		—			
12. Are procedures formally established governing the level and nature of approvals required to purchase or sell an investment?	—			—			
13. Are competitive bids sought for certificate of deposit purchases?	—			—			
Custody							
14. Do adequate physical safeguards and custodial procedures exist over—							
• Negotiable and nonnegotiable securities owned?	—		—				
• Legal documents or agreements evidencing ownership and other rights?	—		—				
15. Are dual signatures or authorizations required to obtain release of securities from safekeeping or to obtain access to the government unit's safe deposit box?	—		—				
16. Are persons with access to securities authorized by the legislative body?	—	—	—				
17. Are all securities registered in the name of the government unit?	—		—				
18. Are securities periodically inspected or confirmed from safekeeping agents?	—		—	—			
19. Are individuals with access to securities bonded?			—				
Detail Accounting							
20. Are detail accounting records maintained for investments?	—	—		—	—		
21. Do procedures exist to ensure that transactions arising from investments are properly processed, including income and amortization entries?	—	—		—	—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
22. Do controls exist to ensure that investment earnings are credited to the fund from which resources were provided for the investment?				—	—		
23. Are periodic comparisons made between income received and the amount specified by the terms of the security or publicly available investment information?	—			—	—		
24. Do controls exist to ensure that transactions are recorded on a timely basis?		—		—	—		
General Ledger							
25. Do procedures exist for reconciling the detail accounting records with the general ledger control?	—			—	—		
26. Is the nature of investments included in general ledger balances periodically reviewed?	—			—	—		
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
.210 C. Revenues and Receivables							
Segregation of Duties							
1. Are the responsibilities for billing property taxes and services segregated from collection and accounting?		—		—			
2. Are the responsibilities for maintaining detail accounts receivable records segregated from collections and general ledger posting?	—	—		—			
3. Are the collection, control, and deposit of funds activities segregated from the accounting records maintenance function?	—	—		—			
4. Are property tax assessment rolls maintained by individuals not engaged in any accounting or collection function?	—	—		—			
5. Are responsibilities for entries in the cash receipts records segregated from those for general ledger entries?	—	—					
6. If EDP is used, is the principle of segregation of duties within processing activities maintained?	—	—					
Procedural Controls							
Data and File Maintenance							
Property Taxes							
7. Do controls exist to ensure that additions, deletions, transfers, and abatements are properly and timely reflected in property tax records?		—		—			
8. Do procedures exist to make property assessments in accordance with the law or legislative intent with prompt adjustment of records?		—	—	—			
Sales, income, and other taxes							
9. Are filed returns cross-referenced against a data base of previous taxpayers?		—					
10. Are records organized and integrated in such a fashion that probable taxpayers are identified as a result of reporting of other governmental activities such as licensing?		—					
License fees and permits							
11. If annual payments are involved, do procedures exist to ensure that previous years' records are properly updated for new registrants and withdrawals?	—	—					
12. Are updated records used as the basis for billing persons subject to payment?		—		—			
Fines, forfeitures, and court fees							
13. Are court and other records of payments due maintained and used as a basis for collections?		—		—			
14. Do procedures exist surrounding the control, issuance, and disposition of traffic violations to ensure that amounts due are assessed and collected?		—					
Enterprise and other service revenues							
15. Are controls maintained that provide assurances that customer data base and, where appropriate, usage records are accurately maintained to ensure that amounts due are billed?	—	—					
Billing/Remittance Verification							
Property Taxes							
16. Do controls exist within the billing system to ensure that eligible property owners are billed?		—		—			
17. Do controls exist to ensure that tax assessments are being properly applied against tax rates and special charges are being considered in the preparation of billing amounts?			—	—			
18. Do controls exist to ensure that tax exemptions are within the law and properly approved?	—		—	—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
Sales, income, and other taxes							
19. Are returns reviewed for mathematical accuracy?				—			
20. Are current year's taxpayers' returns correlated with prior year's returns and are differences reviewed and accounted for?		—		—			
21. Are claims for refunds reviewed and approved separately?	—		—	—			
22. Are audits of returns filed to provide reasonable assurance that taxable income is properly reported?			—	—			
License fees and permits							
23. Are current year receipts compared to those for prior years and are explanations of variations reviewed by senior officials?		—		—			
Fines, forfeitures, and court fees							
24. Do procedures exist providing for correlation of amounts collected with records of court proceedings?	—	—	—	—			
25. Are tickets for fines, arrests, and so forth sequentially numbered and satisfactorily accounted for?		—					
Enterprise and other service revenues							
26. If billing is based on usage, are service readings performed in a timely fashion?	—	—	—				
27. Are assignments of meter readers periodically rotated?		—	—				
28. Do billing procedures exist providing for identification and investigation of unusual patterns of use?	—	—					
General							
29. Are taxes and fees billed in a timely fashion?		—					
30. Do procedures exist designed for other revenue areas ensuring timely payment of amounts due?		—	—	—			
31. Are rates of taxes, fines, fees, and services periodically reviewed and approved by the legislative body?			—	—			
32. Are programs of tax exemption or relief periodically reviewed and approved by the legislative body?			—	—			
33. Are utility rate schedules authorized by the legislative body?			—	—			
34. Do procedures exist providing for timely notification of the accounting department at the time tax, service, or other billings or claims are prepared and rendered?		—		—			
35. Do numerical or batch-processing controls exist over tax, fee, service, or other billings?		—					
36. Do controls exist over the billing of miscellaneous revenues (for example, sidewalk replacement and tree removal assessments)?	—	—	—	—			
37. Do procedures exist to prevent the interception or alteration by unauthorized persons of billings or statements after preparation but before they are mailed?		—		—			
38. Does an individual independent of receivables record keeping promptly investigate disputes with billing amounts that are reported by taxpayers or service recipients?	—		—	—			
39. Do controls exist providing reasonable assurances that restricted revenues are expended only for restricted purposes?			—	—	—		
Collection							
40. Is restrictive endorsement placed on incoming checks as soon as received?		—					
41. Do procedures exist providing reasonable assurances that interest and penalties are properly charged on delinquent taxes, fees, or charges for service?		—	—	—			
42. Do procedures exist providing for the timely filing of liens on property for nonpayment in all cases permitted by law?			—				
43. Do controls exist surrounding the collection, timely deposit, and recording of collections in the accounting records at each collection location?		—					

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
44. Is the general accounting department notified of cash receipts from separate collection centers on a timely basis?		—					
45. If payments are made in person, are receipts for payment used and accounted for and balanced to collections?	—	—					
46. Are amounts collected on behalf of other governments segregated and remitted on a timely basis?			—	—	—		
47. Are taxes and fees collected by another unit of government monitored to assure timely receipt and are amounts received subjected to reviews for reasonableness?		—	—	—			
48. Are delinquent accounts reviewed and considered for charge-off on a timely basis?			—	—	—		
49. Are write-offs or other reductions of receivables formally approved by senior officials not involved in the collection function?					—		
50. Do procedures exist providing for execution of all legal remedies to collect charged-off or uncollectible accounts, including tax sale of property, liens, and so forth?				—	—		
Accounts Receivable Record Keeping							
51. Do controls in the system exist that provide assurances that individual receivable records are posted only from authorized source documents?	—			—			
52. Are aggregate collections on accounts receivable reconciled against postings to individual receivable accounts?		—		—			
53. Are statements of account balance mailed on a timely basis, where appropriate (for example, in proprietary funds)?			—	—			
General Ledger							
54. Are trial balances if individual receivable accounts prepared on a timely basis?				—			
55. Are trial balances reconciled with general ledger control accounts and are reconciling items investigated by someone other than accounts receivable clerks?		—		—			
56. Are aged accounts receivable balances periodically reviewed by supervisory personnel?				—	—		
57. Do procedures exist for providing for timely and direct notification of the accounting department of billings and collection activities?		—		—			
Grant and Entitlement Monitoring							
Grants							
58. Is responsibility for monitoring grant activities properly fixed?			—				
59. Is grant activity monitored from a centralized location?	—		—				
60. Do procedures exist to monitor compliance with—							
• Financial reporting requirements?			—				
• Use of funds and other conditions in accordance with grant terms?	—		—	—			
• Timely billing of amounts due under grants?		—	—				
61. Is grant activity accounted for so that it can be separated from the accounting for locally funded activities?				—	—		
62. Is there a system for obtaining grantor approval before incurring expenditures in excess of budgeted amounts or for unbudgeted expenditures?			—				
63. Are grant revenues and disbursements processed under the same degree of controls applicable to the organization's other transactions (budget, procurement, etc.)?	—	—	—	—	—		
64. Are requirements included in subgrantee agreements that the subgrantee comply with the primary grant agreement conditions as well as the grantee's standards?			—				
65. Do reasonable procedures and controls exist to provide assurances of compliance with recipient eligibility requirements established by grants?			—				

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
66. Is an indirect cost allocation plan established?	—		—	—			
67. Is the plan approved by all grantor agencies?			—	—			
68. Is audit cognizance established for rates generated by the plan?				—			
Entitlements							
69. Is the amount of funds received compared with the amount anticipated by a responsible official and are unusual variances investigated?		—		—			
70. Do procedures exist to ensure that funds received are spent in accordance with legal requirements and spending restrictions?			—				
71. Are statistical or data reports that form the basis for revenue distribution reviewed by a responsible official before submission?	—			—			
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

	ASSERTIONS: *Existence or Occurrence*	ASSERTIONS: *Complete-ness*	ASSERTIONS: *Rights and Obligations*	ASSERTIONS: *Valuation or Allocation*	ASSERTIONS: *Presentation and Disclosure*	Audit Tests of Controls: *Program or W/P Reference*	Substantive Tests: *Program Reference*
.220 **D. Capital Assets**							
Segregation of Duties							
1. Are responsibilities for initiating, evaluating, and approving capital expenditures, leases, and maintenance or repair projects segregated from those for project accounting, property records, and general ledger functions?	—	—					
2. Are responsibilities for initiating capital asset transactions segregated from those for final approvals that commit government resources?	—	—		—			
3. Are responsibilities for the project accounting and property records functions segregated from the general ledger function?	—	—		—			
4. Are responsibilities for the project accounting and property records functions segregated from the custodial function?	—	—					
5. Are responsibilities for the periodic physical inventories of capital assets assigned to responsible officials who have no custodial or record keeping responsibilities?	—	—					
6. If EDP is used, is the principle of segregation of duties maintained within processing activities?		—					
Procedural Controls							
Authorization							
7. Are those individuals authorized to initiate capital asset transactions identified and is there clear definition of the limits of their authority?	—						
8. Are guidelines established with respect to key considerations such as prices to be paid, acceptable vendors and terms, asset quality standards, and the provisions of grants or bonds that may finance the expenditures?	—						
9. Is a separated capital projects budget prepared?	—						
Executive or Legislative Approval							
10. Is written executive or legislative approval required for all significant capital asset projects or acquisitions?	—						
11. Do procedures exist for authorizing, approving, and documenting sales or other dispositions of capital assets?	—	—					
12. Do procedures exist for approving decisions regarding financing alternatives and accounting principles, practices, and methods?	—			—			
13. Do procedures exist providing for obtaining grantor (federal/state) approval, if required, for the use of grant funds for capital asset acquisitions?	—		—				
14. Are grant-funded acquisitions subjected to the same controls as internally funded acquisitions?	—	—					
15. Are supplemental authorizations required, including, if appropriate, those of the grantor agency, for expenditures in excess of originally approved amounts?	—	—					
Project Accounting							
16. Is a qualified employee or independent firm engaged to inspect and monitor technically complex projects?	—	—		—			
17. Are project cost records established and maintained for capital expenditure and repair projects?	—	—		—			
18. Do reporting procedures exist for in-progress and completed projects?					—		
19. Do procedures exist to identify completed projects so that timely transfers to the appropriate accounts can be made?	—	—			—		
20. Is the accounting distribution reviewed to ensure proper allocation of charges to fixed asset and expenditure projects?				—	—		
21. If construction work is performed by contractors, do procedures exist to provide for and maintain control over construction projects and progress billings?	—		—	—			
22. Does the unit of government have the right to audit contractors' records?	—	—	—	—			

	ASSERTIONS: Existence or Occurrence	ASSERTIONS: Completeness	ASSERTIONS: Rights and Obligations	ASSERTIONS: Valuation or Allocation	ASSERTIONS: Presentation and Disclosure	Audit Tests of Controls: Program or W/P Reference	Substantive Tests: Program Reference
23. Is the right to audit contractor records during project performance exercised?	—		—				
24. Do audits of contractors cover compliance with EEO, Davis Bacon, and other regulations and contract terms, in addition to costs?	—	—		—	—		
Asset Accountability							
25. Are detail property records maintained for all significant self-constructed, donated, purchased, or leased assets?	—	—					
26. Is the accountability for each asset established?	—	—					
27. Do procedures exist for periodic inventory of documents evidencing property rights (for example, deeds, leases, and the like)?	—	—		—			
28. Do physical safeguards over assets exist?	—	—					
29. Do procedures exist ensuring that purchased materials and services for capital expenditure and repair projects are subjected to the same levels of controls as exist for all other procurements (for example, receiving, approval, checking)?	—	—					
30. Are detailed property records periodically compared with existing assets?	—	—		—			
31. Are differences between records and physical counts investigated and are the records adjusted to reflect shortages?	—			—			
32. Do procedures exist ensuring that capital assets are adequately insured?	—			—			
33. Are lease transactions subjected to control procedures similar to those required for other capital expenditures?	—	—	—				
34. Is equipment properly identified by metal numbered tags or other means of positive identification?	—			—			
35. Are fully depreciated assets carried in the accounting records as a means of providing accounting control?	—	—					
36. Do procedures exist for monitoring the appropriate disposition of property acquired with grant funds?	—		—				
General Ledger							
37. Are detailed property records periodically reconciled with the general ledger control accounts?	—	—		—			
38. Do procedures and policies exist to—							
• Distinguish between capital projects' fund expenditures and operating budget expenditures?			—	—			
• Identify operating budget expenditures to be capitalized in the fixed asset fund?					—		
• Distinguish between capital and operating leases?			—		—		
• Govern depreciation methods and practices?				—			
39. If costs are expected to be charged against federal grants, are depreciation policies or methods of computing allowances in accord with the standards outlined in OMB circulars or grantor agency regulations; if not, is depreciation charged to grants adjusted accordingly?			—	—			
40. Are the accounting records adjusted promptly—both the asset and related allowance for depreciation—when items of plant and equipment are retired, sold, or transferred?	—		—	—	—		
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

	ASSERTIONS: *Existence or Occurrence*	ASSERTIONS: *Completeness*	ASSERTIONS: *Rights and Obligations*	ASSERTIONS: *Valuation or Allocation*	ASSERTIONS: *Presentation and Disclosure*	Audit Tests of Controls: *Program or W/P Reference*	Substantive Tests: *Program Reference*
.230 E. Procurement and Payables							
Segregation of Duties							
1. Are responsibilities for the requisitioning, purchasing, and receiving functions segregated from the invoice processing, accounts payable, and general ledger functions?	—	—					
2. Are responsibilities for the purchasing function segregated from the requisitioning and receiving functions?	—	—					
3. Are responsibilities for the invoice processing and accounts payable functions segregated from the general ledger functions?	—	—		—			
4. Are responsibilities for the disbursement preparation and disbursement approval functions segregated from those for recording cash disbursements and general ledger entries?	—	—		—			
5. Are responsibilities for the disbursement approval function segregated from those for the disbursement preparation function?	—	—					
6. Are responsibilities for entries in the cash disbursement records segregated from those for general ledger entries?	—	—		—			
7. If EDP is used, is the principle of segregation of duties maintained within processing activities?	—	—					
Procedural Controls							
Requisitioning							
8. Are purchases of goods and services initiated by properly authorized requisitions bearing the approval of officials designated to authorize requisitions?	—						
9. Are requisitions pre-numbered and are those numbers controlled?	—	—					
10. Is the appropriation to be charged indicated on the purchase requisition by the person requesting the purchase?	—				—		
11. Before commitment, are unobligated funds remaining under the appropriation verified by the accounting or budget department as sufficient to meet the proposed expenditure?			—	—			
12. Are requests for special purpose (nonshelf items) materials or personal services accompanied by technical specifications?	—			—			
Purchasing							
13. Are purchasing authorizations structured to give appropriate recognition to the nature and size of purchases and the experience of purchasing personnel?	—	—					
14. Do approval procedures exist for purchase order and contract issuance?	—	—					
15. Are purchase prices periodically reviewed by a responsible employee independent of the purchasing department?				—			
16. Are competitive bidding procedures used?				—			
17. If practicable, are contract or purchasing officer's areas of responsibility rotated on a regular basis?	—						
18. Do provisions in contracts for materials, services, or facilities acquired on other than a fixed price basis provide for an audit of contractors' costs, with payments subject to audit results?			—	—			
19. Do procedures exist for public advertisement of nonshelf item procurements in accordance with legal requirements?	—			—			
20. Are recurring purchases and documentation of the justification for informal rather than competitive bids periodically reviewed?	—			—			
21. Are policies regarding conflicts of interest and business practice policies established, documented, and distributed?	—						
22. Are purchase orders and contracts issued under numerical or some other suitable control?	—	—					
23. Are an adequate number of price quotations obtained before placing orders not subject to competitive bidding?				—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
24. Is splitting orders prohibited to avoid higher levels of approval?	—			—			
25. Are price lists and other appropriate records of price quotations maintained by the purchasing department?				—			
26. Is a record of suppliers who have not met quality or other performance standards by the purchasing department maintained?	—	—					
27. Are procedures modified when funds disbursed under grant or loan agreements and related regulations impose requirements that differ from the organization's normal policies?	—		—		—		
28. Are procedures instituted to identify, before order entry, costs and expenditures not allowable under grant (federal/state) programs?			—	—			
29. Is an adequate record of open purchase orders and agreements maintained?	—		—				
30. Are purchases made for the accommodation of employees prohibited or adequately controlled?	—			—			
31. If construction contracts are to be awarded, are bid and performance bonds considered?	—		—	—			
32. Does predetermining selection criteria exist for awarding personal service or construction contracts and is adequate documentation of the award process required?				—			
33. Are changes to contracts or purchase orders subjected to the same controls and approvals as the original agreement?			—	—			
Receiving							
34. Are receiving reports prepared for all purchased goods?	—						
35. Do procedures exist for the filing of claims against carriers or vendors for shortages or damaged materials?	—		—	—			
36. Are steps taken to ensure that goods received are accurately counted and examined to see that they meet quality standards?	—			—			
37. Is a permanent record of material received by the receiving department maintained?	—	—		—			
38. Are receiving reports numerically accounted for or otherwise controlled to ensure that all receipts are reported to the accounting department?	—	—		—			
39. Are copies of receiving reports sent directly to purchasing, accounting, and, if appropriate, inventory record keeping?	—	—		—			
40. Is a government technical representative assigned to monitor and evaluate contractor performance and approve receipt of services with respect to procurements of special purpose materials, services, or facilities?	—	—		—			
41. If a receiving department is not used, do adequate procedures exist to ensure that goods for which payment is made have been received and are verified by someone other than the individual approving payment that goods have been received and meet quality standards?	—	—		—			
Invoice Processing							
42. Do invoice processing procedures provide for—							
• Obtainment directly from issuing departments of copies of purchase orders and receiving reports?	—	—					
• Comparison of invoice quantities, prices, and terms with those indicated on the purchase order?		—		—			
• Comparison of invoice quantities with those indicated on the receiving reports?		—		—			
• As appropriate, checking accuracy of calculations?				—			
43. Are all invoices received from vendors in a central location, such as the accounting department?		—					
44. Do procedures exist ensuring that the accounts payable system is properly accounting for unmatched receiving reports and invoices?	—	—	—	—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
45. Are requests for progress payments under long-term contracts related to contractors' efforts and are they formally approved?	—		—	—			
46. Do procedures exist for processing invoices not involving materials or supplies (for example, lease or rental payments, utility bills)?	—	—					
47. Do procedures exist ensuring accurate account distribution of all entries resulting from invoice processing?	—			—	—		
48. If applicable, is access to the EDP master vendor file limited to employees authorized to make changes?	—	—					
49. Does the accounting department maintain a current list of those authorized to approve expenditures?	—						
50. Do procedures exist for submission and approval of reimbursement to employees for travel and other expenses?	—		—	—			
51. Is control established by the accounting department over invoices received before releasing them for departmental approval and other processing?	—	—		—			
52. Is the distribution of charges in the accounting department reviewed by a person competent to pass on the propriety of the distribution?				—	—		
53. Are invoices (vouchers) reviewed and approved for completeness of supporting documents and required clerical checking by a senior employee?	—	—					
54. If an invoice is received from a supplier not previously dealt with, are steps taken to ascertain that the supplier actually exists?	—						
55. Are payments made only on the basis of original invoices?	—			—			
56. Is responsibility fixed for seeing that all cash discounts are taken and, if applicable, that exemptions from sales, federal excise, and other taxes are claimed?				—			
57. Are differences in invoice and purchase order price, terms, shipping arrangements, or quantities referred to purchasing for review and approval?	—			—			
58. Does the accounting department record and follow up partial deliveries?		—		—			
59. Are the accounting and purchasing departments promptly notified of returned purchases, and are such purchases correlated with vendor credit advices?	—			—			
60. Is the program and expenditure account to be charged reviewed for propriety and budget conformity?				—	—		
61. Do check signers or other responsible officials determine that restricted revenues are expended only for restricted purposes?			—		—		
62. If applicable, do procedures exist to ensure adjustment of the reserve for encumbrances (obligations) when invoices are prepared for payment?	—			—	—		
Disbursements							
63. Do procedures exist for disbursement approval and warrant or check-signing?	—	—					
64. Is there control over warrant or check-signing machines as to signature plates and usage?	—						
65. Do procedures exist to notify banks when a new signer is authorized or a previous signer leaves the employ of the government?	—						
66. Is the signer furnished with invoices and supporting data and are they reviewed prior to signing the warrant or check?	—	—		—			
67. Are reasonable limits set on amounts that can be paid by facsimile signatures?	—						
68. Are two signatures required on all warrants or checks over a stated amount?	—						

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
69. Are signature plates maintained in the custody of the person whose facsimile signature is on the plate when not in use?	—						
70. Are plates only under the signer's control used and does that person or an appropriate designee record machine readings to ascertain that all checks or warrants signed are properly accounted for?	—			—			
71. Are invoices and supporting documents cancelled by or in the presence of the signer at the time of signing?	—			—			
72. Are signed warrants or checks delivered directly to the mail room, making them inaccessible to persons who requested, prepared, or recorded them?	—						
73. Are warrants or checks cross-referenced to vouchers?	—			—			
74. Are warrants or checks controlled and accounted for with safeguards over those unused and voided?	—	—					
75. Is the drawing of warrants or checks to cash or bearer prohibited?	—						
76. Do procedures exist ensuring that warrants or checks that have been signed and issued are recorded promptly?	—	—		—	—		
Accounts Payable Encumbrances or Obligations							
77. Are statements from vendors compared on a regular basis with recorded amounts payable?	—			—			
78. If an encumbrance (obligation) system is used, are outstanding purchase orders reconciled to the reserve to the reserve for encumbrances (obligations) on a monthly basis?	—			—	—		
79. Are encumbrance (obligation) entries recorded only on the basis of approved purchase orders?	—				—		
80. Do procedures exist ensuring that accounts payable and encumbrances (obligations) are applied against the appropriate account?	—			—	—		
81. Do procedures exist ensuring that department heads are notified of payments made against accounts payable and encumbrances (obligations)?	—			—	—		
General Ledger							
82. Are trial balances of reserve for encumbrances (obligations) and accounts payable prepared on a regular basis?		—		—	—		
83. Are trial balance footings checked and traced to the individual items as well as comparing the total to the general ledger balance by an employee other than the accounts payable clerk?		—		—	—		
84. Are transactions between funds in all affected funds posted in the same accounting period and on a timely basis?				—	—		
Grant and Entitlement Monitoring							
85. Are grants disbursed only on the basis of approved applications?	—			—			
86. Are reporting and compliance requirements defined (for example, in regulations) and communicated to grantees?					—		
87. Do procedures exist to monitor grantee compliance with grant terms?			—		—		
88. Are financial operations of grantees subjected to periodic and timely audit?	—	—	—	—			
89. Are recipients monitored sufficiently and on a timely basis to permit curtailment of any abuse before complete funds disbursement?	—	—	—	—			
90. Are funds disbursed to grantees only on an as-needed basis?	—			—			
91. Does the level of grant approval authority appear appropriate?	—	—					
92. Is failure by grantees to meet financial reporting requirements investigated on a timely basis?			—	—	—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
93. Are grantees required to evidence correction of previously detected deficiencies before approval of an extension or renewal of a grant?	—		—		—		
94. So entitlement procedures exist ensuring that statistics or data used to allocate funds are accurately accumulated (for example, census bureau forms)?				—	—		
95. Are statements of recipient compliance required with entitlement conditions (for example, statement of assurances) to be filed and does a responsible official review them?			—		—		
96. Are audited financial statements or other compliance requirements of entitlement recipients reviewed on a timely basis and are unusual items investigated?			—	—	—		
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
.240 **F. Employee Compensation**							
Segregation of Duties							
1. Are responsibilities for supervision and timekeeping functions segregated from personnel, payroll processing, disbursement, and general ledger functions?	—	—					
2. Are responsibilities for the payroll processing function segregated from the general ledger function?	—	—		—			
3. Is payroll distribution supervised by employees—							
• Who are not responsible for hiring or firing employees?	—						
• Who do not approve time reports?	—						
• Who take no part in payroll preparation?	—						
4. Are responsibilities for initiating payments under employee benefit plans segregated from accounting and general ledger functions?	—	—		—			
5. Is the payroll bank account reconciled regularly by employees independent of all other payroll transaction processing activities?	—	—		—			
6. If EDP is used, is the principle of segregation of duties maintained in processing activities?	—	—					
Procedural Controls							
Personnel							
7. Are all changes in employment (additions and terminations), salary and wage rates, and payroll deductions properly authorized, approved, and documented?	—	—		—			
8. Are notices of additions, separations, and changes in salaries, wages, and deductions promptly reported to the payroll-processing function?		—		—			
9. Are appropriate payroll records maintained for accumulated employee benefits (vacation, pension data, etc.)?		—		—			
10. Are terminating employees interviewed as a check on departure and as a final review of any termination settlement by the personnel department?	—	—		—			
11. Do written personnel policies exist?	—	—					
12. Are controls established to ensure that payroll costs charged to grants are in compliance with grant agreements?				—	—		
13. Are payroll and personnel policies governing compensation in accordance with the requirements of grant agreements?			—	—			
14. Are wages at or above the federal minimum wage?				—			
Supervision/Timekeeping							
15. Are hours worked, overtime hours, and other special benefits reviewed and approved by the employee's supervisor?	—	—		—			
16. Do records and procedures exist for timekeeping and attendance?	—	—					
17. Are time cards or other time reports reviewed for completeness and approved by the employee's supervisor?	—	—					
18. If time cards are used, are they punched only by the employees to whom they are issued?	—						
19. Is the time clock placed in a position where it can be observed by a supervisor?	—						
20. Do procedures exist for authorizing, approving, and recording vacations, holidays, and sick leave and is compensatory time controlled and approved?	—			—	—		
Payroll Processing							
21. Do controls exist over payroll preparation?	—	—		—			
22. Are changes to the EDP master payroll file approved and documented?	—			—			
23. Is access to the EDP master payroll file limited to employees who are authorized to make changes?	—			—			
24. Are completed payroll registers reviewed and approved before disbursements are made?	—			—			

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Complete-ness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
25. Are documents supporting employee benefit payments (such as accumulated vacation or sick leave) reviewed before disbursements are made?	—	—		—			
26. Are comparisons (reconciliations) of gross pay of current to prior period payrolls reviewed for reasonableness by a knowledgeable person not otherwise involved in payroll processing?	—	—		—			
27. Is the payroll (examination of authorizations for changes noted on reconciliations) reviewed by an employee not involved in its preparation?	—	—		—			
28. Is the distribution of dollars and hours of gross pay balanced with the payroll registers, and reviewed by someone independent but knowledgeable in this area?				—	—		
29. Is a comparison to amounts appropriated and budgeted included in the review?				—	—		
30. Are payroll advances to officials and employees prohibited or are they subjected to appropriate review?	—			—	—		
Disbursement							
31. Are signature plates and the use of the payroll check-signing machines kept under control of the official whose name appears on the signature plate or an employee to whom he has delegated that responsibility?	—						
32. Is a log maintained that reconciles the counter on the check-signing machine with the number of checks issued in each payroll?	—						
33. Is a separate, imprest-basis, payroll bank account maintained?	—			—			
34. Is the payroll bank account reconciled on a regular basis?	—			—			
35. Are payroll check endorsements compared, on a test basis, with signatures on file by someone independent of the payroll department?	—						
36. Is someone independent of the payroll department comparing payments made in cash, which require signed receipts, with signatures on file on a test basis?	—			—			
37. Is the supply of unused payroll checks controlled?	—			—			
38. Are employees required to provide identification before being given checks or pay envelopes?	—			—			
39. Are employees prohibited from accepting another employee's pay?	—						
40. Are unclaimed wages returned to a custodian independent of the payroll department?	—				—		
41. Do employees who distribute checks or pay envelopes make a report of unclaimed wages directly to the accounting department?	—				—		
42. Are payments of unclaimed wages made at a later date only upon presentation of appropriate evidence of employment and are they approved by an officer or employee who is not responsible for payroll preparation or time reporting?	—						
43. Are W-2 forms compared to payroll records and mailed by employees not otherwise involved in the payroll process?		—		—			
44. Do procedures exist for investigating returned W-2s?	—			—			
45. Are payroll checks periodically distributed by the internal auditors to ascertain that employees exist for all checks prepared?	—						
General Ledger							
46. Do adequate account coding procedures exist for classification of employee compensation and benefit costs so that such costs are recorded in the proper general ledger account?					—		

	ASSERTIONS					Audit Tests of Controls	Substantive Tests
	Existence or Occurrence	*Completeness*	*Rights and Obligations*	*Valuation or Allocation*	*Presentation and Disclosure*	*Program or W/P Reference*	*Program Reference*
47. Are accrued liabilities for unpaid employee compensation and benefit costs properly recorded or disclosed?		—	—	—	—		
Phase 1: Preliminary Risk Assessment	L M H	L M H	L M H	L M H	L M H		
Phase 2: Final Risk Assessment—Based on audit tests of controls	L M H	L M H	L M H	L M H	L M H		

IV. Administrative Controls

.250 When conducting audits in accordance with the Single Audit Act of 1984, the auditor needs to identify the administrative controls that need to be in place in order to properly administer its federal assistance programs.

.260 These controls are normally established by an entity based on the major requirements with which the entity must comply. AAM section 12,010.270 and .280 are common control procedures which need to be documented and tested to support the auditor's report on internal administrative controls.

.270 A. General Compliance Requirements

1. Political Activity (Compliance Supplement)

a. Ordinances prohibiting partisan political activity.

b. Posters stating the prohibition against partisan political activity.

c. Employee policy statement, handbook or policy manual prohibiting partisan political activity.

d. Expenditure approval process, i.e., expenditures reviewed by a person who is knowledgeable of this restriction.

2. Davis-Bacon Act (Compliance Supplement)

a. The practice of obtaining prevailing wage rates published in the Federal Register or obtained from the Department of Labor and comparing these rates with rates paid by contractors or subcontractors based on payroll records submitted to the grantee.

b. The practice of interviewing contractors' or subcontractors' laborers to verify their wage rates and to compare them to the prevailing wage rate.

c. The practice of posting prevailing wage rates and the provisions of the Davis-Bacon Act at job sites.

d. Existence of provisions in contracts expressly requiring compliance with Davis-Bacon Act.

e. Assignment of responsibility to monitor contractors for compliance with contract terms, including Davis-Bacon provision.

f. Periodic requests of the Division of Labor Standards for their findings regarding the existence of any discriminatory practices by the grantee.

3. Civil Rights (Compliance Supplement)

a. Existence of a civil rights policy—prohibiting discrimination.

b. Existence of an affirmative action policy—encouraging the use of minority firms and employment of individuals from minority groups.

c. Methods of communicating the civil rights/affirmative action policy such as posters, notations on letterhead, etc.

d. Accumulation of data and preparation of periodic reports reflecting status in achieving affirmative action goals.

e. Designated compliance officer to receive and process civil rights inquiries and complaints.

f. Self-evaluation procedures to ensure compliance by grantee.

g. Practice of holding open meetings to ensure the public is knowledgeable of the grantee's management philosophy and major policy issues.

h. Practice of holding public hearings regarding such topics as the use of federal funds and the location of federally financed facilities.

i. Published grievance procedures.

j. Distribution of policies and grievance procedures via the employee handbook.

4. **Cash Management (Compliance Supplement)**

a. Practice of deferring request for reimbursement until after the related expenditure is incurred.

b. Existence of a cash log showing expenditures and cash balances for federal financial programs.

c. Assignment of responsibility for requesting grant drawdowns to a person who has access to and utilizes the cash log and is knowledgeable of the cash management requirements.

d. Utilization of adequate cash forecasting methods (when grant reimbursements are requested prior to incurring the expenditure).

e. Reviewed and documented approval of grant drawdown requests by a person knowledgeable of the cash management restrictions.

f. Inclusion of pertinent requirements in grantee's investment policy.

g. Depository agreement stipulating FDIC/FSLIC and segregation of account requirements.

h. Inclusion in requests for banking services of pertinent requirements.

5. **Relocation Assistance and Real Property Acquisition (Compliance Supplement)**

a. The existence of a policy statement compatible with federal regulations regarding relocation assistance and real property acquisition.

b. The existence of a "relocation officer," i.e., the assignment of a person to monitor compliance with federal requirements.

c. Proper training, copies of regulations and other procedures to ensure that persons responsible for administering programs involving relocation or real property acquisition are made aware of federal requirements.

d. Utilization of a checklist of federal requirements by persons responsible for administering programs involving relocation or real property acquisition.

e. Practice of sending pamphlets to persons being relocated, informing them of their rights and the prescribed procedures.

f. Practice of requesting written acknowledgement of persons being relocated that the required procedures and rights were made available to them.

g. Existence of a review function over the acquisition of real property for compliance with federal requirements.

6. **Federal Financial Reports (Compliance Supplement)**

a. Tickler file to ensure reports (including grant closeout reports) are filed timely (preferably centralized).

b. Assignment of responsibility for preparing reports (perhaps included as a duty in the employee's job description).

c. Policy of requiring review and written approval of federal financial reports for accuracy and timeliness of submission.

d. Periodic documented reconciliations of federal financial reports to the general ledger (or to work sheets that are reconciled to the general ledger).

7. **Allowable Costs/Cost Principles (OMB Circular A-87)**

a. Review of expenditures by a person knowledgeable of the provisions of OMB Circular A-87.

b. Involvement in the grant application/budget process by a person knowledgeable of the provisions of OMB Circular A-87.

c. Utilization of a checklist denoting allowable, unallowable and possibly unallowable costs by persons authorizing and/or reviewing expenditures charged to grant programs.

d. Existence of written policies regarding expenditures eligible for federal reimbursements.

e. Utilization of a person knowledgeable of indirect cost principles for preparation of the plan.

f. Assignment of responsibility for reviewing indirect cost allocations to a person knowledgeable of the requirements.

g. Periodic documented reconciliation of costs accumulated in the indirect cost pool to the general ledger.

h. Utilization of an outside expert to prepare or periodically review the indirect cost allocation plan and/or adherence to the plan.

8. **Drug-Free Workplace Act**

a. Existence of drug-free workplace policy.

b. Designated compliance officer.

c. Tickler file to ensure grant certifications are filed timely for each grant.

d. Checklist or sign-off sheet to ensure policy is distributed to employees paid with federal funds.

e. Assignment of responsibility for reporting violations to the Federal government.

9. **Administrative Requirements (Common Rule)**

a. Interest earned on advances:

(1) Existence of cash log showing interest earned on advances.

(2) Assignment of responsibility to remit such interest to appropriate Federal Agency at least quarterly.

b. Period of availability of funds:

(1) Review of expenditures to ensure charges result from obligations of the funding period unless carryover of unobligated balances is permitted.

(2) Assignment of responsibility to liquidate all obligations incurred under the award no later than 90 days after the end of the funding period.

(3) Tickler file to ensure liquidation of obligations and submission of annual Financial Status Report (SF 269).

c. Program income:

(1) Establishment of records to track program income (and costs to generate program income if Federal Agency authorizes netting of income and costs).

(2) Assign responsibility for ensuring that current program income is deducted from current allowable costs in determining federal drawdowns or reimbursements.

(3) When authorized by Federal Agencies, assign responsibility of ensuring program income is used only in authorized manner. For example:

- program income is added to the total funds committed to the project; or
- program income is used to meet cost sharing or matching requirements.

(4) Establish a grant "Master Control" sheet that indicates how program income is to be used on each grant.

d. Real property:

(1) Maintenance of real property records, including sources of financing, percentage of federal ownership, cost, and other pertinent information.

(2) Periodic reviews made to ensure real property is used for the originally authorized purposes.

(3) Assign responsibility for obtaining disposition instructions for real property and disposing of real property no longer needed for the originally authorized purpose through:

- Retention of title.
- Sale of property.
- Transfer of title.

e. Equipment:

(1) Existence of fixed asset inventory system, which include sources of financing for fixed assets, percentage of federal ownership, location cost, and other pertinent information.

(2) Documentation in fixed asset manual of federal requirements relating to frequency of conducting inventory (every two years), transfer, property utilization, property disposition, and accounting.

(3) Review of fixed asset purchases, maintenance, safeguarding, transfers, and dispositions by a person knowledgeable of the requirements.

f. Supplies:

(1) Maintenance of inventory records of unused supplies.

(2) Establish a policy regarding unused and unneeded supplies and the requirement to compensate the awarding Agency for its share.

g. Subawards to debarred and suspended parties:

(1) Assign responsibility for ensuring that awards are not made to any debarred or suspended parties.

h. Procurement:

(1) Incorporation of federal procurement standards in grantee's purchasing policy.

(2) Knowledge of procurement-related restrictions by persons involved in the review and award of contracts.

(3) Review of purchase requisition and/or purchase orders by persons knowledgeable of procurement requirements.

i. Subgrants:

(1) Inclusion of a provision for compliance with the Common Rule in every subgrant.

(2) Inclusion of other significant provisions in every subgrant.

(3) Policy to make subgrantees aware of the regulations imposed on them.

j. Revolving Fund repayments:

(1) Establish revolving fund records that include information necessary to track repayments.

(2) Establish policy to ensure repayments are made on a timely basis.

.280 B. Example of Specific Requirements

Major Program—Specific Compliance Requirements
Community Development Block Grant

Besides documenting and testing the internal administrative controls over the general compliance requirements, the internal administrative controls over program-specific requirements need to be documented and tested. The controls and control procedures may vary significantly among governments so the individual circumstances in a particular government need to be examined. This section provides an example of the types of questions that may be asked to provide information about internal administrative controls over specific program requirements.

A. Types of services allowed or unallowed

1. What control procedure does the entity have in place to ensure that activities funded by the program are for allowable purposes and meet one of the national objectives?
2. What control procedure does the entity have in place to ensure that not more than 20 percent of the total grant is expended for planning and administration?

B. Eligibility

The auditor is not expected to make tests for recipient eligibility.

C. Matching, level of effort, and/or earmarking requirements

There are no matching, level of effort, or earmarking requirements.

D. Reporting requirements

1. What control procedure does the entity use to ensure that the grantee performance report is fully completed and submitted within two months after the end of each program year?
2. What control procedures are in place to ensure other Federal reports required by the program are identified, fully completed and submitted on a timely basis?

E. Special tests and provisions

1. What control procedures exist to ensure that program funds are not obligated or expended before the receipt of HUD's approval of a Request for Release of Funds (RROF) and environmental certification?

2. How does the entity ensure that all projects requiring an environmental review receive one?

3. What procedures do you employ to ensure that income earned under this program, if any, is properly accounted for and utilized in accordance with federal laws and regulations?

4. Describe the accounting processing involved from initiating the transaction to its inclusion in the financial statements, including how the computer is used to process data.

   This understanding involves knowledge of the ways in which transactions are valued, classified, recorded, and summarized in the journals and ledgers.

   After gaining an understanding of the direct flow of accounting information from its origin through the processing system to its compilation in the general ledger, an understanding of the processing steps, including how transactions are valued, classified, recorded and summarized, and control points at each processing step needs to be obtained.

5. Describe the financial reporting process including the extent of client procedures to prepare significant accounting and disclosure estimates. Also, describe the way in which general ledger information is summarized to arrive at the amounts and disclosures reported in the financial statements.

[*The next page is 12,101.*]

AAM Section 12,100
Designing the Audit Program

.01 The objective of an audit is to express an opinion on whether financial statements present fairly in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards. The procedures that the auditor plans to use to gather evidence are outlined in an audit program.

.02 Since the audit program describes the evidence-gathering steps to be used in the audit, it should be carefully designed. Designing an audit program involves three major considerations:

a. Deciding *what* procedures to apply—the *nature* of audit tests

b. Deciding *when* to apply the procedures—the *timing* of audit tests

c. Deciding *which* items to apply the procedures to—the *extent* of audit tests

.03 Flowchart 1 presents an overview of the structure of the audit process. To design an audit program that is efficient and effective, the auditor should—

a. Identify the client's assertions regarding each material component of the financial statements.

b. Consider the risk of material misstatement.

c. Establish specific audit objectives relating to the assertions in the financial statements.

d. Determine the audit procedures to be performed to accomplish the audit objectives.

e. Determine when to perform the audit procedures.

f. Determine which of many items to apply audit procedures to.

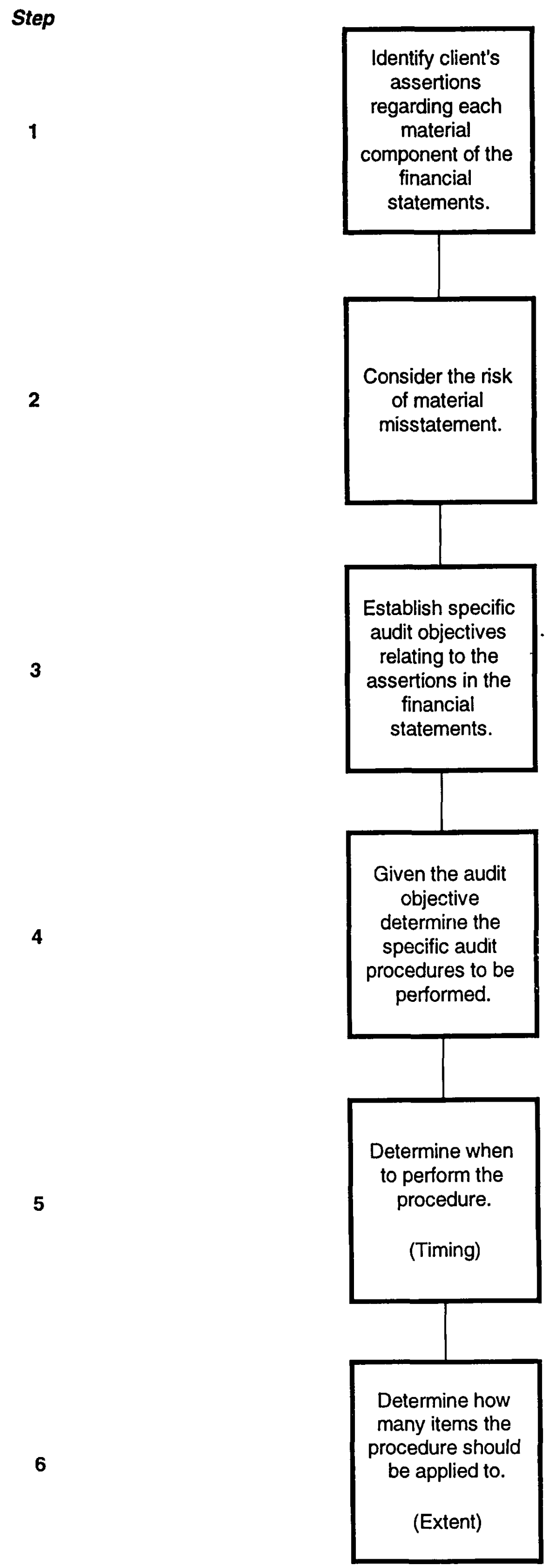
.04 The six steps illustrated in flowchart 1 result in a determination of the nature, timing, and extent of audit tests.

Financial Statement Assertions

.05 According to SAS No. 31, *Evidential Matter,* as amended by SAS No. 48 (AU section 326),* the independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. These assertions are embodied in the account balance, transaction class, and disclosure components of financial statements and are classified according to the following broad categories:

* In May 1995 the Auditing Standards Board issued a proposed amendment to SAS No. 31 (AU section 326), that would incorporate the concept of evidential matter in electronic form, including guidance on the potential audit impact of evidential matter in electronic form and a description of matters an auditor should consider in such circumstances. If approved, the final SAS would be effective for engagements beginning on or after January 1, 1997 with earlier application encouraged.

Flowchart 1
Audit Logic Process



a. *Existence or Occurrence.* Reported assets and liabilities actually exist at the balance-sheet date, and transactions reported in the income statement actually occurred during the period covered.

b. *Completeness.* All transactions and accounts that should be included in the financial statements are included, or there are no undisclosed assets, liabilities, or transactions.

c. *Rights and Obligations.* The company owns and has clear title to assets and liabilities are obligations of the company.

d. *Valuation or Allocation.* The assets and liabilities are valued properly, and the revenues and expenses are measured properly.

e. *Presentation and Disclosure.* The assets, liabilities, revenues, and expenses are properly classified, described, and disclosed in the financial statements.

Developing Audit Objectives

.06 A misrepresentation of any of the five financial statement assertions could cause a material misstatement in the financial statements. The auditor should consider the risk of material misstatement for each assertion in the financial statements, and then obtain evidence to support the financial statement assertions to reduce the risk of material misstatement to an acceptably low level. To determine what type of evidence to obtain, the auditor develops specific audit objectives related to each assertion.

.07 In determining audit objectives, the auditor should evaluate each of the five assertions as they relate to the specific account balance or class of transactions being examined. For example, if the auditor is attempting to gather evidence on the assertion of *existence* of inventory, the auditor's objective would be to gather evidence that inventory included in the balance sheet physically existed at the date of the balance sheet.

Figure 1

Relationship of Assertions and Objectives for Inventory

Financial Statement Assertion	*Illustrative Audit Objectives*
Existence or occurrence	—Inventories included in the balance sheet physically exist.
Completeness	—Inventory quantities include all products, materials, and supplies on hand.
	—Inventory quantities include all products. materials, and supplies owned by the client that are in transit or stored at outside locations.
	—Inventory listings are accurately compiled and the totals are properly included in the inventory accounts.
Right and obligations	—The entity has legal title or similar rights of ownership to the inventory.
Valuation or allocation	—Inventories are properly stated at cost (except when market is lower).
Presentation and disclosure	—Inventories are properly classified in the balance sheet as current assets.

An example of the relationship between financial statement assertions and audit objectives is shown in Figure 1.

Audit Tests

.08 After the auditor has determined the audit objectives, the method of achieving the objectives should be selected. Although these methods are referred to by various names such as audit procedures, audit techniques, and audit tests, they represent the evidence-gathering methods auditors use. The basic requirement for determining audit procedures, according to SAS No. 31, paragraph 12 (AU section 326.13), is that:

> The procedures adopted should be adequate to achieve the audit objectives developed by the auditor, and the evidential matter obtained should be sufficient for the auditor to form conclusions concerning the validity of the individual assertions embodied in the components of financial statements.

.09 Some audit procedures can satisfy a combination of audit objectives for a given account balance or class of transactions. For example, the auditor's observation of a physical inventory count can provide evidence that inventories physically exist and that inventory quantities include all products, materials, and supplies on hand.

.10 Audit tests or procedures can be classified or categorized in a variety of ways. The most common classifications are by purpose of the test or by type of test.

Purpose of the Test

.11 According to SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78 (AU section 319), the purpose of performing audit tests are:

a. To evaluate the effectiveness of the design and operation of internal controls. These tests are referred to as tests of controls.

b. To detect material misstatements in financial statement assertions. These tests are referred to as substantive tests.

.12 Substantive tests are procedures applied to account balances or classes of transactions to determine if there are material misstatements in the financial statements. The substantive test that the auditor performs consists of tests of details of transactions and balances and analytical procedures. In assessing control risk, the auditor also may use tests of details of transactions as tests of controls. The objective of tests of details of transactions performed as substantive tests is to detect material misstatements in the financial statements. The objective of tests of details of transactions as tests of controls is to evaluate whether controls have been placed in operation. Although these objectives are different, both may be accomplished concurrently through performance of a test of details on the same transaction.

.13 If the control risk is assessed at less than the maximum level, the auditor should obtain sufficient evidential matter to support that assessed level. The evidential matter that is sufficient to support a specific assessed level of control risk is a matter of auditor judgment. The type of evidential matter obtained all bear on the degree of assurance provided. Since the auditor's substantive testing is affected by the quality of the controls, the auditor is concerned with whether the controls established are designed and operating effectively. The role of tests of controls is to justify this assertion.

.14 The nature, timing, and extent of substantive tests are generally based on the assessment of inherent and control risk made during the planning phase of the engagement. For example, the higher the assessment of control risk, the more comprehensive the substantive tests should be. If analytical procedures performed during the planning phase of the engagement suggest that some account balances are unexpectedly high or low, the auditor may determine that those balances warrant more testing. Tests' effectiveness can be modified by changing their nature (for example, tests of balances versus analytical procedures), timing (testing as of the balance-sheet date versus an interim date), or extent (testing 100 percent versus sampling). Similarly, the auditor may be able to change the same factors to make audits more efficient. While the main objective is to perform an effective audit, if alternative tests are equally effective, the auditor should choose the most efficient one.

.15 Planning occurs throughout the engagement and as a result the auditor might have to reassess risk as the engagement unfolds. For example, even if tests of controls indicated that an area had low risk and the auditor planned substantive tests accordingly, information might come to the auditor's attention during the audit that requires reassessment of the risk. Such information might include, for example, unexpected deviations from control procedures, misstatements that the internal controls should have caught, or new information about transactions or balances.

.16 The most effective and efficient audit strategy for a small business engagement generally is to assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control). In this case, the auditor will use the knowledge obtained from the understanding of internal control and the assessed level of control risk in designing substantive tests for financial statement assertions.

Type of Test

.17 Auditors perform four types of tests:

a. Analytical procedures

b. Inquiry and observation

c. Tests of transactions

d. Tests of balances

The relationship of audit tests by purpose to audit tests by type is shown in figure 2.

Analytical Procedures

.18 Analytical procedures are tests applied to the *total* recorded amounts and are based on the existence of plausible and consistent relationships among financial statement elements or between financial and nonfinancial amounts. Analytical procedures are used for the following purposes:

a. To assist the auditor in planning the nature, timing, and extent of other auditing procedures.

b. As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.

c. As an overall review of the financial information in the final review stage of the audit.

.19 Analytical procedures can be effective:

- For certain types of assertions (for example, the completeness assertion, which cannot be tested directly using a test of balances on recorded amounts).
- When the relationships between amounts are very predictable.
- When the data used to develop expectations based on the relationship are reliable.
- When relatively precise expectations can be developed.

.20 Analytical procedures can provide evidence supporting financial statement assertions and, thus, can be used as substantive tests. Because analytical procedures are often the least expensive tests, they should be used whenever practical.

.21 SAS No. 56, *Analytical Procedures* (AU section 329), describes analytical procedures as follows:

Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:

a. Financial information for comparable prior period(s) giving consideration to known changes.

b. Anticipated results—for example, budgets, or forecasts including extrapolations from interim or annual data.

c. Relationships among elements of financial information within the period, such as interest income in relation to the average loan balance.

d. Information regarding the industry in which the client operates—for example, cost of funds information.

e. Relationships of the financial information with relevant nonfinancial information.

.22 Whenever analytical procedures are applied as substantive tests, the auditor must apply the following procedures:

a. Consider whether the relationship is plausible and predictable.

b. Consider whether the data used for the comparison is reliable.

c. Consider whether the account balance tested is consistent with the auditor's expectations. If it is not consistent, obtain the client's explanation for the variance and get evidence to corroborate the client's explanation.

.23 SAS No. 56 (AU section 329) also requires that analytical procedures be performed at the planning and final review stages of the audit.

Inquiry and Observation

.24 Testing of control activities that leave no audit trail of documentary evidence is usually done by inquiry and observation. Auditors make inquiries of different individuals and conduct observation tests to determine who performs a particular activity or how or when the activity is done. For example, the auditor may ask different individuals about who posts to the receivables ledger, the auditor may observe who prepares the bank reconciliation, or the auditor may observe when cash is deposited in the bank.

.25 Inquiry and observation can also be used as substantive tests. For example, an audit procedure such as an observation of a *physical asset* to determine that it exists is a substantive test relating to the existence assertion. Likewise, inquiries regarding subsequent events would be a substantive test because they provide evidence regarding the adequacy of disclosures in the financial statements.

Matrix of Audit Tests by Purpose and Type *Figure 2*

		Purpose of Test	
		Substantive Test	Test of Controls
Type of Test	Analytical Procedures	Yes Example A	No
	Inquiry and Observation	Yes Example H	Yes Examples B, C
	Tests of Transactions	Yes Example D	Yes Examples E, F
	Tests of Balances	Yes Examples G, H	No

Examples:

A—Comparison of this year's expenses with last year's expenses

B—Observation by auditor that cash is deposited daily by a specific clerk

C—Inquiry by auditor about who deposits cash and how often

D—Examination of invoices to support additions (specific transactions) to fixed assets account during year

E—Examine sales invoices to see if initials of credit manager are there to indicate a credit file and credit approval (Inspection Test)

F—Vouch from sales invoices to credit files to see if customer has a credit file and has been approved for credit (Reperformance Test)

G—Confirmation of year-end balances in accounts receivable

H—Observation of the existence of a building

Tests of Transactions

.26 Tests of transactions consist of the examination of the documents and accounting records involved in the processing of specific transactions. Such procedures can accomplish both testing of controls and substantive testing and are sometimes used concurrently.

.27 Tests of controls are accomplished when the auditor examines transaction documentation to determine if control activities have been applied as prescribed. Tests of transactions as tests of controls can be classified as either inspection tests or reperformance tests. If the auditor examines documentation, the tests of controls are classified as an inspection test. Alternatively, if the auditor repeats a control activity performed by the client, the tests of controls are classified as reperformance tests. For example, a control activity may require employees to match vendors' invoices with purchase orders and receiving reports and then initial the invoices to indicate that the procedure was performed. If the auditor tests the control by examining invoices for initials, the test is an inspection test. If the auditor tests the control by comparing vendors' invoices with purchase orders and receiving reports, the test is a reperformance test. Regardless of whether the auditor tests by inspection or reperformance, the test of control is a test of transactions.

.28 The substantive objective of tests of transactions is accomplished when the auditor examines transaction documentation to determine if dollar errors exist in a balance. For example, if the auditor examines documentation supporting individual charges (debits) to an equipment account to determine that the account balance is fairly stated, the test is classified as a substantive test of transactions.

Tests of Balances

.29 Tests of balances are procedures applied to the *individual items* that compose an account balance or class of transactions. The tests involve confirmation, inspection, or observation procedures to provide evidence about the recorded amount. Tests of balances are substantive tests designed to identify misstatements by a direct test of the ending balance rather than by testing the transactions that make up that balance.

.30 Substantive tests of transactions and tests of balances are interrelated in that each class of transactions affects a related account balance. Since financial statement amounts are the accumulation of transactions, an auditor may test the transactions that enter the account (that is, the debits and credits), the account balance itself (that is, the ending balance), or both.

Linking Audit Procedures to Objectives

.31 To design an audit program, the audit should select audit procedures that achieve specific audit objectives developed from the five broad assertions for each material account balance in the financial statements.

.32 In selecting audit procedures to achieve the audit objectives developed, an auditor considers the following, according to SAS No. 31, as amended:

a. The risk of material misstatement of the financial statements including the assessed levels of control risk.

b. The expected efficiency and effectiveness of possible audit procedures.

c. The nature and materiality of the items being tested.

d. The kinds and competence of available evidential matter.

e. The nature of the audit objective to be achieved.

The Completeness Assertion

.33 SAS No. 31, paragraph 5, as amended (AU section 326.05), discusses the completeness assertion:

> Assertions about completeness deal with whether all transactions and accounts that should be presented in the financial statements are so included. For example, management asserts that all purchases of goods and services are recorded and are included in the financial statements. Similarly, management asserts that notes payable in the balance sheet include all such obligations of the entity.

.34 Substantive tests that provide assurance regarding the completeness assertion are those that provide evidence about whether all transactions have been captured by the client's financial reporting information system and are included in the financial statements.

.35 Gathering evidence about whether all transactions have been recorded is one of the most difficult audit objectives to achieve. Evidence of completeness can be even more difficult to obtain when a client does not have good internal control or has only an informal record-keeping system. Because these two characteristics often apply to small business, satisfying the completeness objective can be difficult for the auditor in a small business engagement.

.36 Completeness relates to whether all items have been included in the financial statements. The completeness assertion is violated if a transaction or account is omitted from the financial statements. If a transaction is merely recorded in the wrong account, there is no violation of the completeness assertion since the transaction is still recorded in the financial statements. In such a situation, the accounts are not incorrect because of a completeness error; rather, they are incorrect because of a classification error. A classification error is a violation of the presentation and disclosure assertion.

.37 For many accounts, the completeness assertion is the most difficult to test. The difficulty arises because the auditor must gather evidence about potential unrecorded items. Sources of audit evidence regarding unrecorded items often are not readily available.

Lack of Evidence

.38 To give an unqualified opinion, the auditor must gather sufficient, competent evidential matter to reduce the level of audit risk to an appropriately low level. SAS No. 31, paragraph 23, as amended (AU section 326.23), provides the following guidance when the auditor is unable to gather sufficient evidence to be satisfied regarding the completeness assertion:

> To the extent the auditor remains in substantial doubt about an assertion of material significance, he must refrain from forming an opinion until he has obtained sufficient competent evidential matter to remove such substantial doubt, or he must express a qualified opinion or a disclaimer of opinion.

.39 SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, paragraph 8 (AU section 316.08), states:

> The auditor should exercise (*a*) due care in planning, performing and evaluating the results of audit procedures, and (*b*) the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected. Since the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor is not an insurer and his report does not constitute a guarantee.

.40 SAS No. 31, as amended, requires the auditor to obtain evidence concerning inclusion in the financial statements of all types of transactions that the auditor has reason to believe has occurred based on the auditor's knowledge of the client and the industry in which it operates. The excerpt from SAS No. 53 (AU section 316), refers to transactions which the auditor has reason to believe have occurred. Utilizing professional skepticism while performing the audit, this would require the auditor to question transactions which are peculiar to the particular client or industry as well as questioning the lack of specific types of transactions.

.41 The results of a research study on audit problems encountered in small business engagements (Auditing Research Monograph No. 5) indicates that many practitioners sometimes accept client representations as sufficient audit evidence when completeness of recorded transactions cannot be substantiated.[1] Client representations are part of the evidential matter the auditor gathers, but they should not be used as a substitute for the performance of those procedures considered necessary to form an opinion on the financial statements. An auditor cannot rely on client representations alone as sufficient audit evidence to substantiate the completeness of account balances and classes of transactions. Obtaining such representations complements but does not replace other auditing procedures that the auditor should perform. [See Auditing Interpretation No. 3 of SAS No. 31, "The Auditor's Consideration of the Completeness Assertion" (AU section 9326.18–.21).] When an auditor is unable to form an opinion, even though representations from the client have been received, there is a limitation on the scope of the audit that precludes the auditor from issuing an unqualified opinion (SAS No. 19, *Client Representations*, paragraph 12 [AU section 333.12]).

Internal Control Activities Related to Completeness

.42 Internal control activities related to completeness include control activities that are designed (1) to count or otherwise identify transactions executed by the entity and (2) to provide reasonable assurance that all transactions have been accurately recorded by the accounting system. For example, completeness controls over purchases can include reconciliation of all pre-numbered receiving reports (which would be required for all goods received) to recorded purchases and investigation of receiving reports that are missing, not recorded, or not otherwise accounted for. Many auditors prefer to rely on controls when gathering evidence of completeness since extensive substantive tests for completeness may be more difficult to design than those for other SAS No. 31 assertions.

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[1] D.D. Raiborn, Auditing Research Monograph No. 5, *Audit Problems Encountered in Small Business Engagements* (New York: AICPA, 1982), p. 74.

.43 If the auditor desires to assess control risk at less than the maximum level, tests of controls should be performed to determine that the controls are working as prescribed to make that control risk assessment. Once the control risk is assessed at less than maximum, the auditor may restrict substantive procedures designed to obtain evidential matter regarding the completeness assertion. Taken alone, the assessed level of control risk, ordinarily, is not sufficiently low to eliminate the need to perform any substantive tests. In addition, small businesses often lack segregation of duties, which usually prevents the auditor from assessing control risk at a low level. As a result, it is necessary to perform substantive tests of the completeness assertion.

Substantive Tests

.44 Many substantive tests are of limited usefulness in detecting errors of omission because they are usually applied to recorded amounts. Unrecorded transactions are not included in the account balances or classes of transactions to which the auditor applies substantive tests.

.45 Of all the financial statement assertions, only completeness involves consideration of whether there are material amounts that are not included in the account balance or class of transactions being tested. Therefore, substantive tests of the completeness assertion differ somewhat from substantive tests of other financial statement assertions. The difference is highlighted by the following excerpt from SAS No. 31, paragraph 11, as amended (AU section 326.11):

> In designing substantive tests to achieve an objective related to the assertion of existence or occurrence, the auditor selects from items contained in a financial statement amount and searches for relevant evidential matter. On the other hand, in designing procedures to achieve an objective related to the assertion of completeness, the auditor selects from evidential matter indicating that an item should be included in the relevant financial statement amount and investigates whether that item is so included.

.46 Substantive tests can be designed to provide evidential matter to support a conclusion that specific account balances are not misstated by amounts that would cause the financial statements, taken as a whole, to be materially misstated because of unrecorded transactions.

.47 Important sources of evidential matter for completeness include source documents, such as order logs, shipping and receiving documents, and checks. One common test of completeness involves tracing amounts from source documents to amounts recorded in the accounting records. For example, the auditor may vouch selected cash disbursements after the end of the audit period to test the completeness of amounts recorded as accounts payable at the balance-sheet date. Other substantive procedures that provide evidence concerning the completeness of financial statement account balances include the following:

a. Sales-and-purchases cutoff procedures that include tracing shipping and receiving documents processed after the audit period to accounting records for the proper period.

b. Analytical procedures in which the auditor investigates relationships among data that indicate a financial statement account or balance may be understated. For example, the auditor may obtain evidence that all interest-bearing debt is recorded by examining the relationship between recorded interest expense and the average balance of interest-bearing debt outstanding for the period. Disproportionate relationships based on the auditor's knowledge of interest rates should be investigated. Other examples include: a comparison of investment income to average investments for the period to test whether income earned on investments is recorded; the relationship of average pay times number of employees to payroll expense to substantiate that salaries are recorded; and the relationship of membership fee revenue to the number of members of an organization.

c. Confirmations of balances or transactions designed to identify unrecorded amounts, such as accounts payable confirmations that request the creditor to specify the amount of the client's obligation.

d. Tests of bank reconciliations, including examination of checks clearing the bank after the audit period to identify cash disbursements processed but not recorded or inappropriately recorded in the subsequent period.

e. Reading the minutes of the meetings (of the) board of directors and stockholders and tracing transactions authorized in the minutes to amounts recorded in the accounting records.

f. Overall reconciliations using financial and nonfinancial data, such as "proofs" of cash and sales.

[*The next page is 12,201.*]

AAM Section 12,200

Illustrative Audit Program for State and Local Governmental Units

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

.010

	Done by	*Date*	*W/P Ref.*
I. Engagement Planning and Administration			
A. Engagement Planning Procedures			
1. Determine that a signed engagement letter proposal or contract covering the current engagement is on file. Read letter for any special provisions.	____	____	____
2. Determine that the decision to accept engagement (in case of new client) or to retain client has been documented. (See AAM section 11,200.09.)	____	____	____
3. Review those suggested reference materials shown in AAM section 12,210 which are relevant to the scope of the engagement.	____	____	____
4. If this is a new client:			
a. Ascertain that required communications in SAS No. 7, *Communications Between Predecessor and Successor Auditors* [AU section 315], if any, have been made.	____	____	____
b. Request client to communicate with predecessor auditor authorizing predecessor auditor to allow your firm to review prior years working papers.	____	____	____
c. Prepare list of prior year working papers needed for review and communicate list to predecessor auditor.	____	____	____
d. Make arrangements for inspection of prior year working papers.	____	____	____
5. Ascertain that all applicable independence rules, particularly those related to performance of accounting services and component units, have been met.	____	____	____

	Done by	*Date*	*W/P Ref.*
6. Obtain an initial, overall understanding of the client's operations:			
a. Determine the form of government, for example, a legislative body with an elected (i.e., mayor) administrator versus a legislative body with an appointed manager.	____	____	____
b. Obtain a copy of the organizational structure, including the names of all elected officials and the names and experience of top management. Determine the number of employees by governmental function.	____	____	____
c. Obtain a list of all related parties.	____	____	____
d. Inquire of management, and assess management's identification, of laws, statutes, and regulations governing the general operations of the governmental unit.	____	____	____
e. Determine whether the governmental unit has an audit committee or other group or individual with oversight responsibility for financial reporting.	____	____	____
f. Inquire of management as to factors affecting the continued functioning of the governmental unit, for example, the presence or absence of taxpayer initiatives that limit the taxing authority's growth, expenditure growth, or the addition of services.	____	____	____
g. Inquire as to whether the governmental entity is required to have a single audit or other special compliance reporting.	____	____	____
h. Determine annually which governmental units are to be included in the financial statements as component units of the reporting entity as well as determine whether the units are discrete or blended.	____	____	____
i. Determine the extent of involvement of other audit firms and inquire about their independence and professional reputation. Clearly define the responsibilities of each audit firm and which firm is the primary auditor.	____	____	____
j. Determine that audit covered by the signed engagement letter will satisfy relevant legal, regulatory or contractual requirements.	____	____	____
k. If audit does not satisfy *j.* above, communicate this to management, the audit committee (or other with equivalent authority, such as City Council, or other elected officials) either in writing or orally. If orally, document in working papers.	____	____	____
7. Review prior year's reports and financial statements:			
a. Identify primary sources of revenue (for example, property taxes, grants, contracts, service charges).	____	____	____
b. Identify services provided by the governmental unit.	____	____	____
c. Identify services provided by separate governmental departments and independent component units (for example, hospitals, schools) and their relationship to the governmental unit to be audited.	____	____	____

	Done by	Date	W/P Ref.
d. Determine the number and nature of funds and account groups.	____	____	____
e. Determine whether any departures from GAAP were identified in prior financial statements that could lead to report modifications in the current audit.	____	____	____
8. Review prior year's working papers and permanent file, particularly, the following:			
a. Internal control questionnaires, memoranda, and related summary evaluation notes.	____	____	____
b. Engagement time summary records.	____	____	____
c. Adjusting and reclassification entries.	____	____	____
d. Audit partner memoranda regarding consultations on accounting and auditing matters.	____	____	____
e. Suggestions for next audit.	____	____	____
f. Review client's correspondence file.	____	____	____
9. If client has an internal audit department:			
a. Obtain an understanding of the internal audit function sufficient to identify those internal audit activities that are relevant to planning the audit.	____	____	____
b. If the internal auditors' work is to be considered in determining the nature, timing and extent of audit procedures, assess the competence and objectivity of the internal audit function in light of the intended effect of the internal auditors' work on the audit. (SAS No. 65, paragraph 9 [AU section 322.09 et. seq.])	____	____	____
10. Obtain copies of minutes of meetings of the governing body and relevant committees and review for items of financial significance.	____	____	____
11. Obtain copy (including all amendments) of entity's current budget (for all funds legally budgeted).	____	____	____
12. Discuss the following (and other appropriate) matters with appropriate client personnel:			
a. Changes in operations, including pending/planned changes.	____	____	____
b. Changes in accounting methods or accounting principles applied.	____	____	____
c. Changes in key personnel, particularly those who can influence financial reporting.	____	____	____
d. Significant accounting or reporting problems.	____	____	____
e. Changes in data processing methods or equipment.	____	____	____
f. Significant legal matters and contingencies.	____	____	____
g. Disposition of prior year's management letter points.	____	____	____
h. Disposition of prior year's reportable conditions.	____	____	____
i. Extent of client assistance to be provided.	____	____	____

	Done by	Date	W/P Ref.
j. Timing of preliminary audit work, inventory observation, confirmation procedures, final audit work, etc.	____	____	____
k. Due dates for delivery of report(s).	____	____	____
l. Other matters (prepare list and attach to program).	____	____	____
13. Obtain an understanding of the client's controls over financial reporting and over compliance with laws and regulations sufficient to plan the nature, timing, and extent of audit procedures and tests.	____	____	____
a. Complete questionnaires or prepare flowcharts and/or narrative descriptions relating to the client's internal control. Consideration should be given to all five components of internal control to obtain sufficient knowledge of the control structure and the design of controls and to determine whether those controls have been placed in operation.	____	____	____
b. Assess control risk for financial statement assertions, including those related to compliance with laws and regulations that have a direct and material effect on the financial statements.	____	____	____
(1) For each assertion for which control risk is assessed at the maximum, record that conclusion in the working papers.	____	____	____
(2) For each assertion for which a lowering of control risk below the maximum is deemed feasible and efficient:			
(a) Identify the key control activities which will be subjected to audit tests.	____	____	____
(b) Conduct audit tests to determine how the policies and procedures were applied, the consistency with which they were applied and by whom they were applied. Working papers relating to the tests should describe the policies and procedures tested, test objectives, sample selection, test criteria, test results, and conclusions concerning the effectiveness of the control activity being tested.	____	____	____
(c) Document conclusions in the working papers concerning the assessed level of control risk for the assertion.	____	____	____
14. Obtain preliminary financial information from client for year under audit.	____	____	____
a. Compute planning materiality at the appropriate level for the engagement being undertaken (GPFS, individual fund, etc.).	____	____	____
b. If audit involves a single audit of federal financial assistance, compute planning materiality for each major federal financial assistance program.	____	____	____
c. Perform analytical procedures to identify unusual or unexpected transactions, amounts, ratios or trends that might have planning ramifications. Compare recorded amounts to:			

	Done by	Date	W/P Ref.
(1) Prior year amounts, adjusted for known changes from the prior year to the current year;	____	____	____
(2) Current year amounts to budgeted amounts;	____	____	____
(3) Other financial/nonfinancial information for which plausible relationships exist.	____	____	____
d. Document and explain (if explanations are available) any unusual or unexpected transactions, amounts, ratios, or trends noted in the preceding procedure; explain the disposition to be made of such variances and the effect thereof on the nature, timing, and extent of audit procedures.	____	____	____
15. Consider factors influencing the risk of errors, irregularities, or illegal acts causing financial statements to be materially misstated by evaluating the following factors:			
a. The existence of laws, rules, and regulations that may have a direct and material effect on amounts reported in the financial statements.	____	____	____
b. The existence of material accounting estimates.	____	____	____
c. The existence of many contentious or difficult accounting issues.	____	____	____
d. Recent accounting/auditing pronouncements affecting the client.	____	____	____
e. The existence of significant difficult-to-audit transactions.	____	____	____
f. Management's and elected officials' poor reputation in the governmental community.	____	____	____
g. The potential for management misrepresentation.	____	____	____
h. The susceptibility of assets to unauthorized use or disposition.	____	____	____
i. The ability of the entity to operate within approved budgets and to issue timely and accurate financial reports.	____	____	____
j. The appropriate segregation of duties and responsibilities.	____	____	____
k. The dependence of the governmental unit on one or more individuals to operate key programs or to manage the budget or financial reporting function.	____	____	____
l. Turnover and qualifications of key personnel.	____	____	____
m. Qualifications in auditors' reports for prior years.	____	____	____
n. Decentralized or centralized records.	____	____	____
Document conclusions in the working papers and their effects on engagement staffing, extent of supervision, and overall strategy for the conduct and scope of the audit.	____	____	____
16. Use the information obtained or developed concerning materiality levels, controls over financial reporting and compliance with laws and regulations and the related assessments of control risk, the results of analytical procedures, and the evaluation of other factors impacting on audit risk to:			
a. Plan the nature, timing, and extent of substantive tests;	____	____	____

	Done by	Date	W/P Ref.
b. Determine staffing requirements and related levels of supervision;			
c. Plan the overall strategy for the conduct and scope of audit; and			
d. Prepare/revise the audit program.			
17. Estimate time required to complete audit procedures and prepare appropriate planning documents (engagement time summary, scheduling and staffing summary, etc.).			
18. Obtain and record audit partner's approval for:			
a. Documentation of internal control.			
b. Approach used to audit computer generated records.			
c. Use of statistical sampling methods.			
d. Assessment of audit risk and materiality.			
e. Audit programs.			
f. Time budget and staffing of engagement.			
19. Prepare listing of schedules/analyses to be prepared by client (and working paper set-ups, if considered necessary) and deliver to client.			

B. Engagement Administration and Supervision Procedures

	Done by	Date	W/P Ref.
1. Schedule timing of work to be done on priority basis, assigning top priorities to more significant or problem areas of engagement.			
2. Obtain all documents and information required for the permanent file and remove superseded materials for filing in a closed file.			
3. Accumulate all points to be included in the report on internal control, a management letter or report(s) on compliance with laws and regulations, indicating for each whether the point applies to internal control or compliance.			
a. Review with engagement partner and determine which points are to be included in written communications and which points are to be communicated verbally to the client.			
b. For those items to be communicated verbally to client, document the communication.			
c. For all other items, furnish client with the findings and recommendations and request a written response regarding action client expects to take.			
4. Ascertain that all steps in all audit programs have been considered and/or completed, and that any modifications to the programs resulting from changed conditions have been properly approved and documented.			

	Done by	*Date*	*W/P Ref.*
5. Ascertain that all working papers have been headed, indexed, cross-referenced, initialed, and dated. If they were initially prepared by client, they should be marked "Prepared by Client" or "PBC."	____	____	____
6. Clear all pending items, and dispose of all follow-up or "TO DO" sheets and any other similar notations in the files.	____	____	____
7. Review financial statements and notes and determine:			
a. The adequacy of evidence gathered in response to unusual or unexpected balances or transactions identified during audit planning or audit performance;	____	____	____
b. The existence of unusual or unexpected balances or relationships which have not been evaluated;	____	____	____
c. Whether additional evidential matter is necessary to explain unexpected differences between reported amounts and expected amounts or relationships.	____	____	____
d. Investigate and explain any unusual or unexpected balances or relationships not previously evaluated and document results in the working papers.	____	____	____
8. Ascertain that working papers include appropriate memoranda regarding consultations with firm specialists, outside consultations, and resolution of differences of opinion, if any, among firm personnel regarding accounting/auditing matters.	____	____	____
9. Determine that differences between the accounting records and the evidential matter gathered during the application of audit procedures have been evaluated as to both their quantitative and qualitative effects.	____	____	____
10. In the event that illegal acts were noted, determine that:			
a. An understanding of the nature of the acts was obtained;	____	____	____
b. The circumstances in which it occurred were evaluated;	____	____	____
c. The effect of the illegal act on the financial statements was considered; and	____	____	____
d. Such other auditing procedures necessary in the circumstances were performed. (See SAS No. 54, paragraphs .09 through .15 [AU section 317.09–.15].)	____	____	____
11. Determine that required communications, proper as to form and content, have been made to disclose irregularities and/or illegal acts noted during the course of the audit.	____	____	____
12. Determine whether the audit work performed indicates that substantial doubt exists with regard to the entity's ability to continue as a going concern for a reasonable period of time.	____	____	____
13. If a substantial doubt exists with regard to the entity's ability to continue as a going concern for a reasonable period of time:			

	Done by	Date	W/P Ref.
a. Obtain information about management's plans, assess the expected effectiveness of the plans, and gather evidence to evaluate pertinent provisions of those plans and to support audit conclusions concerning the government's ability or inability to continue as a going concern.	____	____	____
b. Evaluate the adequacy of the related financial statement disclosures.	____	____	____
c. Consider the effects on the auditors' report.	____	____	____
14. If the government has an audit committee or has otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee), determine that the following matters have been communicated to the appropriate committee and include documentation to that effect in the working papers:			
a. The auditors' responsibility under generally accepted auditing standards (SAS No. 61, paragraph 6 [AU section 380.06]);	____	____	____
b. Initial selection of and changes in significant accounting policies or their application (SAS No. 61, paragraph 7 [AU section 380.07]);	____	____	____
c. Significant unusual transactions and the methods used to account for them;	____	____	____
d. The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;	____	____	____
e. The process used by management in formulating particularly sensitive accounting estimates and the basis for the auditors' conclusions regarding the reasonableness of those estimates;	____	____	____
f. Adjustments arising from the audit that could, in the auditor's judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process;	____	____	____
g. The auditor's responsibility for other information in documents containing audited financial statements (i.e., a CAFR);	____	____	____
h. Disagreements with management;	____	____	____
i. Consultations by management with other accountants about auditing and accounting matters;	____	____	____
j. Major issues discussed with management prior to retention;	____	____	____
k. Difficulties encountered in performing the audit;	____	____	____
l. Irregularities and/or illegal acts;	____	____	____
m. Significant deficiencies in the design or operation of controls over financial reporting and over compliance with laws and regulations ("reportable conditions"); and,	____	____	____
n. Other matters relevant to oversight responsibilities.	____	____	____

	Done by	*Date*	*W/P Ref.*
15. Ascertain that all time has been posted to the daily time control records, and record totals on the engagement time summary. Write explanations for any significant variations between budgeted and actual time.	____	____	____

This audit program has been completed in accordance with firm policy.

	Date
Done by	____________
Reviewed by	____________

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.020

Obj.		*Done By*	*Date*	*W/P Ref.*

II. Budget Compliance

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. An annual budget has been adopted for all governmental funds and, if required by law, for other funds of the entity. (Assertions 1 and 2)

B. All amendments to the initially adopted budget have been properly approved. (Assertions 1 and 2)

C. Budgetary amounts shown in the financial statements include the initially adopted budget and all legally approved amendments thereto. (Assertions 1, 2, and 5)

D. The budget has been administered in accordance with laws and regulations and excesses of expenditures over appropriations (if any) do not constitute violations of laws and regulations and have been adequately disclosed in the financial statements. (Assertions 3 and 5)

E. Budgetary amounts shown in the financial statements are shown on the same basis of accounting as the actual financial statements. (Assertions 4 and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Audit Procedures to Test Budgetary Information

Obj.	Procedure	Done By	Date	W/P Ref.
[A] D	1. Discuss with management the applicable statutes and ordinances governing the legal status of the budget and its applicability to the various funds of the governmental entity.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
C	2. Determine the level of budgetary control—that is, object, department, program, or fund, and the adequacy of the financial reporting information system to operate at that level of control.	____	____	____
E	3. Determine the basis of accounting on which the budget is prepared.	____	____	____
A B	4. Consider whether the budgetary process was performed in accordance with statutes and ordinances, including required public notifications and hearings.	____	____	____
A	5. Review minutes of meetings of the governing body for proper approval of the adopted budget.	____	____	____
B	6. Determine whether amendments to the adopted budget during the audit period were approved in accordance with applicable laws and regulations.	____	____	____
C	7. Determine that final budgetary amounts reflect all approved amendments.	____	____	____
	B. Audit Procedures to Test Budgetary Compliance			
A B D	1. Determine whether the monitoring process for budgetary controls leads to amendments to the budget as dictated by changing circumstances or laws and regulations.	____	____	____
D	2. For any material excess of expenditures over appropriations in individual funds:			
	a. Determine whether such excess constitutes a violation of law or contract.	____	____	____
	b. Determine whether such excess has been adequately disclosed.	____	____	____
E	3. If applicable, review reconciliation of budgetary basis to GAAP basis and determine whether such reconciliation has been adequately disclosed in the financial statements.	____	____	____

This audit program has been completed in accordance with firm policy.

	Date
____________________ Done by	____________
____________________ Reviewed by	____________

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.030

Obj.		*Done By*	*Date*	*W/P Ref.*

III. Cash

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Cash balances as stated in the combined balance sheet properly represent cash and cash items on hand, in transit, or on deposit with third parties in the name of the governmental unit. (Assertions 1, 2, 3, 4, and 5)

B. Cash is properly classified in the financial statements and adequate disclosure (by segregation or otherwise) is made of restricted or committed funds or of cash not subject to immediate withdrawal. (Assertions 3, 4, and 5)

C. Deposits are properly classified as to credit risk as required by GASB Statement No. 3. (Assertions 4 and 5)

D. Applicable accounting principles have been consistently applied. (Assertions 4 and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control

1. Review the understanding of internal control over cash transactions and the preliminary assessment of control risk. ____ ____ ____

2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	____	____	____
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on cash and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	C. Other Auditing Procedures			
A	1. Where material, count cash on hand, reconcile balances on hand to required amounts, and obtain signature of custodian acknowledging return of funds intact.	____	____	____
A	2. Confirm cash balances with banks or other depositories as of the balance-sheet date using the *AICPA Standard Form to Confirm Account Balance Information.*	____	____	____
[A]	3. Obtain copies of client's bank reconciliations at the end of the year.	____	____	____
A	4. If deemed appropriate, obtain bank cutoff statements (or statements for month succeeding year end) and related supporting documents directly from the bank.	____	____	____
A	5. Substantiate reconciling items as follows:			
	a. Trace deposits in transit to subsequent bank statements. Determine whether there was any extraordinary delay between the date deposit was recorded on the accounting records and the date deposited per bank.	____	____	____
	b. Trace checks in excess of $_____ dated on or before balance-sheet date but clearing after the balance-sheet date to the list of outstanding checks.	____	____	____
	c. Investigate checks in excess of $______ included on the list of outstanding checks but which have not cleared in the month following year-end.	____	____	____
	d. Trace any significant transfers between banks or accounts of a bank (including investment accounts) near year-end to verify both transactions have been recorded in the same accounting period.	____	____	____
	e. Investigate any remaining significant reconciling items not covered above.	____	____	____

Obj.		Done By	Date	W/P Ref.
[A]	6. Consider reversing old outstanding checks. (Investigate those over $______.) Determine that such amounts have been handled properly in accordance with state or local escheat laws.	____	____	____
[A]	7. Review receipts, etc., issued shortly before and shortly after year-end to determine that all cash collected has been recorded in the proper period.	____	____	____
C	8. Obtain copies of all collateral agreements the local government has with depositories.	____	____	____
	a. Confirm collateral with bank or agency holding the collateral securities.	____	____	____
	b. Determine if the collateral complies with legal requirements for the entity.	____	____	____
	c. Determine whether the market value of the collateral is adequate to secure the funds on deposit and to meet legal requirements.	____	____	____
	d. Test collateralization throughout the year to determine its adequacy. Note instances in which the local government's uncollateralized deposits during the period significantly exceeded that category of credit risk at balance-sheet date.	____	____	____
C [D]	*e.* Review clients classifications as to credit risk for note disclosure.	____	____	____
A B	9. Identify which (if any) individual funds are required by law or other contractual agreement to maintain separate bank accounts and ascertain that separate bank accounts are maintained.	____	____	____
	a. Note any withdrawal restrictions or other commitments which may exist.	____	____	____
	b. Review note disclosure regarding significant restrictions or other commitments on cash funds.	____	____	____
B D	10. If the government pools cash:			
	a. Determine whether pooling of cash funds is permissible under applicable laws and contractual agreements.	____	____	____
	b. Obtain records from entity personnel indicating allocation of earnings on pooled cash to individual funds.	____	____	____
	c. Review for reasonableness, and test accuracy of allocations.	____	____	____
	d. Determine whether overdrafts by individual funds have been reported in accordance with GAAP.	____	____	____

D. Overall Conclusions

1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:

a. Cash balances as stated in the combined balance sheet properly represent cash and cash items on hand, in transit, or on deposit with third parties in the name of the governmental unit;	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	b. Cash is properly classified in the financial statements and adequate disclosure (by segregation or otherwise) is made of restricted or committed funds and of cash not subject to immediate withdrawal;	____	____	____
	c. Deposits are properly classified as to credit risk as required by GASB Statement No. 3; and,	____	____	____
	d. Applicable accounting principles have been consistently applied;	____	____	____
	Except as follows: ________ ________ ________	____	____	____

This audit program has been completed in accordance with firm policy.

Date

____________________ ________
Done by

____________________ ________
Reviewed by

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.040

Obj.		*Done By*	*Date*	*W/P Ref.*

IV. Investments

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Investments reported in the financial statements are on hand in the name of the governmental entity or held in custody and safekeeping by others in the name of and on behalf of the entity. (Assertions 1, 2, and 3)

B. The basis on which the investments are stated is in accordance with generally accepted accounting principles. (Assertions 4 and 5)

C. Income from investments has been accounted for properly. (Assertions 4 and 5)

D. Investments and the related income are properly classified and described in the financial statements. (Assertions 4 and 5)

E. Adequate disclosure has been made of the pledging of any investments and credit risks are properly disclosed as required by GASB Statement No. 3. (Assertions 2, 3, and 5)

F. Investments are made in accordance with state and local laws and regulations. (Assertions 3 and 5)

G. Applicable accounting principles have been consistently applied. (Assertions 4 and 5)

H. Securities lending transactions are properly accounted for and reported. (Assertions 1, 2, and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Obj.		Done By	Date	W/P Ref.
	A. Evaluation of Internal Control			
	1. Review the understanding of internal control over investments and investment transactions and the preliminary assessment of control risk.	____	____	____
	2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk.	____	____	____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	____	____	____
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on investments and related income and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	C. Other Auditing Procedures			
[F]	1. Obtain an understanding of state and local laws and regulations governing investment of idle funds.	____	____	____
[A] [D]	2. Obtain a list of investments and identify ownership by fund.	____	____	____
A	3. For securities held on hand:			
	a. Examine securities and trace applicable information from each security to list of investments.	____	____	____
	b. Obtain signature of custodian acknowledging return of all securities.	____	____	____
	c. If inspection is performed at other than the balance-sheet date, verify all changes between date of physical inspection and date of balance sheet.	____	____	____
A	4. For securities held by others, confirm information pertaining to securities held by them, including name in which security is registered.	____	____	____
C[D]	5. Test accrued interest to balance-sheet date.	____	____	____
B C	6. Test amortization of premiums (or discount) paid, where applicable.	____	____	____
D[G]	7. Obtain market values at balance-sheet date.	____	____	____

Obj.		Done By	Date	W/P Ref.
	a. Investigate significant differences from recorded values to determine if any write-downs are necessary.	____	____	____
	b. Review management's intended holding period and liquidity requirements in the case of a decline in market value.	____	____	____
F	8. Test investment transactions during the year to determine that investments are in accordance with statutory requirements (if applicable).	____	____	____
	a. If required by local laws and regulations, trace approval for investment transactions to minutes of governing body or investment committee.	____	____	____
	b. Review for unusual transactions (high risk or churning).	____	____	____
C[D]	9. Test interest revenue accounts in the various funds and reconcile interest income to the investment transactions.	____	____	____
C[D]	10. Verify that all investments and related income were applied to the proper fund of ownership.	____	____	____
C D [F]	11. If the government pools investments:			
	a. Determine whether pooling of funds for investment purposes is permissible under applicable laws and contractual agreements.	____	____	____
	b. Obtain records from entity personnel indicating allocation of earnings on pooled investments to individual funds.	____	____	____
	c. Review allocation of earnings for reasonableness, and test accuracy of allocations.	____	____	____
E[G]	12. Review GASB Statement No. 3 disclosures:			
	a. Identify any significant violations of state statutes, local charters, resolutions or ordinances, grant regulations, or internal policies in the investment of funds.	____	____	____
	b. Determine whether the basis of valuation (e.g., cost, market value, or lower of cost or market value) is in accordance with GAAP, and that appropriate allowances and/or write-downs have been provided.	____	____	____
	c. Identify any commitments at the balance-sheet date to resell securities under yield maintenance repurchase agreements.	____	____	____
	d. Determine types of investments made during the year but not owned as of the balance-sheet date.	____	____	____

______ State investment pool

______ Repurchase agreement

______ Federal securities

______ Derivatives and similar investments

______ Other

Obj.		*Done By*	*Date*	*W/P Ref.*
	e. Are there any reverse repurchase agreements used during the year? If yes, see GASB Statement No. 3. Yes_____ No_____	____	____	____
	f. Are there any derivatives or similar investments owned during the year? If yes, see GASB Technical Bulletin 94-1. Yes_____ No_____	____	____	____
E	13. Review client's classification of investments as to credit risk for note disclosure.	____	____	____
E[G]	14. Review client's disclosure under GASB Statement No. 3 for overall adequacy.	____	____	____
[E]F[G]	15. Concerning repurchase agreements:			
	a. Determine that such transactions are allowable under applicable laws and regulations.	____	____	____
	b. Review terms of outstanding repurchase commitments, including the types and coupon rate of collateral and the repurchase date and prices.	____	____	____
	c. Consider reputation and reliability of collateral holders. Those holders should be banks or trust companies that specialize in providing safekeeping services and that are independent of the broker-dealer arranging the transaction.	____	____	____
	d. Review the reputation and financial position of broker-dealers or other parties to the transaction.	____	____	____
	e. Consider the financial credibility and legal responsibility of any company or agency that is insuring completion of the transaction.	____	____	____
	f. Review broker's advices and other documentation regarding the completion of the repurchase transaction during the period following the balance-sheet date.	____	____	____
A	16. If the client is a buyer/lender (and surrendered possession of the securities):			
	a. Examine securities held or request confirmation of securities held in safekeeping and determine who holds legal title to the securities.	____	____	____
	b. Test collateral value of securities.	____	____	____
H	17. Determine if accounting and reporting for securities lending transactions is in accordance with GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions.*	____	____	____
	D. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. Investments reported in the financial statements are on hand in the name of the entity or held in custody and safekeeping by others in the name of and on behalf of the governmental entity;	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	b. The basis on which the investments are stated is in accordance with generally accepted accounting principles;	____	____	____
	c. Income from investments has been accounted for properly;	____	____	____
	d. Investments and the related income are properly classified and described in the financial statements;	____	____	____
	e. Adequate disclosure has been made of the pledging of any investments and credit risks are properly disclosed as required by GASB Statement No. 3;	____	____	____
	f. Investments are made in accordance with state and local laws and regulations;	____	____	____
	g. Applicable accounting principles have been consistently applied;	____	____	____
	h. Securities lending transactions are properly accounted for and reported;	____	____	____
	Except as follows: ____________ ____________ ____________	____	____	____

This audit program has been completed in accordance with firm policy.

	Date
____________________ Done by	____________
____________________ Reviewed by	____________

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.050

Obj.		*Done By*	*Date*	*W/P Ref.*

V. Receivables and Revenues—Governmental Funds

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Revenue accounts and related income and expense accounts include all transactions that relate to the period. (Assertions 1, 2, and 5)

B. Only those revenues that are measurable and available in the fiscal period are recorded as revenue of the period. (Assertions 1, 2, 3, and 5)

C. Receivables are valid and are stated at the net realizable amount. (Assertions 1, 3, and 4)

D. Judgments as to valuations, allowances and deferral of revenue are reasonable and responsible. (Assertions 4 and 5)

E. Descriptions, classifications, and related disclosures are adequate and not misleading. (Assertion 5)

F. All loss contingencies related to revenues and receivables are identified and reported or disclosed. (Assertions 2, 3, and 5)

G. Applicable accounting principles have been consistently applied. (Assertions 4 and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control

1. Review the understanding of internal control over revenue and receivable transactions and the preliminary assessment of control risk. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk.	____	____	____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	____	____	____
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on revenue and receivables and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	C. Other Auditing Procedures—Receivables and Revenues—Governmental Funds			
	1. General Property Taxes			
[A]	*a.* Review computation of total assessed value for property.	____	____	____
[A][B][C]	*b.* Compare current year's assessed value to that of the prior year and obtain explanations for significant changes.	____	____	____
A B C	*c.* Determine that the appropriate tax was properly levied.	____	____	____
	(1) Determine that property assessments have been made in compliance with laws.	____	____	____
	(2) Determine that property tax rates are in compliance with laws.	____	____	____
A C	*d.* Recalculate total tax levy and compare to recorded revenue.	____	____	____
A E	*e.* Recalculate tax levies for individual funds and compare to amounts recorded in each fund.	____	____	____
A C E	*f.* Confirm amounts of special or supplemental tax distributions and trace into proper funds relating to:			
	(1) Back taxes collected	____	____	____
	(2) Tax objections overruled	____	____	____
	(3) Tax settlements	____	____	____
C F	*g.* Review allowance for uncollectible taxes for reasonableness and compare to prior year's computation. Obtain explanation for any unusual changes.	____	____	____
B D G	*h.* Determine that deferred revenue accounts have been recorded in accordance with generally accepted accounting principles. Trace amounts to tax levies.	____	____	____

Obj.			Done By	Date	W/P Ref.
A [C]	*i.*	Determine that property tax sales were properly authorized for nonpayment of taxes and the major receipts were deposited on a timely basis.	____	____	____
E	*j.*	Determine that property taxing policies and procedures are properly disclosed in the notes to financial statements.	____	____	____
	2.	**Sales Taxes**			
A B C	*a.*	Review the methods used by the local government to reasonably assure that all taxes due have been remitted (for example, systems providing for the cross-referencing of returns to a database showing prior returns, registered corporations, etc.).	____	____	____
A	*b.*	Compare current year's actual revenue with the current year's budget and prior year's actual revenue; explain any unusual fluctuations or variances.	____	____	____
A B C	*c.*	Determine that proper accruals have been made to accrue sales taxes held by other governments at fiscal year end.	____	____	____
		(1) Confirm revenues collected by collecting government and amounts not yet remitted directly with the collecting government.	____	____	____
		(2) Trace receipts to subsequent accounting period.	____	____	____
	d.	For sales taxes collected by merchants but not yet required to be remitted to the taxing authority at the end of the fiscal year:			
A B		(1) Review methods used by the local government to estimate the amount of such sales tax collections.	____	____	____
A B		(2) Compare current year accrual with prior year accrual.	____	____	____
A C E		(3) Determine that proper consideration has been given to merchants' compensation and uncollectible taxes.	____	____	____
C E		(4) Compare collections in subsequent period (usually the first month of the subsequent period) to amounts estimated at year end and explain any unusual differences.	____	____	____
B		(5) Determine that amounts accrued at year-end were both measurable and available to finance expenditures of the fiscal period.	____	____	____
A	*e.*	Select a sample of returns and verify that the tax liability was computed in accordance with governing laws and regulations and that related payments were deposited and properly recorded in the accounting records.	____	____	____
	3.	**Income and Other Self Assessed Taxes**			
A B C	*a.*	Review the methods used by the local government to reasonably assure that all taxes due have been remitted (for example, systems providing for the cross-referencing of returns to a database showing prior returns, registered corporations, etc.).	____	____	____

Obj.		Done By	Date	W/P Ref.
A	*b.* Compare current year's actual revenue with the current year's budget and the prior year actual revenue; explain any unusual fluctuations or variances.	____	____	____
A B C	*c.* Determine that proper accruals have been made to accrue income and other taxes held by other governments at fiscal year end.	____	____	____
	(1) Confirm revenues collected by collecting government and amounts not yet remitted directly with the collecting government.	____	____	____
	(2) Trace receipts to subsequent accounting period.	____	____	____
	d. For income taxes and other self-assessed taxes not yet required to be remitted to the taxing authority at the end of the fiscal year:			
[A] B [C]	(1) Review methods used by the local government to estimate the amount of such tax collections.	____	____	____
A	(2) Compare current year accruals with prior year accruals.	____	____	____
B D	(3) Determine that proper consideration has been given to uncollectible taxes and estimated refunds.	____	____	____
A C	(4) Compare collections in subsequent period to amounts estimated at year end and explain any unusual differences.	____	____	____
B	(5) Determine that amounts accrued at year-end were both measurable and available to finance expenditures of the fiscal period.	____	____	____
A	*e.* Select a sample of returns and verify that the tax liability was computed in accordance with governing laws and regulations and that related payments were deposited and properly recorded in the accounting records.	____	____	____
	4. Revenue From Federal, State, and County Agencies			
A F	*a.* Review grant applications, agreements, contracts, budgets, and reports to determine that grant expenditures are in accordance with grant agreements.	____	____	____
A F	*b.* Review the reasonableness of the government's indirect cost allocation plan and determine the propriety of indirect cost items allocated to grant programs.	____	____	____
D F	*c.* Review grant records and correspondence files for material areas of noncompliance and questioned costs.	____	____	____
A	*d.* For grant programs requiring matching funds, review supporting documentation to support the local government's contribution and determine allowability of any in-kind (goods or services) matching efforts.	____	____	____
A B	*e.* Determine that grant revenues earned based on expenditures are properly accrued.	____	____	____
A [D]	*f.* Confirm revenue received from federal, state, and county agencies and any revenue earned but not yet remitted directly with the appropriate agency.	____	____	____

Obj.		Done By	Date	W/P Ref.
A	*g.* Determine if pass-through grants are properly accounted for.	____	____	____
	5. Licenses and Permits			
[A]	*a.* Determine licenses and permits in effect and rates set by ordinance.	____	____	____
A	*b.* Compare revenue from license and permits by totals to current year's budget and prior year actual revenue. Explain any unusual fluctuations or variations.	____	____	____
	c. If licenses and permits constitute a material source of revenue:			
A	(1) On a test basis, trace collections from persons or businesses ordinarily required to pay fees to accounting records.	____	____	____
A C	(2) On a test basis, recompute amounts of licenses and permits to determine that fees are being assessed in accordance with laws and regulations.	____	____	____
A B	(3) Where appropriate, reconcile inventories of licenses and permits to revenues.	____	____	____
	6. Franchise Fees			
A B	*a.* Review franchise ordinances and compare fees as indicated therein with amounts received.	____	____	____
A	*b.* Compare revenue from franchise fees by totals to current year's budget and prior year actual revenue. Explain any unusual fluctuations or variations.	____	____	____
A B C	*c.* For major franchise fees, determine that all fees for the fiscal year have been properly accrued.	____	____	____
A	*d.* Consider confirmation of franchise fees received during the year directly with the franchisee.	____	____	____
	7. Fines			
[A]	*a.* Review and test client's procedures for accounting for tickets, and determine that tickets are being properly disposed of through the collection of cash or authorized dismissal.	____	____	____
A	*b.* Compare fine revenue by totals to current year's budget and prior year actual revenue. Explain any unusual fluctuations or variations.	____	____	____
E	*c.* Determine that fines are distributed in accordance with governing regulations.	____	____	____
	8. Sale of Property and Equipment			
[A] [C]	*a.* Review minutes of legislative body to determine authority to sell property and equipment and that such sales have been conducted in accordance with applicable state and local laws and regulations.	____	____	____
A E	*b.* Determine that proceeds are credited to the proper fund as required by law and that any receivables are properly classified.	____	____	____

Obj.		Done By	Date	W/P Ref.
A	*c.* Determine that major dispositions have been removed from the property and equipment records.	____	____	____
	9. Rentals of Property and Equipment			
A C	*a.* Examine authorizing laws and regulations, schedules, contracts, leases, and other documents governing the use of public property by others.	____	____	____
A B C	*b.* On a test basis, compare the amounts of billings against terms of rental agreements.	____	____	____
A E	*c.* Trace billings to recording in proper fund in the accounting records.	____	____	____
	10. Special Assessments			
[A]	*a.* Examine minutes of legislative body for authorization of special assessments.	____	____	____
[A] [B]	*b.* Obtain a schedule of assessment installments.	____	____	____
A B	(1) Compare current installment to revenue recorded for current year.	____	____	____
D	(2) Compare total installment amounts due in subsequent years and compare to deferred revenue amounts.	____	____	____
A	*c.* Using interest rate stated in assessment ordinance, compute interest revenue for current fiscal year and compare to recorded amounts.	____	____	____
A	*d.* Obtain a list of all assessments receivable balances and compare the total of these balances to the general ledger control accounts.	____	____	____
A C	*e.* Consider confirmation of unpaid assessment balances directly with property owners, especially significant or old balances.	____	____	____
A D	*f.* Review all adjustments to the accounts for authority and propriety.	____	____	____
	11. Other Revenues			
A B C D	*a.* Schedule any other revenue accounts of material amount and perform audit procedures determined necessary.	____	____	____
	D. Other Auditing Procedures—Receivables			
	1. All Receivables			
	a. If accounts receivable are not being confirmed, document the reason. One of the following is acceptable:			
	(1) Accounts receivable are immaterial to the financial statements.	____	____	____
	(2) Use of confirmations would be ineffective.	____	____	____

Obj.		Done By	Date	W/P Ref.
	(3) Combined assessed level of inherent risk and control risk is low, and the assessed level, in conjunction with the evidence expected to be provided by analytical procedures or other substantive tests of details, is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions.	____	____	____
	2. Other Receivables			
C [D]	*a.* Obtain aged listing of accounts receivable not examined in preceding audit procedures. Test accuracy of listing and reconcile balance with general ledger.	____	____	____
C	*b.* Confirm individual accounts with large or unusual balances directly with the owing party.	____	____	____
C D	*c.* Obtain or list subsequent collections of past due items to date of field work.	____	____	____
D F	*d.* Obtain list of uncollectible accounts written off during the year and of all credits issued during the year, and review for authority and propriety.	____	____	____
C F	*e.* Review collectibility of accounts with responsible personnel and determine that proper allowance is established for uncollectible accounts.	____	____	____

E. Overall Conclusions

1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:

	Done By	Date	W/P Ref.
a. Revenue accounts and related income and expense accounts include all transactions that relate to the period;	____	____	____
b. Only those revenues that are measurable and available in the fiscal period are recorded as revenue of the period;	____	____	____
c. Receivables are valid and are stated at the net realizable value;	____	____	____
d. Judgments as to valuations, allowances and deferral of revenue are reasonable and responsible;	____	____	____
e. Descriptions, classifications, and related disclosures are adequate and not misleading;	____	____	____
f. All loss contingencies related to revenue and receivables are identified and reported or disclosed; and	____	____	____
g. Applicable accounting principles have been consistently applied;			
Except as follows: ________________________ ________________________ ________________________	____	____	____

This audit program has been completed in accordance with firm policy.

	Date
Done by	
Reviewed by	

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

VI. Expenditures, Expenses, and Payables

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Expenditure/expense accounts include all costs and expenses applicable to the period and all losses and estimated future expenses that should be reflected in the period, and that classification is consistent with the accounting system and generally accepted accounting principles. (Assertions 1, 2, 4, and 5)

B. Amounts payable are properly authorized, represent the correct amounts of currently payable items and reflect all outstanding obligations. (Assertions 2, 3, and 5)

C. Prepaid and accrued accounts are properly stated. (Assertion 4)

D. Account descriptions, classifications and related disclosures are adequate and not misleading. (Assertion 5)

E. All loss contingencies are identified and recorded or disclosed. (Assertions 2, 3, and 5)

F. The governmental entity has complied with legal requirements relating to purchasing, payrolls, and disbursements. (Assertion 3)

G. Municipal solid waste landfill closure and postclosure care costs have been reasonably estimated and are being accounted for in accordance with generally accepted accounting principles. (Assertions 1, 3, 4, and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Obj.		Done By	Date	W/P Ref.
	A. Evaluation of Internal Control			
	1. Review the understanding of internal control over expenditures and the preliminary assessment of control risk.	____	____	____
	2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk.	____	____	____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	____	____	____
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on expenditures/expenses and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	C. Other Auditing Procedures—Expenditures/Expenses			
	1. General			
[B]D F	*a.* Review the applicable state and local laws and regulations setting forth the procedures for making purchases.	____	____	____
A[B][C]F	*b.* For selected expenditures/expenses (excluding payroll expenditures) examine supporting documents and compare to disbursement records noting:			
	(1) Authorization for disbursement and approval of supporting document.	____	____	____
	(2) Data supporting invoice such as purchase order and receiving report.	____	____	____
	(3) Evidence of compliance with purchasing laws and procedures. (Examine bid files for those items requiring competitive bids.)	____	____	____
	(4) Evidence of check of clerical accuracy.	____	____	____
	(5) Cancellation of document.	____	____	____
	(6) Evidence of duplicate payment, in whole or in part.	____	____	____
	(7) Charge to proper expenditure and appropriation account or reserve for encumbrances.	____	____	____
	(8) That discounts were taken when offered.	____	____	____
	(9) Authorized check signer.	____	____	____
	(10) That purchase was recorded in the period received.	____	____	____

Obj.		Done By	Date	W/P Ref.
A D	c. Compare individual expenditure/expense accounts to current year's budget and prior year's actual. Explain any unusual fluctuations or variations.	____	____	____
	2. Payrolls			
	a. For selected payroll disbursements:			
F	(1) Compare rate of pay used in computing payroll disbursement with applicable employee's personnel files and with the salary and appropriation ordinances or other established pay scales.	____	____	____
[A] B F	(2) Examine appropriate attendance records for disbursement being examined.	____	____	____
A B	(3) Recompute gross pay and compare to amount computed by client.	____	____	____
[A]	(4) When applicable, verify that appropriate entries were made to the client's leave records.	____	____	____
A B D	(5) Determine that payroll disbursement was charged to the proper appropriation account.	____	____	____
B F	(6) For payroll disbursements charged to federal financial assistance programs or other grant programs, determine that salary position and amount are authorized in approved grant budget.	____	____	____
[D] F	b. Verify payment of the various payroll deductions to the proper authority.	____	____	____
	(1) Review year-end accruals for reasonableness.	____	____	____
	(2) Trace material liability amounts to applicable payroll reports and payment in subsequent period.	____	____	____
A B [E]	c. Compare payroll accounts to budgeted amounts and to prior year's actual. Explain any unusual variations or fluctuations.	____	____	____
	d. If client has a deferred compensation plan:			
B C	(1) Confirm amounts on deposit in plan directly with plan administrator and trace to appropriate agency fund.	____	____	____
D	(2) Review presentation and footnote disclosure for conformity with disclosures required under GAAP.	____	____	____
D	e. Determine if local government pays postretirement health care or life insurance costs.	____	____	____
	(1) Obtain description of policies and related costs for current year.	____	____	____
	(2) Review financial statement treatment and disclosures in notes to financial statements for conformity with GAAP.	____	____	____
A B	f. Inquire as to whether there have been any retroactive pay increases, large overtime payments, or other unusual compensation arrangements. If so, determine authority for and propriety of such payments.	____	____	____

Obj.		Done By	Date	W/P Ref.
	3. **Other Expenditures/Expenses**			
A B	*a.* Determine that expenditures made by or on behalf of key officials are reasonable and adhere to client's policies.	____	____	____
A	*b.* Schedule any other expenditure/expense accounts of material amount or unusual nature and perform audit procedures determined necessary.	____	____	____
F	*c.* Determine if on-behalf payments for salaries and fringe benefits have been accounted for in accordance with GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance.*	____	____	____
	D. **Other Auditing Procedures—Liabilities**			
	1. **Accounts or Vouchers Payable and Encumbrances**			
	a. Obtain schedule of accounts payable and encumbrances outstanding at end of audit period.	____	____	____
A	*b.* Reconcile detail of liabilities and encumbrances to general ledger amounts.	____	____	____
A B	*c.* Consider confirmation of large or unusual accounts payable balances.	____	____	____
B	*d.* For selected entries in accounts payable (those in excess of $________), examine underlying documentation for proper support and proper inclusion in the period being audited.	____	____	____
D E	*e.* Ascertain nature and extent of unencumbered purchase commitments at year end.	____	____	____
B	*f.* Trace encumbrances (in excess of $______) to unfilled purchase orders.	____	____	____
B E	*g.* Inquire as to material commitments to purchase or construct property, equipment, etc.	____	____	____
A B	*h.* Examine invoices received and payments made subsequent to year-end on a test basis (those in excess of $________) to determine if any should be included in period being audited.	____	____	____
	2. **Deposits**			
B	*a.* If deposit liabilities are not material to the financial statements, review liability for reasonableness and explain any unusual variations from prior years. Otherwise—	____	____	____
C	*b.* Obtain listing of deposits (with indication of purpose of deposit if not otherwise noted) and reconcile to general ledger.	____	____	____
C	*c.* Confirm balances on a test basis.	____	____	____
	d. If interest is paid—			
C F	(1) Examine documentation authorizing payment of interest and determine that proper rate is being paid/accrued.	____	____	____
A C	(2) Test interest payments made during the period and accrued as of the end of the period being audited.	____	____	____

Obj.			Done By	Date	W/P Ref.
C F		*e.* Review the provisions of any related ordinances and test for compliance.	____	____	____
A C		*f.* Determine whether deposits are refundable in full or in part.	____	____	____
[F]		*g.* Determine whether records of "bid" or "good faith" deposits are maintained, including records indicating disposition of such deposits.	____	____	____
	3.	**Taxes Levied or Collected for Other Units of Government**			
B		*a.* Verify collections, payments and balances on hand and collected balances due other units of government.	____	____	____
B D		*b.* Determine that such items are recorded as liabilities to other governmental units.	____	____	____
B		*c.* Trace material amounts to settlement in subsequent period.	____	____	____
	4.	**Accrued Salaries and Wages**			
B		*a.* From a comparison of pay periods and salary payment dates, determine whether an accrual should be made at year end of salaries and applicable employer's payroll taxes.	____	____	____
B		*b.* Obtain a copy of client's worksheets for accrual of salaries and wages and test for accuracy.	____	____	____
	5.	**Taxes or Fees Collected in Advance**			
A B D		*a.* Obtain listing of taxes or fees collected in advance and reconcile to amounts recorded as deferred revenue in general ledger.	____	____	____
A B		*b.* Trace large or unusual amounts to supporting documents.	____	____	____
A B		*c.* Consider confirmation of amounts (in excess of $_______).	____	____	____
F		*d.* Trace disposition of items recorded as deferred revenue at beginning of period.	____	____	____
	6.	**Compensated Absences**			
		a. Obtain the entity's personnel policies and procedures and review the provisions relating to the accrual and payment of compensated absences.	____	____	____
A B [C] D		*b.* Obtain client's computation of compensated absences and determine by appropriate tests that:			
		(1) The schedule is arithmetically correct;	____	____	____
		(2) All qualifying employees are included and that all employees included on the schedule are qualified;	____	____	____
		(3) Appropriate salary and benefit rates are applied;	____	____	____
		(4) Leave balances shown on the schedule are reasonable and are consistent with leave records of selected employees;	____	____	____
		(5) The schedule is correct as to the employing fund.	____	____	____
A D		*c.* Determine that the current and long-term portions of the liability have been recorded in accordance with GASB Codification section C60.	____	____	____

Obj.		Done By	Date	W/P Ref.
	E. Other Auditing Procedures—Prepaid Items			
[C]	1. Review the type and amount of other assets and prepaid items, such as:			
	a. Unexpired insurance	____	____	____
	b. Prepaid rent	____	____	____
	c. Supplies inventories	____	____	____
	d. Advances	____	____	____
	e. Unamortized expense	____	____	____
	f. Deposits	____	____	____
	g. Other (itemize):			
	______________________________			
	______________________________	____	____	____
C	2. Review amounts for reasonableness by comparison with balances at end of preceding period, related expense accounts, etc.	____	____	____
C	3. For material amounts, ascertain propriety of balances by review of calculations and supporting documents.	____	____	____
C	4. Consider confirmation of balances.	____	____	____
C	5. Trace selected amounts to disposition in subsequent period.	____	____	____
D	6. Determine that accounting treatment is in accordance with GAAP.	____	____	____
	F. Other Auditing Procedures—Municipal Solid Waste Landfill Closure and Postclosure Care Costs			
[D]	1. Review and document entity's policies concerning estimating and accounting for municipal solid waste landfill closure and postclosure care costs.	____	____	____
D	2. Obtain copy of client's computation of costs for the current period.	____	____	____
D	*a.* Compare to prior period's computation to determine whether assumptions or methods of calculation have changed.	____	____	____
D	*b.* Trace cumulative capacity used to supporting documentation. Compare to prior year's amount and current year's additions.	____	____	____
D	*c.* Determine whether computations have been adjusted for inflation and current changes in federal, state, or local laws and regulations.	____	____	____
D F	*d.* Trace current period costs and total liability to financial statements and determine that accounting and reporting are proper for the applicable fund type (governmental or proprietary).	____	____	____

Obj.		Done By	Date	W/P Ref.
D F	3. Compare information obtained in preceding procedure with information disclosed in notes to financial statements and ascertain that disclosures are in accordance with GASB Statement No. 18, *Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs.*	____	____	____

G. **Overall Conclusions**

1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:

	Done By	Date	W/P Ref.
a. Expenditure/expense accounts include all costs and expenses applicable to the period and all losses and estimated future expenses that should be reflected in the period and that classification is consistent with the accounting system and generally accepted accounting principles;	____	____	____
b. Accounts payable are properly authorized, represent the correct amounts of currently payable items and reflect all outstanding obligations;	____	____	____
c. Prepaid and accrued accounts are properly stated;	____	____	____
d. Account descriptions, classifications, and related disclosures are adequate and not misleading;	____	____	____
e. All loss contingencies are identified and recorded or disclosed; and,	____	____	____
f. Legal requirements relating to purchasing, payrolls and disbursements have been complied with;	____	____	____
g. Municipal solid waste landfill closure and postclosure care costs have been reasonably estimated and are being accounted for in accordance with generally accepted accounting principles; Except as follows: ____________ ____________ ____________	____	____	____

This audit program has been completed in accordance with firm policy.

	Date
______________________ Done by	____________
______________________ Reviewed by	____________

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

.070

Obj.		*Done By*	*Date*	*W/P Ref.*

VII. Inventories

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Inventories physically exist, in good condition, unencumbered by pledge or lien. (Assertions 1, 2, and 3)

B. The accounts reflect all inventory held for sale or use in the ordinary course of operations. (Assertions 3 and 5)

C. Estimates of realizable value are carefully and consistently made. (Assertion 4)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control

1. Review the understanding of internal control over inventory and the preliminary assessment of control risk. _____ _____ _____

2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk. _____ _____ _____

3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests. _____ _____ _____

Obj.		*Done By*	*Date*	*W/P Ref.*
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on inventories and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	C. Other Auditing Procedures			
A B	1. Observe the taking of physical inventories.	____	____	____
	a. Review client's arrangements for the physical inventory, paying particular attention to controls to ensure completeness of the physical count.	____	____	____
	b. Make test counts of various items, recording description and quantities of items selected.	____	____	____
	c. Inspect inventory for evidence of damaged items and/or obsolete goods and determine that such stock has been appropriately identified in the inventory count.	____	____	____
	d. Inspect inventory for unusual concentration or overstocking of particular items, unusual storage which could cause difficult or impossible count of items, and any other unusual conditions which need to be investigated.	____	____	____
	e. Prepare a memorandum for the files describing procedures used and activities noted during the physical inventory and express some conclusion as to whether it appeared that the physical inventory was conducted in such a manner that all inventory was properly counted.	____	____	____
A B	2. Ascertain that proper cut-off is effected with respect to purchases and consumption.	____	____	____
B	3. Trace quantities and descriptions per audit test counts into final inventory sheets.	____	____	____
B C	4. Test clerical accuracy of inventories as to:			
	a. Unit prices	____	____	____
	b. Extensions	____	____	____
	c. Footings	____	____	____
	d. Totals to summaries	____	____	____
C	5. Select several items included in the inventory test counts and verify prices to determine that the inventory has been consistently valued.	____	____	____

Obj.		Done By	Date	W/P Ref.
A C	6. Review inventory issuance records for evidence of obsolete inventory.	____	____	____
A C	7. Ascertain that obsolete and damaged stock has been identified and appropriately valued.	____	____	____
B	8. Compare the dollar amount of inventory by fund to prior periods and investigate any material fluctuations. (Consider the reasonableness of the change in relation to the expected change.)	____	____	____
[C]	9. Compute and analyze turnover rates for significant inventories.	____	____	____

D. Overall Conclusions

1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:

   a. Inventories physically exist, in good condition, unencumbered by pledge or lien; ____ ____ ____

   b. The accounts reflect all inventory held for sale or use in the ordinary course of operations; ____ ____ ____

   c. Cost of inventory items is measured in accordance with generally accepted accounting principles, consistently applied; and ____ ____ ____

   d. Estimates of realizable value are carefully and consistently made; ____ ____ ____

   Except as follows:

   ____

   ____

   ____________________ ____ ____ ____

This audit program has been completed in accordance with firm policy.

Date

____________________ ____________

Done by

____________________ ____________

Reviewed by

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

.080

Obj.		*Done By*	*Date*	*W/P Ref.*

VIII. Capital Expenditures and Related Fund and Account Group Activity (for proprietary funds, use Audit Program in AAM section 5400.090)

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Property and equipment recorded in the general fixed assets account group represent a valid listing of the capitalized cost of assets purchased, constructed, donated, or leased and physically on hand. (Assertions 1, 2, and 3)

B. Capital expenditures represent a complete and valid listing of all costs incurred by the acquiring fund of the property and equipment acquired during the period, and costs that meet the capitalization policy are excluded from repair and maintenance and similar expenditure accounts. (Assertions 2, 4, and 5)

C. Capitalized costs and, if applicable, related depreciation associated with all fixed assets no longer owned or possessed have been removed from the General Fixed Asset Account Group (GFAAG). (Assertions 1, 4, and 5)

D. Property and equipment is stated at historical or estimated historical cost. Donated assets are recorded at their estimated fair value at the date of donation. (Assertions 4 and 5)

E. Capital expenditures are accounted for properly by fund type; fixed assets capitalized are classified properly by major classes of assets and related sources of funding; and related disclosures are adequate. (Assertions 2, 4, and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedures only secondarily accomplishes the objective.

Obj.		Done By	Date	W/P Ref.
	A. Evaluation of Internal Control			
	1. Review the understanding of internal control over capital assets and capital expenditure transactions and the preliminary assessment of control risk.	____	____	____
	2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk.	____	____	____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	____	____	____
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on capital expenditures and capital assets and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	C. Other Auditing Procedures—Capital Expenditures—Equipment			
A E	1. Review minutes of governing authority for approval of purchase, if applicable, and for classification in proper fund.	____	____	____
A B D	2. Examine invoices or other documentation for capital expenditures during the period.	____	____	____
[A]	3. Where applicable, review bids for compliance with state or local bid laws and regulations.	____	____	____
	4. Document entity's capitalization policy.	____	____	____
A D E	5. Trace selected capital expenditures into the general fixed assets account group, noting agreement of description and amount, classification, and compliance with capitalization policy.	____	____	____
A B	6. When capital expenditure is being paid from federal financial assistance or other grant funds, determine that the purchase has been properly authorized and complies with grant provisions.	____	____	____
	D. Other Auditing Procedures—Capital Expenditures—Construction			
A E	1. Review minutes of governing authority for approval of construction contract, if applicable.	____	____	____
[A]	2. Where applicable, review bids for compliance with state or local bid laws and regulations.	____	____	____

Obj.		Done By	Date	W/P Ref.
A B	3. When construction is being paid from federal financial assistance or other grant funds, determine that project is properly authorized and complies with grant provisions.	____	____	____
	4. For major construction contracts:			
[B]	*a.* Review and brief contract and change orders.	____	____	____
B	*b.* Examine documentary support for payments.	____	____	____
B	*c.* Determine that amounts are paid in accordance with the terms of the contracts.	____	____	____
B	5. Ascertain amounts of contracts payable, including retainage withheld, which are due but unpaid and trace to liability accounts in general ledger.	____	____	____
[B]	6. Compare amounts of major contracts (including change orders) to amounts appropriated for the project. Determine if additional funds will be required for completion.	____	____	____
A D E	7. Trace completed construction to closing and transfer to GFAAG, noting proper classification by major class of assets and related sources of funding.	____	____	____
	E. Other Auditing Procedures—Leases			
[B]	1. Obtain copies of major leases for equipment and/or facilities.	____	____	____
A E	2. Review minutes of governing body for approval of lease agreement.	____	____	____
[A] E	3. From a review of the lease, determine if the lease is an operating lease or capital lease.	____	____	____
A B D E	4. If lease is a capital lease:			
	a. Determine that transaction has been recorded in accordance with generally accepted accounting principles (as described in GASB Codification section L20).	____	____	____
	b. Trace recording of cost of the asset to capital expenditure accounts (if lease is new in the period under audit) or to the GFAAG (if lease originated in a prior fiscal period).	____	____	____
	c. Trace unpaid lease amounts to general long term debt account group (GTLDAG).	____	____	____
	F. Other Auditing Procedures—GFAAG			
A	1. Obtain detailed listing of property records and reconcile with the appropriate control accounts in the general ledger.	____	____	____
A B	2. Physically inspect a sample of fixed assets and trace into detailed property records.	____	____	____
	3. Obtain a listing of fixed assets disposed of during the year.	____	____	____
C	*a.* Determine that disposals were properly authorized (and, if applicable, properly advertised) and were removed from the detailed property records.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
[C]	*b.* Trace proceeds into the record of cash receipts or receivables.	____	____	____
[C]	*c.* Determine that proceeds have been recorded in proper fund in accordance with state or local laws and regulations.	____	____	____
D E	4. If the entity records an allowance for depreciation on general fixed assets, review allowances for accuracy of additions during the year and reasonableness of ending balances.	____	____	____
[E]	5. Document client's policy regarding insurance of general fixed assets.	____	____	____
E	*a.* If applicable, inspect major insurance policies to determine coverage and compliance with entity's policy.	____	____	____
E	*b.* If applicable, determine that proper disclosure has been made in the notes to financial statements of any material uninsured assets.	____	____	____
	G. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. Property and equipment recorded in the GFAAG account group represent a valid listing of the capitalized cost of assets purchased, constructed, donated, or leased and physically on hand.	____	____	____
	b. Capital expenditures represent a complete and valid listing of all costs incurred by the acquiring fund of the property and equipment acquired during the period, and costs that meet the capitalization policy are excluded from repair and maintenance and similar expenditure accounts.	____	____	____
	c. Capitalized costs and, if applicable, related depreciation associated with all fixed assets no longer owned or possessed have been removed from the GFAAG.	____	____	____
	d. The cost or other basis of recording property and equipment is in accordance with generally accepted accounting principles.	____	____	____
	e. Capital expenditures are accounted for properly by fund type; fixed assets capitalized are classified properly by major classes of assets and related sources of funding; and related disclosures are adequate.	____	____	____

This audit program has been completed in accordance with firm policy.

	Date
Done by ____________________	____________
Reviewed by ____________________	____________

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

IX. Debt and Debt Service

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Debt is authorized and recorded in the proper fund type or the GLTDAG. (Assertions 1, 2, and 3)

B. All indebtedness of the governmental unit is identified, recorded, and disclosed. (Assertions 2, 3, and 5)

C. The governmental unit has complied with the provisions of indentures and agreements related to debt, including provisions on the use of proceeds. (Assertions 3, 4, and 5)

D. Debt service expenditures (principal and interest payable) are properly recorded, classified, and disclosed for current and future periods. (Assertions 2 and 5)

E. Debt and related restrictions, guarantees, and commitments are properly presented in the combined financial statements, and related disclosures are adequate. (Assertions 2 and 5)

F. If the government is subject to the rebate calculation and refund requirement of the Tax Reform Act of 1986 (TRA):

   a. The calculation has been made as required by law or regulation (annually on the anniversary date of each bond issue);

   b. If applicable, the refund has been made as required (30 days after the end of the fifth rebate year); and

   c. Liabilities resulting from a failure to comply with rebate and refund requirements have been properly recorded as a loss or contingency and/or disclosure has been made in the notes of potential loss of tax-exempt status. (Assertions 3 and 5)

G. Conduit debt obligations and debt defeasances are recorded and disclosed in accordance with GAAP. (Assertions 2 and 5)

Obj.		Done By	Date	W/P Ref.
	Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.			
	A. Evaluation of Internal Control			
	1. Review the understanding of internal control over debt and debt service transactions and the preliminary assessment of control risk.	____	____	____
	2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk.	____	____	____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	____	____	____
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on debt and debt service and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	C. Other Auditing Procedures—Notes and Tax Anticipation Warrants			
A	1. Determine that all obligations of this nature have been properly authorized.	____	____	____
B C	2. Review applicable documents to determine interest rates, collateral, liens, and security agreements, if any.	____	____	____
B C	3. Confirm outstanding balances and other pertinent information (see 2 above) with note holders.	____	____	____
A B C	4. Determine that warrants, etc., have not been issued in excess of legal limitations and confirm that payments have been made in accordance with legal requirements.	____	____	____
D	5. Review interest paid or accrued for reasonableness. Recompute on a test basis.	____	____	____

Obj.		Done By	Date	W/P Ref.
	D. Other Auditing Procedures—Loans and Advances			
A	1. Determine that all obligations of this nature have been properly authorized.	____	____	____
B C	2. Review applicable documents to determine interest rates, collateral, liens, and security agreements, if any.	____	____	____
B C	3. Confirm outstanding balances and other pertinent information (see 2 above) with note holders.	____	____	____
D	4. Review interest paid or accrued for reasonableness. Recompute on a test basis.	____	____	____
	E. Other Auditing Procedures—Bond and Interest Expenditures/Expenses			
A C	1. Examine provisions of bond ordinances and tax levies for retirement of bonds and interest and test compliance therewith.	____	____	____
	a. Compute required balances of restrictive accounts required by bond ordinance and compare to amounts actually on deposit.	____	____	____
	b. Review transactions in restrictive accounts during period under audit to determine that deposits/transfers are being made at intervals/dates required by the bond ordinance.	____	____	____
	2. Obtain maturity schedule for outstanding bonds:			
B D	*a.* Trace amounts maturing currently to expenditure/expense accounts for interest and principal.	____	____	____
B D	*b.* Trace unmatured bond principal to general long term debt account group or applicable proprietary fund(s).	____	____	____
C D	3. Confirm directly with the paying agent the amounts transmitted to the paying agent during the year, amount of bonds and interest retired during the year, and any year end balances (including canceled bonds and coupons).	____	____	____
	4. For bonds issued during the fiscal year under audit:			
A	*a.* Trace approval of issuance to minutes of governing body.	____	____	____
A	*b.* If applicable, review approval from third parties.	____	____	____
B C D	*c.* Trace proceeds from bond issuance to determine they have been handled as specified in the bond ordinance.	____	____	____
D E	*d.* Verify that bonds have been recorded in the GLTDAG or applicable proprietary fund(s).	____	____	____
D E	5. Determine that cash on hand with the paying agent is recorded as both an asset and a liability.	____	____	____
E	6. Determine that the total outstanding debt does not exceed the legal restrictions.	____	____	____

Obj.		Done By	Date	W/P Ref.
C D E	7. For advance refundings and in-substance defeasance of debt:			
	a. Determine that refunding transaction has been accounted for in accordance with generally accepted accounting principles.	____	____	____
	b. Trace applicable disclosures to supporting documentation.	____	____	____
	F. Other Auditing Procedures—Arbitrage Rebate and Refund Requirements Under the Tax Reform Act of 1986			
F	1. Obtain a listing of obligations issued since August 15, 1986, the effective date of 1986 TRA.	____	____	____
F	2. Obtain for each bond issue the certificate as to arbitrage issued by bond counsel (which is essential for an understanding of the compliance requirements relative to a bond issue).	____	____	____
F	3. Determine whether:			
	a. The foregoing bonds are subject to arbitrage rebate calculation and refund requirements of the TRA;	____	____	____
	b. The procedures adopted to ensure compliance with the arbitrage provisions of TRA are adequate, including the maintenance of accounting records by debt issue for proceeds, related investment earnings, and related rebate amounts, if any;	____	____	____
	c. Debt proceeds and bond issue reserve funds have been invested and the nature of the investment;	____	____	____
	d. The arbitrage rebate calculation has been made annually on the bond issue anniversary date and whether the rebate amount has been placed in a separate account;	____	____	____
	e. The appropriate rebate refund payment (90 percent of the calculated rebate amount and all interest earned on the rebate amount) was made to the U.S. Treasury within 30 days after the end of the fifth rebate year;	____	____	____
	f. Any penalties have been imposed by the Internal Revenue Service for failure to comply with the TRA; and,	____	____	____
	g. The government has been advised of the possible loss of tax exempt status on bond issues for failure to comply with the provisions of the TRA.	____	____	____
F	4. Obtain client's worksheets for computing arbitrage liability.	____	____	____
	a. Trace date and amount of deposits and disbursements to supporting accounting records.	____	____	____
	b. Review client's computations for reasonableness.	____	____	____
	c. Determine whether arbitrage liabilities have been recorded/disclosed in accordance with GAAP.	____	____	____
[C][F]	5. Determine whether the government's record retention policy requires records to be maintained for 6 years after the bonds are retired.	____	____	____

Obj.		Done By	Date	W/P Ref.
	G. Other Audit Procedures			
	1. Determine if conduit debt obligations are in accordance with GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations.*	____	____	____
	2. Determine if debt defeasances are in accordance with GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt,* and GASB Statement No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Propietary Activities.*	____	____	____
	H. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. Debt is authorized and recorded in the proper fund type or the GLTDAG.	____	____	____
	b. All indebtedness of the governmental unit is identified, recorded, and disclosed.	____	____	____
	c. The governmental unit has complied with the provisions of indentures and agreements related to debt, including provisions on the use of proceeds.	____	____	____
	d. Debt service expenditures (principal and interest payable) are properly recorded, classified, and disclosed for current and future periods.	____	____	____
	e. Debt and related restrictions, guarantees, and commitments are properly presented in the combined financial statements, and related disclosures are adequate.	____	____	____
	f. If applicable, arbitrage rebate calculations and arbitrage refunds have been made as required by law/regulation.	____	____	____
	g. There are no loss contingencies due to noncompliance that have not been properly recorded or disclosed.	____	____	____
	Except as follows: ____________________ ____________________ ____________________	____	____	____

This audit program has been completed in accordance with firm policy.

	Date
______________________________ Done by	__________
______________________________ Reviewed by	__________

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Obj.		*Done By*	*Date*	*W/P Ref.*

X. **Interfund Transactions and Fund Equity**

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. All recorded interfund transactions, and changes in reserved, designated, and undesignated fund balance are based on actual transactions between funds and are in accordance with any contractual or legal requirements. (Assertions 1, 2, and 4)

B. All interfund transactions and reservations and designations of fund balance are identified, recorded, and disclosed. (Assertions 2 and 5)

C. Reserves required by law or contractual agreement comply with contractual or legal restrictions. Interfund transactions are in accordance with budget, legislative, or management authorizations, as applicable. (Assertions 2, 3, and 5)

D. Interfund transactions are recorded at the correct amounts in the proper funds and are valued at appropriate amounts. (Assertions 3 and 4)

E. All balance sheet interfund balances between funds are reconciled and disclosed, and all reserves and designations are properly classified and adequately described. (Assertions 2 and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. **Evaluation of Internal Control**

1. Review the understanding of internal control over fund equity and interfund transactions and the preliminary assessment of control risk. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk.	____	____	____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	____	____	____
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on interfund transactions and fund equity and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	C. Other Auditing Procedures—Interfund Transactions			
[A]	1. Obtain or prepare a schedule of transfers between funds and of all interfund account balances at year end.	____	____	____
A C	2. Determine that all interfund balances are in reciprocal balance.	____	____	____
[A]	3. Review minutes of local government, adopted budget, and appropriate bond ordinances for authorization of interfund activity.	____	____	____
A C E	4. Determine that all transfers are properly classified as operating or equity and reported accordingly in the financial statements.	____	____	____
B D F	5. Review ending balances of accounts as to:			
	a. Aging of balances.	____	____	____
	b. Reason for transactions.	____	____	____
	c. Method of liquidation anticipated.	____	____	____
	d. Proper reporting classification.	____	____	____
	e. Collectibility.	____	____	____
	D. Other Auditing Procedures—Fund Equity			
A	1. Review minutes of the governing body, charter, and debt ordinances or other similar documents to identify the authorizations for reservations or designations of fund balances.	____	____	____
A B C E	2. Determine whether reservations or designations of fund balance have been made in compliance with the applicable law/regulation and are properly disclosed in the financial statements.	____	____	____

Obj.		Done By	Date	W/P Ref.
	a. If applicable, reconcile reserve for encumbrances to information on encumbrances developed at AAM section 12,200.060, "Expenditures, Expenses, and Payables," item D.1.	____	____	____
B E	3. Analyze all transactions to fund balances or retained earnings accounts for the year to determine that all such transactions are properly reported in the financial statements or notes.	____	____	____
E	4. Verify the validity of any adjustment to the fund balance/retained earnings accounts, and determine appropriate reporting.	____	____	____

E. Overall Conclusions

1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:

	Done By	Date	W/P Ref.
a. All recorded interfund transactions, and changes in reserved, designated, and undesignated fund balance are based on actual transactions between funds and are in accordance with any contractual or legal requirements.	____	____	____
b. All interfund transactions and reservations and designations of fund balance are identified, recorded, and disclosed.	____	____	____
c. Reserves required by law or contractual agreement comply with contractual or legal restrictions. Interfund transactions are in accordance with budget, legislative, or management authorizations, as applicable.	____	____	____
d. Interfund transactions are recorded at the correct amounts in the proper funds and are valued at appropriate amounts.	____	____	____
e. All balance sheet interfund balances between funds are reconciled and disclosed, and all reserves and designations are properly classified and adequately described.	____	____	____

This audit program has been completed in accordance with firm policy.

	Date
________________________	____________
Done by	
________________________	____________
Reviewed by	

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		Done By	Date	W/P Ref.

XI. Proprietary Funds—Special Topics

Note: Most of the audit procedures applicable to proprietary funds will be completed in connection with other audit programs. However, certain types of accounts and transactions are so unique to proprietary funds that they have been separately addressed in this program.

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Utility or enterprise revenue accounts include all transactions that relate to the period. (Assertions 1, 2, and 5)

B. Utility or enterprise receivables are valid and are stated at the net realizable amount. (Assertions 1, 3, and 4)

C. Deposits received from customers and others have been properly recorded and are being accounted for in accordance with generally accepted accounting principles. (Assertions 1, 2, and 5)

D. Contributed capital has been accounted for in accordance with generally accepted accounting principles applied on a consistent basis. (Assertions 1, 2, 4, and 5)

E. Descriptions, classifications, and related disclosures are adequate and not misleading. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control

1. Review the understanding of internal control over proprietary fund revenues and receivables and deposits and the preliminary assessment of control risk. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk.	____	____	____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	____	____	____
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on proprietary fund revenues, receivables, and deposits and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	C. Other Auditing Procedures—Proprietary Fund Revenues			
A [B]	1. Obtain rate schedules for services and determine that rates have been properly authorized.	____	____	____
A [B]	*a.* Where charges are based on variable quantities or volumes of usage:			
	(1) Test records of usage, such as meter readers' reports, to determine reliability of usage data.	____	____	____
	(2) Determine reasonableness of enterprise revenues when compared to records showing the usage/consumption of goods or services.	____	____	____
	(3) Compute average revenue per unit of usage/consumption and compare to average for prior years.	____	____	____
	(4) Compare records of usage with records of production; investigate and explain any unusual differences between them.	____	____	____
A [B]	*b.* Where charges are based on direct and allocated costs:			
	(1) Determine method used by client to accumulate direct costs and/or allocated costs for each customer.	____	____	____
	(2) Trace direct costs into customers' ledger to determine that costs have been properly accumulated.	____	____	____
	(3) Recompute allocated costs to determine that they have been properly assigned to individual customers.	____	____	____
A B	*c.* If cycle billing is used, obtain client's computation of unbilled service receivables and—			
	(1) Review for accuracy of computation	____	____	____
	(2) Trace billings to subsequent periods	____	____	____

Obj.		Done By	Date	W/P Ref.
	(3) Agree total of unbilled service to general ledger account.	____	____	____
A	2. For selected accounts:			
	a. Trace records of usage (such as meter reader reports) to usage shown on customer's bill.	____	____	____
	b. Recompute billing, making sure that authorized rates are in use.	____	____	____
	D. Other Auditing Procedures—Utility or Enterprise Receivables			
A B	1. Obtain aged listing of accounts receivable. Test accuracy of listing and reconcile balance with general ledger.	____	____	____
B	2. Investigate individual accounts with large or unusual balances; trace to subsequent transactions.	____	____	____
A B	3. Consider confirming accounts receivable directly with customers. If receivables are not confirmed, however, the reason for nonconfirmation must be documented. One of the following is acceptable:			
	a. Accounts receivable are immaterial to the financial statements.	____	____	____
	b. Use of confirmations would be ineffective.	____	____	____
	c. Combined assessed level of inherent risk and control risk is low, and the assessed level, in conjunction with the evidence expected to be provided by analytical procedures or other substantive tests of details, is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions.	____	____	____
A B	4. Obtain or list subsequent collections of past due items to date of field work.	____	____	____
B	5. Obtain list of uncollectible accounts written off during the year and of all credits issued during the year, and review for authority and propriety.	____	____	____
B F	6. Review collectibility of accounts with responsible personnel and determine that proper allowance is established for uncollectible accounts.	____	____	____
	E. Other Auditing Procedures—Deposits			
C	1. If deposit liabilities are not material to the financial statements, review liability for reasonableness and explain any unusual variations from prior years. Otherwise—	____	____	____
C	2. Obtain listing of deposits (with indication of purpose of deposit if not otherwise noted) and reconcile to general ledger.	____	____	____
C	3. Confirm balances on a test basis.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	4. If interest is paid—			
C	*a.* Examine documentation authorizing payment of interest and determine that proper rate is being paid/accrued.	____	____	____
C	*b.* Test interest payments made during the period and accrued as of the end of the period being audited.	____	____	____
[C] F	5. Review the provisions of any related ordinances and test for compliance.	____	____	____
C F	6. Determine whether deposits are refundable in full or in part.	____	____	____
	F. Other Auditing Procedures—Contributed Capital			
E	1. Analyze all changes in contributed capital during the period and determine whether recording is in accordance with GAAP.	____	____	____
E	2. Analyze income accounts to determine whether any contributions, grants or system development fees have been received during the period and recorded as revenue. Determine the propriety of the accounting and whether any such revenues should be considered to be contributed capital.	____	____	____
E	3. If depreciation on fixed assets financed by contributed capital is closed to contributed capital:			
	a. Determine that the government's accounting records have properly identified fixed assets financed by contributed capital.	____	____	____
	b. Review computation of depreciation on such assets and reconcile total depreciation thereon to amounts charged to contributed capital.	____	____	____
	G. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. Utility or enterprise revenue accounts include all transactions that relate to the period.	____	____	____
	b. Utility or enterprise receivables are valid and are stated at the net realizable amount.	____	____	____
	c. Deposits received from customers and others have been properly recorded and are being accounted for in accordance with generally accepted accounting principles.	____	____	____
	d. Contributed capital has been accounted for in accordance with generally accepted accounting principles applied on a consistent basis.	____	____	____
	e. Descriptions, classifications, and related disclosures are adequate and not misleading.	____	____	____

This audit program has been completed in accordance with firm policy.

	Date
Done by	
Reviewed by	

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

XII. Risk Financing and Insurance Related Activities

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. The local government has adopted policies to provide reasonable coverage for risk of loss. (Assertion 3)

B. Self-insurance programs are properly authorized and are in accordance with state and local laws and regulations. (Assertion 3)

C. Self-insurance program premiums have been properly assessed and recorded in benefiting funds. (Assertions 3, 4, and 5)

D. Claims payable for self-insurance programs have been properly determined and recorded. (Assertions 2, 3, 4, and 5)

E. Claims paid by self-insurance programs conform to self-insurance program requirements. (Assertion 3)

F. Risk financing and insurance-related activities have been accounted for in accordance with generally accepted accounting principles. (Assertions 1, 2, and 5)

G. Note disclosures relative to the entity's insurance programs and risks provide adequate disclosure and are in accordance with disclosures required under generally accepted accounting principles. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Obj.		Done By	Date	W/P Ref.
	A. Evaluation of Internal Control			
	1. Review the understanding of internal control relative to insurance related issues and transactions and the preliminary assessment of control risk.	____	____	____
	2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk.	____	____	____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	____	____	____
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on insurance and risk related transactions and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	C. Other Auditing Procedures—Risk Related—General			
A	1. Obtain copy of entity's adopted policy relative to risk financing and related insurance coverage.	____	____	____
A	2. Determine that the policy has been considered and adopted by the applicable governing body.	____	____	____
	3. Prepare a schedule showing the types of risks of loss to which the entity is exposed and how those risks are handled (for example, through commercial insurance, self-insurance, public risk pool, etc.).	____	____	____
A	*a.* Consider whether material risks of loss have not been addressed in the entity's policies.	____	____	____
G	*b.* Review financial statements for adequacy of disclosure regarding entity's risk policies and, if applicable, any material uninsured risks.	____	____	____
	4. If the entity's policy is to purchase insurance coverage for identified risks—			
A	*a.* Determine compliance of purchased insurance with adopted policy.	____	____	____
A [F]	*b.* For selected premiums, determine whether payments have been made in accordance with policy terms and whether charges have been made to the proper fund/function.	____	____	____

Obj.		Done By	Date	W/P Ref.
A G	*c.* From analysis of selected policies, determine whether there has been a transfer of risks. If not, determine that premiums and claims have been properly recorded to reflect the continuing risks of refunds or assessments.	____	____	____
	5. If the entity participates in a public entity risk pool(s)—			
[A]	*a.* Determine the type of public entity risk pool (i.e., risk-sharing, insurance-purchasing, banking, or claims-servicing) and the type of entity risk handled by each pool.	____	____	____
A	*b.* Obtain copy of agreement with risk pool and determine whether all required payments have been made in accordance with the agreement and have been charged to the proper fund/function.	____	____	____
A F	*c.* Obtain copy of financial statements from public entity risk pool and determine whether audit entity has any continuing contingencies (asset or liability) relative thereto.	____	____	____
G	*d.* Review notes to financial statements for adequacy of disclosures regarding risks being handled by public entity risk pool(s).	____	____	____
	D. Other Auditing Procedures—Self Insurance Funds			
A B	1. For risks of loss retained by the entity, determine methods used to determine estimated losses from claims (including losses incurred but not reported).	____	____	____
D	*a.* If an actuarial report is used to record estimated losses, obtain copy of report and perform procedures relative thereto as required by SAS No. 73, *Using the Work of a Specialist* [AU section 336].	____	____	____
D	*b.* If an actuarial report is not used—			
	(1) Review methods used to determine estimated losses for reasonableness and logic.	____	____	____
	(2) Trace information used in computation to historical data.	____	____	____
	(3) For selected categories of loss, recompute estimated losses.	____	____	____
	(4) Consider need to obtain services of a specialist.	____	____	____
D E	2. Determine that claims and related expenditures/expenses have been recognized in accordance with GASB Codification section C50.	____	____	____
E	3. Select a representative sample of claims paid and verify that the claimed losses were documented and that the payments made conform to program provisions.	____	____	____
	4. For self-insurance programs accounted for within a general fund:			
C F	*a.* Determine that claims payable are recorded using the modified accrual basis, with the current portion recorded as an expenditure and a fund liability and the long-term portion recorded in the general long-term debt account group.	____	____	____

Obj.		Done By	Date	W/P Ref.
C F	*b.* Review method of charging losses to other funds, and determine that any amounts charged to other funds in excess of total expenditures and liabilities have been recorded as operating transfers.	____	____	____
	5. For self-insurance programs accounted for within an internal service fund:			
C	*a.* Determine that premiums are:			
	(1) Recorded as charges for services in the internal service fund;	____	____	____
	(2) Recorded as expenditures/expenses of the insured funds; and,	____	____	____
	(3) Based on the loss experience of the internal service fund and allocated to the insured funds on a reasonable basis.	____	____	____
C	*b.* Determine that total claims payable are reported as internal service funds liabilities.	____	____	____
C F	*c.* Determine that consideration has been given to recording properly authorized interfund receivables and payables to eliminate internal service fund deficits.	____	____	____
	(1) If receivables/payables have not been recorded, determine whether a feasible plan has been developed to eliminate the deficit within a reasonable period and whether such plan is properly disclosed.	____	____	____
D	6. Correspond directly with client's attorney handling self-insurance claims regarding large or unusual claims which have not been settled.	____	____	____
D	7. Examine claims paid subsequent to the close of the fiscal year to determine the existence of unrecorded payables.	____	____	____
F	8. Determine that assets accumulated to pay claims are appropriately shown as reserved or designated for self insurance.	____	____	____
G	9. Determine the accuracy and completeness of related note disclosures.	____	____	____
	E. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. The local government has adopted policies to provide reasonable coverage for risks of loss.	____	____	____
	b. Self-insurance programs are properly authorized and are in accordance with state and local laws and regulations.	____	____	____
	c. Self-insurance program premiums have been properly assessed and recorded in benefiting funds.	____	____	____
	d. Claims payable for self-insurance programs have been properly determined and recorded.	____	____	____
	e. Claims paid by self-insurance programs conform to self-insurance program requirements.	____	____	____

Obj.		Done By	Date	W/P Ref.
	f. Risk financing and insurance-related activities have been accounted for in accordance with generally accepted accounting principles.	____	____	____
	g. Note disclosures relative to the entity's insurance programs and risks provide adequate disclosure and are in accordance with disclosures required under generally accepted accounting principles.			
	Except as follows: ________ ________ ________	____	____	____

This audit program has been completed in accordance with firm policy.

	Date
________ Done by	________
________ Reviewed by	________

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

XIIIA. Fiduciary Funds (Other Than Pension Trust Funds)

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Agency funds have been properly established and maintained, and are reported in accordance with generally accepted accounting principles. (Assertions 1, 2, 3, 4, and 5)

B. Trust funds (other than pension trust funds) are being maintained in compliance with the applicable trust indentures and are reported in accordance with generally accepted accounting principles. (Assertions 1, 2, 3, 4, and 5)

C. Information and disclosures pertaining to PERS (other than pension trust funds administered by the entity) are in accordance with the requirements of generally accepted accounting principles. (Assertions 1, 2, and 4)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Evaluation of Internal Control

1. Review the understanding of internal control over fiduciary fund transactions and the preliminary assessment of control risk. ____ ____ ____

2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.			
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on fiduciary funds and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.			
	2. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.			
	C. Other Auditing Procedures—Agency Funds			
A	1. Determine the purpose of each agency fund.			
A	2. Trace collections into agency funds on a test basis.			
A	3. Trace disbursements from agency funds to supporting documentation on a test basis.			
A	4. Note and examine the properly filed reports supporting payments to other governmental agencies.			
A	5. Determine that client is complying with applicable state/local escheat laws.			
	D. Other Auditing Procedures—Trust Funds			
B	1. Obtain copies of documents establishing trust funds (other than pension trust funds).			
B	2. Trace collections into trust funds on a test basis.			
B	3. Trace disbursements from trust funds to supporting documentation on a test basis.			
B	4. Determine compliance of collection and disbursement transactions with terms of trust.			
	E. Other Auditing Procedures—PERS			
C	1. Obtain copy of most recent actuarial report from third party administrator.			
C	2. Compare information received from administrator to plan disclosures included in notes to financial statements.			

Obj.		Done By	Date	W/P Ref.

F. **Overall Conclusions**

1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:

   a. Agency funds have been properly established and maintained, and are reported in accordance with generally accepted accounting principles. ____ ____ ____

   b. Trust funds (other than pension trust funds) are being maintained in compliance with the applicable trust indentures and are reported in accordance with generally accepted accounting principles. ____ ____ ____

   c. Information and disclosures pertaining to PERS (other than pension trust funds administered by the entity) are in accordance with the requirements of generally accepted accounting principles. ____ ____ ____

   Except as follows:

   ____

   ____

   ______________________________ ____ ____ ____

This audit program has been completed in accordance with firm policy.

	Date
______________________________	____________
Done by	
______________________________	____________
Reviewed by	

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

XIIIB. Pension Trust Funds*

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. Investments reported in the financial statements are on hand in the name of the pension trust fund or held in custody and safekeeping by others in the name of and on behalf of the pension trust fund. (Assertions 1, 2, and 3)

B. Investments and the related income are properly valued, allocated, classified, and described in the financial statements. (Assertions 2, 4, and 5)

C. Adequate disclosure has been made of the pledging of any investments and credit risks are properly disclosed as required by GASB Statement No. 3. (Assertions 3 and 5)

D. The amounts received or due the plan have been determined in accordance with plan requirements and recorded and reported in conformity with generally accepted accounting principles. (Assertions 3, 4, and 5)

E. Benefit payment amounts conform to plan provisions. (Assertion 3)

F. Financial statement representations and disclosures are consistent with actuarial findings. (Assertions 4 and 5)

G. Applicable accounting principles have been consistently applied. (Assertions 4 and 5)

H. Required supplementary information has been presented in accordance with guidelines established for its presentation and measurement. (Assertions 2 and 5)

* This program assumes GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans*, and GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, have not been adopted. If GASB Statements No. 25 and 27 are adopted, the program must be modified.

Obj.		Done By	Date	W/P Ref.
	Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.			
	A. Evaluation of Internal Control			
	1. Review the understanding of internal control relative to pension trust funds and the preliminary assessment of control risk.	____	____	____
	2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk.	____	____	____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	____	____	____
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on pension trust funds and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	____	____	____
	2. If analytical procedures are used for substantive testing purposes, document the basis for the expected relationship, the results of the comparison of the recorded amount to the expectation, and the results of the evaluation of unexpected differences between the recorded amount and the expectation.	____	____	____
	C. Other Auditing Procedures—General			
B[D]F	1. Obtain copies of the following documents, if applicable:			
	a. Pension plan instruments, including amendments.	____	____	____
	b. State and local laws and regulations authorizing the retirement program.	____	____	____
	c. Minutes of meetings of governing board.	____	____	____
	d. Agreements with trustees, investment advisers, and insurance companies.	____	____	____
	e. Relevant policy and procedure manuals.	____	____	____
	f. Service auditors' reports on the processing of transactions and applicable controls of service organization(s) responsible for processing data for the pension fund.	____	____	____
	g. Current actuary's report on the retirement system.	____	____	____
	D. Other Auditing Procedures—Investments			
[A][B] C G	1. Obtain schedule of investments and determine that investments are in accordance with the provisions of the plan.	____	____	____

Obj.		Done By	Date	W/P Ref.
	a. Trace selected investment transactions to approval in minutes of governing board.	____	____	____
	b. Reconcile balances to financial statements.	____	____	____
A	2. Obtain evidence (by confirmation or physical count) concerning the existence and ownership of the investments.	____	____	____
B	3. Obtain information concerning any liens, pledges, or other security interests by reviewing minutes, agreements, and confirmations.	____	____	____
C G	4. Determine that income accruing from investments has been properly allocated and recorded.	____	____	____
C G	5. Obtain market values at balance-sheet date and investigate significant differences from recorded values to determine if any write-downs are necessary.	____	____	____
B	6. Review GASB Statement No. 3 disclosures.	____	____	____
A C	7. Perform such procedures as necessary to satisfy audit objectives concerning plan investments administered by trustees.	____	____	____
D	8. For plan assets held by an insurance company:			
	a. Read the contracts between the contract holder and the insurance company.	____	____	____
	b. Confirm with the insurance company:			
	(1) Contributions or premium payments.	____	____	____
	(2) Interest, dividends, refunds, credits, and changes in value and whether such amounts have been charged or credited during the year on an estimated or actual basis.	____	____	____
	(3) The contract value or the fair value of the funds at the plan's year-end and the basis for determining such values.	____	____	____
	(4) The amount of insurance company fees and other expenses.	____	____	____
	(5) Annuity purchases or benefits paid.	____	____	____
	(6) Transfers between funds or accounts.	____	____	____
	c. Reconcile the confirmed balances and transactions with amounts recorded and reported by the client.	____	____	____
	d. Evaluate compliance with contract terms.	____	____	____
	e. Evaluate reasonableness of amounts credited to the contracts.	____	____	____
	f. Evaluate the sufficiency of related note disclosures.	____	____	____
	E. Other Auditing Procedures—Contributions and Related Receivables			
D	1. Obtain a list of participating employers (for multi-employer plans).	____	____	____

Obj.		Done By	Date	W/P Ref.
D	2. Obtain a schedule showing, by employer, contributions received or receivable and compare to the list of participating employers.	____	____	____
D G	3. Test contribution reports for arithmetical accuracy, use of proper contribution rates, and use of proper payroll or salary base amount.	____	____	____
D G	4. Test posting from the employer contribution reports to participant records and from participant records to contribution reports.	____	____	____
D G	5. Reconcile contributions received to the plan's receipt records or trustee records.	____	____	____
D G	6. Confirm amounts contributed and receivable directly with selected contributors.	____	____	____
D G	7. Review accruals for conformance with generally accepted accounting principles and determine reasonableness of allowances for doubtful accounts.	____	____	____
D	8. Review note disclosures relative to pension plan contributions and related receivables.	____	____	____
	F. Other Auditing Procedures—Benefit Payments and Payables			
E G	1. Obtain schedule of pension payments made during the year (including any lump sum refunds, if applicable, to members withdrawing from the plan) and reconcile to general ledger accounts.	____	____	____
	a. Refer to plan provisions and recompute monthly benefits to selected employees retiring during the period under audit.	____	____	____
	b. For selected employees withdrawing from the system during the year, trace refunds to supporting documentation.	____	____	____
	c. Trace payments made during the year to selected employees who retired in prior years to prior year's working papers to determine that benefits have remained in accordance with plan provisions.	____	____	____
E	2. Evaluate the continued eligibility of participants or beneficiaries to whom payments have been made over an unusually long period of time.	____	____	____
E	3. Investigate benefit payment checks which have been outstanding for a long period of time.	____	____	____
E G	4. Evaluate benefit payment accruals for conformance with generally accepted accounting principles.	____	____	____

Obj.		Done By	Date	W/P Ref.
	G. Other Auditing Procedures—Participants' Data and Plan Objectives			
D E	1. By reviewing pertinent sections of the pension plan instrument, statutes, or rules, identify participant data which should be tested because of its use in determining vesting, eligibility or benefit amounts (for example, demographic data, payroll data, benefit levels and options, etc.).	____	____	____
D	2. For selected participants, verify relevant participant file data by comparing it to corroborative employer records (such as payrolls, employee earnings records, personnel files, etc.).	____	____	____
	a. For selected employees, recompute vesting and compare to client's records.	____	____	____
D E	3. For selected employees, trace payroll data to participant file data.	____	____	____
F	4. With regard to actuarial valuations of defined benefit plans:			
	a. Obtain information concerning the professional qualifications and reputation of the actuarial firm and other information as required by SAS No. 73 [AU section 336].	____	____	____
	b. Obtain an understanding of the actuary's methods and assumptions.	____	____	____
	c. Submit an inquiry to the actuary concerning:			
	(1) Whether the actuarial valuation considers all pertinent provisions of the plan, including any changes to the plan or other events affecting the actuarial calculations.	____	____	____
	(2) Relationships between the actuary and the plan or an employer which may impair the actuary's objectivity.	____	____	____
	(3) Aggregate and selected individual participant data amounts used in the actuarial valuations.	____	____	____
	(4) Whether the actuary has reviewed the relevant portions of the financial statements and agrees with such information as presented.	____	____	____
	d. Verify the accuracy and completeness of the participant data used in the actuarial valuations.	____	____	____
D E	5. With respect to defined contribution plans:			
	a. Verify that employer contributions have been properly allocated.	____	____	____
	b. Verify that allocations of income or loss, investment appreciation or depreciation, administrative expenses, and forfeitures have been made in compliance with plan provisions.	____	____	____
	c. For selected participants, verify that employee contributions have been credited to the proper participant account and investment medium.	____	____	____
	d. Reconcile the sum of individual accounts to total net assets available for benefits.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*

H. Review Procedures—Required Supplementary Information

1. With regard to historical trend information, inquire of management as to the methods used in preparing the information, including:
   a. Whether it is measured and presented in accordance with the guidelines of GASB. ____ ____ ____
   b. Whether the methods of measurement or presentation have been changed from those of the prior period and the reasons for such changes, if any. ____ ____ ____
   c. Any significant assumptions or interpretations underlying the measurement or presentation. ____ ____ ____
2. Compare the information for consistency with:
   a. Audited financial statements. ____ ____ ____
   b. Other knowledge obtained during the examination of the financial statements. ____ ____ ____
   c. Measurement and presentation in accordance with GASB guidelines. ____ ____ ____
3. Consider whether representations on required supplementary information should be included in the request for the management representation letter. ____ ____ ____

I. Overall Conclusions

1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:
   a. Investments reported in the financial statements are on hand in the name of the pension trust fund or held in custody and safekeeping by others in the name of and on behalf of the pension trust fund. ____ ____ ____
   b. Investments and the related income are properly valued, allocated, classified, and described in the financial statements. ____ ____ ____
   c. Adequate disclosure has been made of the pledging of any investments and credit risks are properly disclosed as required by GASB Statement No. 3. ____ ____ ____
   d. The amounts received or due the plan have been determined in accordance with plan requirements and recorded and reported in conformity with generally accepted accounting principles. ____ ____ ____
   e. Benefit payment amounts conform to plan provisions. ____ ____ ____
   f. Financial statement representations and disclosures are consistent with actuarial findings. ____ ____ ____
   g. Applicable accounting principles have been consistently applied. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	h. Required supplementary information has been presented in accordance with guidelines established for its presentation and measurement. Except as follows: ____________________ ____________________ ____________________	____	____	____

This audit program has been completed in accordance with firm policy.

	Date
____________________ Done by	________
____________________ Reviewed by	________

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Obj.		*Done By*	*Date*	*W/P Ref.*

XIV. Financial Reporting

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. The financial statements being reported upon are fairly stated in accordance with generally accepted accounting principles consistently applied (or in accordance with another comprehensive basis of accounting), including all required disclosures. (Assertions 1, 2, 3, 4, and 5)

B. The effect of any significant or unusual transactions occurring during the period from the balance-sheet date to the date of our report is adequately considered or disclosed in the financial statements. (Assertions 1, 2, 4, and 5)

C. Our report on the examination is appropriately worded, and in conformity with generally accepted auditing standards.

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Other Auditing Procedures

Obj.	Procedure	Done By	Date	W/P Ref.
A	1. Post all adjusting and reclassification journal entries that have properly been approved by firm and client personnel to the working papers, and give a copy of appropriate entries to the client for posting to the accounting records.	____	____	____
A	2. Prepare a summary of passed adjustments which reflects the net effect of such adjustments on individual fund/fund type, account group, and discretely presented component unit assets, liabilities, equity, revenue, and expenditures.	____	____	____

Obj.			Done By	Date	W/P Ref.
		a. Determine if the overall effect on each fund type, account group, and discretely presented component unit is material and state conclusion in summary.	____	____	____
		b. Consider the need for additional audit adjustments.	____	____	____
A	3.	Extend trial balances and compare to amounts reported in the financial statements.	____	____	____
	4.	Obtain signed management representation letter from responsible client officials. In addition to representations normally obtained in a GAAS audit, consider obtaining additional representations regarding:			
A		*a.* Acknowledging management's responsibility for entity's compliance with laws and regulations.	____	____	____
A		*b.* The financial reporting entity's financial statements to be audited.	____	____	____
A		*c.* The inclusion of all component units.	____	____	____
A		*d.* The proper classification of funds and account groups.	____	____	____
A		*e.* The proper approval of reserves or designations of fund equities.	____	____	____
A		*f.* Compliance with laws and ordinances, including budget laws and ordinances.	____	____	____
A B		*g.* Status of environmental related matters, including identification of any known or potential contamination requiring remediation.	____	____	____
A		*h.* Representations relative to GASB-required supplementary information.	____	____	____
A		*i.* Identification of all federal and state assistance programs, if applicable, and compliance with all related grant requirements.	____	____	____
A B		*j.* Possible claims for disallowed costs or expenditures incurred under a federal financial assistance program.	____	____	____
	5.	Review minutes of governing body and important committee meetings from audit date through ________.	____	____	____
B		*a.* Consider whether any matters included in those minutes require further investigation to determine if the financial statements should be adjusted or disclosure regarding subsequent events should be made in the notes to financial statements.	____	____	____
A B		*b.* Obtain signed minutes representation letter and ascertain that we have received and reviewed all minutes listed in the letter.	____	____	____
A B	6.	Obtain from management a description and evaluation of litigation, claims and assessments that existed at the audit date and during the period from the audit date to the date the information is furnished, including an identification of those matters referred to legal counsel.	____	____	____

Obj.		Done By	Date	W/P Ref.
A B	7. Mail a letter of audit inquiry to client's attorney(s) to obtain corroboration of the information furnished by management concerning litigation, claims and assessments.	____	____	____
A B	8. Ascertain that replies received from attorneys are complete and that all matters discussed therein have been considered for possible disclosure in the financial statements.	____	____	____
A	9. Perform analytical procedures for overall review purposes.	____	____	____
	B. Other Auditing Procedures—Review of Subsequent Events			
	Scope of Review			
	From: ________________ *(Audit date)*			
	To: ________________ *(Report date—last date of significant field work)*			
B	1. Review interim financial statements for period subsequent to balance-sheet date and compare them to statements being reported on as well as to statements for comparable prior periods. Investigate any significant differences, results, events, or changes in accounting method.	____	____	____
B	2. Scan general ledger for subsequent period for any unusual entries or transactions and obtain explanation of entries noted.	____	____	____
B	3. Inquire of responsible officials as to the following items (attach memorandum or comments regarding significant matters discussed):	____	____	____
	a. Property and equipment:			
	(1) Commitments or plans for major purchases or sales of buildings/equipment.	____	____	____
	(2) Loss of buildings/equipment due to fires, abandonment, etc.	____	____	____
	b. New debt issuance or other borrowing, including important covenants agreed to in connection therewith.	____	____	____
	c. Other matters:			
	(1) Wage negotiations or strikes in progress or pending.	____	____	____
	(2) Loss of significant grant funds.	____	____	____
	(3) Changes in accounting and/or financial policies.	____	____	____
	(4) Illegal acts.	____	____	____
	d. Others (list as applicable): ________________ ________________ ________________ ________________	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	C. Other Auditing Procedures—Report			
C	1. Ascertain that all required disclosures are included in the financial statements or notes. See AICPA *Checklists for State and Local Governmental Units.*	____	____	____
C	2. Ascertain that the independent auditors' report is appropriately worded.	____	____	____
C	3. Have the client review and approve the final draft of the financial statements.	____	____	____
	D. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. The financial statements being reported upon are fairly stated in accordance with generally accepted accounting principles consistently applied (or in accordance with another comprehensive basis of accounting), including all required disclosures.	____	____	____
	b. The effect of any significant or unusual transactions occurring during the period from the balance-sheet date to the date of our report is adequately considered or disclosed in the financial statements.	____	____	____
	c. Our report on the examination is appropriately worded, and in conformity with generally accepted auditing standards.	____	____	____
	Except as follows: ____________________ ____________________ ____________________	____	____	____

This audit program has been completed in accordance with firm policy.

	Date
______________________________ Done by	____________
______________________________ Reviewed by	____________

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.		*Done By*	*Date*	*W/P Ref.*

XV. Federal Financial Assistance (Single Audit)

Financial Statement Assertions

1. Existence or occurrence
2. Completeness
3. Rights and obligations
4. Valuation or allocation
5. Presentation and disclosure

Audit Objectives

A. The financial statements of the entity are presented in conformity with GAAP. (Assertions 1, 2, 3, 4, and 5)

B. The local government's internal control provides reasonable assurance that it is managing federal and state financial assistance programs in compliance with applicable laws and regulations. (Assertions 1 and 2)

C. The local government has complied with laws and regulations that have a material effect on the financial statements and on each major federal financial assistance program. (Assertions 1, 2, and 3)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

A. Audit Planning

Obj.	Procedure	Done By	Date	W/P Ref.
C	1. Review applicable laws, regulations, and other references governing performance of the single audit of federal financial assistance (see AAM section 12,210).	____	____	____
B	2. Obtain a copy of the local government's single audit report from the preceding year. Make note of federal programs, reportable conditions relating to internal control, and any compliance findings. Obtain copy of client's corrective action plan. Determine if any state programs are to be included in the audit scope.	____	____	____
B [C]	3. Review and discuss with responsible local government officials the procedures used to administer federal programs.	____	____	____

Obj.		Done By	Date	W/P Ref.
A C	4. Obtain a schedule of federal financial assistance, reconcile the schedule to the general accounting records, and:			
	a. Determine that the schedule includes all types of federal assistance as defined by OMB Circular A-128, paragraph 5b.	____	____	____
	b. Determine that the schedule reports federal "programs," not individual grants. Federal programs are defined in the *Catalog of Federal Domestic Assistance.*	____	____	____
	c. Determine the "entity" for Single Audit purposes.	____	____	____
	d. Where appropriate, contact the cognizant agency and receive input on important areas.	____	____	____
	e. Determine that the schedule shows at a minimum:			
	(1) The program title and the CFDA number for each program, unless the program is not included in the *Catalog of Federal Domestic Assistance.* Those programs not included in the *Catalog* should be shown as other federal assistance;	____	____	____
	(2) Total expenditures for each federal program by grantor, department, or agency; and,	____	____	____
	(3) Total federal financial assistance expenditures.	____	____	____
	5. Rank the federal programs in descending order by expenditure amount, determine the major program threshold, and identify the major federal financial assistance programs.	____	____	____
B	6. For testing controls, if expenditures for all major programs do not exceed 50 percent of total federal financial assistance program expenditures, or if the local government has no major federal financial assistance programs, select the largest nonmajor programs until at least 50 percent of total federal financial assistance expenditures are included.	____	____	____
B	7. Review samples selected during tests of internal control and the examination of the general purpose financial statements and identify nonmajor program transactions included therein.	____	____	____
A B C	8. Prepare a working paper showing the federal programs to be subjected to further auditing procedures and indicate the nature of the procedures to be applied to each program. Such procedures may include:			
	a. Obtain an understanding of the internal control policies and procedures relevant to the programs administered (required for all federal programs: however, see PCIE Position Statement No. 3 that provides for the rotation of nonmajor programs on a 3-year basis for purposes of obtaining an understanding of internal control).	____	____	____

Obj.			Done By	Date	W/P Ref.
		b. Internal control evaluation (required for all major programs and nonmajor programs selected pursuant to the "50 percent rule").	____	____	____
		c. Program compliance review (required for all major programs to determine compliance with laws and regulations material in effect to the respective program).	____	____	____
		d. Transaction compliance review (required for nonmajor program transaction selected for testing as a result of the audit of the general purpose financial statements).	____	____	____
C		9. Obtain a copy of grant agreements for those programs selected for testing from the permanent file. Review the documents for unusual provisions, budgets, or other items of significance. Also, locate other sources of compliance information, for example the OMB *Compliance Supplement for Single Audits of State and Local Governments*, specific program regulations, the *Catalog of Federal Domestic Assistance*, etc.	____	____	____
B [C]		10. While testing controls, obtain an understanding of the possible effects on each major program (and the largest nonmajor programs if the 50 percent rule must be applied) of applicable program laws, rules, and regulations, Document this understanding by listing those laws, rules, and regulations which may have a material effect on the allowability of program expenditures in the event of substantial noncompliance. These laws, rules, and regulations shall be considered during the evaluations of administrative controls, tests of transactions, and other procedures deemed necessary (e.g., tests of compliance with matching requirements).	____	____	____
[A] C		11. Determine if the local government has an indirect cost allocation plan.	____	____	____
[A] C		12. Determine the extent to which grantor funds have been disbursed to subrecipients.	____	____	____
		13. Discuss with client the format desired for the Single Audit Report (included in the CAFR, separate Single Audit Report, etc.).	____	____	____
	B.	**Internal Control Evaluation**			
B		1. Identify the significant categories of internal control.	____	____	____
B		2. For major and nonmajor programs, obtain an understanding of internal control policies and procedures relevant to the programs administered. (Note: PCIE Statement Nos. 2 and 3 permit obtaining an understanding of internal control for nonmajor programs on a 3-year cycle.)	____	____	____
B		3. For major programs (and selected nonmajor programs selected pursuant to the "50 percent rule"), perform tests of controls to evaluate the effectiveness of the design and operation of the internal control policies and procedures relevant to preventing or detecting material noncompliance with:	____	____	____

Obj.		Done By	Date	W/P Ref.
	a. *Specific Requirements:* For examples of common control procedures which should be evaluated as part of a basis for issuing an opinion on compliance with laws and regulations applicable to federal financial assistance programs, see AAM section 12,100.			
	(1) Types of services allowed or not allowed;	____	____	____
	(2) Eligibility;	____	____	____
	(3) Matching, level of effort, or earmarking;	____	____	____
	(4) Reporting;	____	____	____
	(5) Special tests and provisions.	____	____	____
	b. *General Requirements:* For examples of common control procedures which should be evaluated as part of a basis for issuing an opinion on compliance with laws and regulations applicable to federal financial assistance programs, see AAM section 12,100.			
	(1) Civil rights;	____	____	____
	(2) Political activity;	____	____	____
	(3) Cash management;	____	____	____
	(4) Davis-Bacon Act;	____	____	____
	(5) Relocation assistance and real property management;	____	____	____
	(6) Federal financial reports;	____	____	____
	(7) Allowable costs/cost principles;	____	____	____
	(8) Drug-Free Workplace Act;	____	____	____
	(9) Administrative requirements.	____	____	____
	c. Revise audit program as appropriate.	____	____	____
	C. Compliance Procedures			
A	1. For selected grants determine that grant receipts were properly recorded and classified, in compliance with grant conditions.	____	____	____
	a. Review receipts issued shortly before and shortly after year-end to determine that all cash collected has been recorded in the proper period.	____	____	____
A [C]	2. For each major federal and state program, select a sample of expenditures charged and determine whether:			
	a. Expenditures appeared reasonable and necessary for the program;	____	____	____
	b. Expenditures were for allowable charges under the terms of the program and were adequately documented;	____	____	____
	c. Expenditures were properly authorized and recorded as to program, account, amount, and period:	____	____	____
	d. Records document that those who received services or benefits were eligible to receive them;	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	e. Expenditures were in accordance with the provisions of OMB *Compliance Supplement for Single Audits of State and Local Governments* applicable to the particular transaction;	____	____	____
	f. Expenditures were in accordance with the provisions of OMB Circular A-87 applicable to the particular transaction;	____	____	____
	g. Expenditures were in accordance with the provisions of OMB Circular A-102 and the "Common Rule" to the extent applicable to the grantor and the particular transaction; and,	____	____	____
	h. Expenditures were in accordance with applicable state laws and program requirements.	____	____	____
C	3. For each major federal and state program and selected nonmajor federal programs, as applicable, perform general (see supplemental audit program on general requirements) and specific compliance tests. List programs and attach separate work programs based on the *Compliance Supplement for Single Audits of State and Local Governments* or other sources (grants agreements, etc.):			
	a. ____________________	____	____	____
	b. ____________________	____	____	____
	c. ____________________	____	____	____
	d. ____________________	____	____	____
C	4. Determine that nonmajor program transactions tested as part of an audit of the general purpose financial statements comply with the laws and regulations applicable to each of the respective transactions. This includes the following:			
	a. Expenditures appeared reasonable and necessary for the program;	____	____	____
	b. Expenditures were for allowable charges under the terms of the program and were adequately documented;	____	____	____
	c. Expenditures were properly authorized and recorded as to account, amount, and period.	____	____	____
	d. Records document that those who received services or benefits were eligible to receive them; and,	____	____	____
	e. Amounts were determined according to Circular A-87 and Circular A-102.	____	____	____
C	**D. Test of Subrecipient Compliance**			
	If the local government does not pass through federal monies to subrecipients (receiving at least $25,000) of federal programs, check here _____ and omit the balance of this section.			
	1. Determine all subrecipients receiving at least $25,000.	____	____	____
	2. Review the local government's controls established to monitor that the subrecipient spent the federal funds in compliance with applicable laws and regulations. (OMB Circulars A-87, A-102, and A-128)	____	____	____

Obj.		Done By	Date	W/P Ref.
	3. Determine that the local government monitored the subrecipient audit reports (the subrecipient must meet the audit requirements of A-110 or A-128) and has taken any corrective measures required.	____	____	____
	E. Property			
A	1. For selected property items acquired with grant funds, review the property records to determine that the records include a description of the property, a serial number or other identification number, the source of the property, who holds title, acquisition date, cost, location, use and condition of the property, percentage of federal participation, and disposition data.	____	____	____
	2. Determine that title to the property has been properly recorded in the government's name.	____	____	____
	3. Determine that a physical inventory of property is taken and reconciled to the property records at least once every two years.	____	____	____
	4. For property dispositions, review supporting documentation to ascertain the conditions of disposition and determine that any required settlements have been made with the awarding agency.	____	____	____
	F. Reporting on Federal and State Financial Assistance			
	1. Determine that the signed management representation letter(s) contained references regarding Single Audit representations.	____	____	____
	2. If the local government requests that the Report on Federal and State Financial Assistance be included with their annual financial statements, prepare the Independent Auditor's Report on such financial statements and determine that it is appropriately worded and dated.	____	____	____
	3. If the client requests a separate Report on Federal and State (if applicable) Financial Assistance, prepare the Independent Auditor's Report on the schedule of Federal and State financial assistance.	____	____	____
	4. Prepare the schedule of findings and questioned costs. (See AAM section 12,200.190.)	____	____	____
	5. Prepare the Independent Auditor's Report on internal control based on an evaluation made as part of the audit of the general purpose financial statements.	____	____	____
	6. Prepare the Independent Auditor's Report on Internal Control Used in Administering Federal Financial Assistance Programs required by the Single Audit Act.	____	____	____
	7. Prepare the Independent Auditor's Report on compliance with laws and regulations that may have a material effect on the general purpose financial statements.	____	____	____

Obj.		*Done By*	*Date*	*W/P Ref.*
	8. Prepare the Independent Auditor's Reports on compliance required by the Single Audit Act.	____	____	____
	9. Review the Single Audit Report draft with appropriate local government officials.	____	____	____
	G. Overall Conclusion			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. The local government has complied with laws and regulations that may have a material effect upon the financial statements;	____	____	____
	b. The local government's internal control provides reasonable assurance that the local government is managing its federal programs according to the applicable laws and regulations;	____	____	____
	c. The local government has complied with laws and regulations that may have a material effect upon each major federal program, according to generally accepted auditing standards, the provisions of *Government Auditing Standards*, promulgated by the U.S. General Accounting Office, as they pertain to financial audits, the Single Audit Act of 1984 (Pub. Law No. 95-502) the provisions of the Office of Management and Budget's Circular No. A-128, *Audits of State and Local Governments*, and the *Compliance Supplement for Single Audits of State and Local Governments*.			
	Except as follows: ____________________ ____________________ ____________________	____	____	____

This audit program section has been completed in accordance with firm policy. Date

______________________________ ____________

Done by

______________________________ ____________

Reviewed by

> The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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	Done by	*Date*	*W/P Ref.*
XVI. Financial Assistance Supplement			
A. Test of General Compliance Requirements			
1. Political Activity			
Compliance Requirement—Federal funds cannot be used for partisan political activity of any kind by any person or organization involved in the administration of federally-assisted programs. (Hatch Act (5 U.S.C. 1501-1508) and Intergovernmental Personnel Act of 1970 as amended by Title VI of Civil Service Reform Act (Public Law 95-454), Section 4728).			
Auditing Procedures			
a. Test the expenditures and related records for indications of lobbying activities, publications, or other materials intended for influencing legislation or similar type costs.	____	____	____
b. Test the personnel and payroll records, and identify persons whose responsibilities or activities include political activity.	____	____	____
c. Test whether the above costs, if any exist, are charged directly or indirectly, to federally-assisted programs.	____	____	____
2. Davis-Bacon Act			
Compliance Requirement—When required by the federal grant program legislation, all laborers and mechanics employed by contractors or subcontractors to work on construction projects financed by federal assistance must be paid wages not less than those established for the locality of the project by the Secretary of Labor. (40 Stat 1494, Mar. 3, 1921, Chap. 411, 40 U.S.C. 276A-276A-5)			
Auditing Procedures			
a. Identify the programs involving construction activities.	____	____	____
b. Review selected construction contracts and subcontracts and determine whether they contain provisions requiring the payment of "prevailing" wages.	____	____	____
c. Review the Government's system for monitoring applicable contractors and subcontractors with respect to payment of prevailing wages and evaluate for adequacy.	____	____	____

	Done by	Date	W/P Ref.
d. Review the monitoring system for contracts for selected programs and determine whether there is adherence to prescribed procedures.	____	____	____
e. For Governments that have not developed a system, or for a system not operating effectively:			
(1) Obtain the "local" DOL wage determination from the recipient, the architect/engineer (A/E) managing the project, or DOL.	____	____	____
(2) Obtain from the auditee payroll registers of the construction company and test to determine whether wages paid conform to the prevailing wages.	____	____	____

3. Civil Rights

Compliance Requirement—No person shall, on the grounds of race, color, national origin, age, or handicap, be excluded from participation in or be subjected to discrimination in any program or activity funded, in whole or in part, by federal funds. Discrimination on the basis of sex or religion is also prohibited in some federal programs. (Age—42 U.S.C. 6101 et seq.; Race—42 U.S.C. 2000d; Handicap—29 U.S.C. 794.)

Auditing Procedures

	Done by	Date	W/P Ref.
a. Determine whether the governmental unit has announced a formal policy of nondiscrimination.	____	____	____
b. For recipients employing 15 or more persons, ascertain whether a person has been designated to oversee civil rights compliance.	____	____	____
c. Ascertain from the grant agreement(s) whether any of the programs contain prohibitions against discrimination on the basis of sex or religion.	____	____	____
d. Ascertain the number of complaints filed with federal, state and/or local agencies responsible for ensuring nondiscrimination in government programs during the fiscal year, the status of unresolved complaints or investigations, and the actions taken on resolved complaints or completed investigations.	____	____	____
e. Ascertain whether programs contain prohibitions against discrimination in employment; for those programs (1) review the annual report filed with the Equal Employment Opportunity Commission (EEOC), if any, (2) ascertain the number of complaints or completed investigations and (3) review the status of and actions taken on unresolved complaints or investigations.	____	____	____
f. Determine whether facilities financed by federal funds that are required to be located in a nondiscriminatory manner are so located.	____	____	____
g. Obtain representation and/or attorney letters to determine if any civil rights suits have been adjudicated or are pending.	____	____	____

	Done by	Date	W/P Ref.

4. **Cash Management**

Compliance Requirement—Grantee financial management systems shall include procedures to minimize the item elapsed between the transfer of funds from the U.S. Treasury and disbursement of funds by the Grantee.

Advances made by primary recipients to secondary recipients shall conform substantially to the same standards of timing and amount as apply to advances by federal agencies to primary recipient organizations.

(OMB Circular A-102; Intergovernmental Cooperations Act of 1968, P.L. 90-577 (sec. 403), as amended by P.L. 96-470, Title I, Section 10-1 (b)).

Auditing Procedures

a. Review the Government's cash forecasting process and evaluate for adequacy.[1] ____ ____ ____

b. Review the Government's system for requesting federal funds and evaluate whether it is adequate to keep federal cash disbursements limited to the Government's immediate needs. ____ ____ ____

c. For selected grant programs, determine dates and amounts for selected advances, drawdowns, and other receipts of federal funds and compare to the dates the funds were disbursed or checks were presented to the banks for payment. ____ ____ ____

d. For the same programs, evaluate the size of the balances in relation to the program's needs. ____ ____ ____

e. Review the Government's system for monitoring advances and payment requests by secondary recipients. Evaluate whether the system is sufficient to limit payments to amounts needed to meet immediate cash requirements. ____ ____ ____

f. Review selected cash reports submitted by subrecipients and determine if the reports show large amounts of excess cash. If they do, ascertain why. ____ ____ ____

5. **Relocation Assistance and Real Property Acquisition**

Compliance Requirements

Federal aid programs may require the acquisition of property by a public agency and subsequent displacement of households and businesses.

Grant recipients acquiring property in the administration of federal aid must carry out certain actions systematically, e.g., have property appraised in presence of owner, review appraisals, set price and negotiate settlements. Similarly, when displacement (relocations) are involved, the recipient must, for example, provide assistance systematically in locating replacement housing, assure that it meets acceptable standards and maintain re-

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[1] For purposes of the Compliance Supplement, adequacy can be interpreted as providing a reasonable assurance that the system or procedures, if followed, will result in the intended event or action occurring.

	Done by	Date	W/P Ref.
cords on all acquisitions and displacements (Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970 (URA) (Public Law 91-646 as amended by the Uniform Relocation Act Amendments of 1987, Title IV of Surface Transportation and Relocation Act of 1987 (1987 Amendments) Public Law 100-17, 100 Stat. 246-256 (see Common Rule Appendix B)).			
Auditing Procedures			
a. Ascertain whether the recipient is administering a federal or federally-assisted program that involves the acquisition of property or the displacement of households or businesses by a public agency.	____	____	____
b. Review the organization's system for compliance with relocation assistance and real property acquisition requirements and evaluate for adequacy.	____	____	____
c. Review the monitoring system for relocation and acquisition activity for selected programs and determine whether there is adherence to the prescribed procedures.	____	____	____

6. **Federal Financial Reports**

Compliance Requirement—Most federal programs require the periodic submission of financial reports that fall within one or more of the following three categories. The special requirement for each grant program is presented in the Reporting Requirements (III-D) section for that program. The suggested audit procedures are provided below to facilitate the requirements for the auditor to comment on completeness and accuracy [Section .41, "Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments" (Common Rule) and Treasury Circular 1075, "Withdrawal of Cash from the Treasury for Advances under Federal Grant and Other Programs"]:

a. Section .41, "Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments," list four required financial reports that apply to most of the programs described in this document.

(1) Financial Status Report (SF-269 or SF-269a)—Reports status of funds for all non-construction programs.

(2) Request for Advance or Reimbursement (SF-270)—Request funds for non-construction programs when advance letter of credit or predetermined advance payments are not used.

(3) Outlay Report and Request for Reimbursement for Construction Programs (SF-271)—Requests for reimbursements and reports status of funds for construction programs.

(4) Federal Cash Transaction (SF-272)—Reports cash transactions and balances for Grantees receiving cash by letter of credit or treasury checks.

	Done by	Date	W/P Ref.

b. Treasury Circular 1075 list two alternative cash management reports, one of which applies to each program financed through letters-of-credit:

(1) Request for Payment on Letter of Credit and Status of Funds Report (SF-183)

(2) Payment Voucher on Letter of Credit (TFS 5041)

c. Certain Federal agencies have received OMB approval to adapt the above reports or require other financial reports to meet their particular program needs.

Auditing Procedures

(1) Review the procedures for preparing the federal financial reports and evaluate for adequacy. ____ ____ ____

(2) Sample federal financial reports for each material program and review for completeness of submission. ____ ____ ____

(3) Trace data to the supporting documentation, i.e., worksheets, ledgers, etc. ____ ____ ____

(4) Review adjustments made to the general ledger amounts in the report affecting Federal programs and evaluate for propriety. ____ ____ ____

7. **Allowable Costs/Cost Principles**

Compliance Requirement (Direct and Indirect Costs)

The cost of a federally-supported program is comprised of the allowable direct cost of the program plus its allocable portion of allowable indirect costs less applicable credits. Federal cost principles are designed to provide that federally-assisted programs bear their fair share of recognized costs as determined by allowable cost principles. No provision for profit or other increment above cost is intended.

OMB Circular No. A-87, "Cost Principles for State and Local Governments," establishes principles and standards for determining costs applicable to grants, contracts, and other agreements with state and local governments and federally-recognized Indian Tribal Governments. A cost is allowable for federal reimbursement only to the extent of benefits received by federal programs, and costs must meet the basic guidelines of allowability, reasonableness, allocability and remain the net of all applicable credits.

[OMB Circular No. A-87 is issued under the authority of the Budget and Accounting Act of 1921, as amended; the Budget and Accounting Procedures Act of 1950, as amended; Reorganization Plan No. 2 of 1920; and Executive Order 11541.]

Auditing Procedures

For transactions selected by the auditor which involve federal funds, determine whether the costs meet the criteria set forth in the "Basic Guidelines" of Circular A-87, Attachment A, paragraph C, i.e., that the cost is:

	Done by	*Date*	*W/P Ref.*
a. Necessary and reasonable for the performance and administration of the federal program and be allocable thereto under the provisions of the Circular.	____	____	____
b. Authorized or not prohibited under state or local laws or regulations. Certain costs require specific approval by the grantor agency while some costs are not allowable as set forth in Circular A-87, Attachment A.	____	____	____
c. Conforms to any limitations or exclusions set forth in Circular A-87, or limitations in the program agreement or specific requirements in the program regulations.	____	____	____
d. Given consistent treatment with policies, regulations and procedures applied uniformly to federal and non-federal activities of the governmental unit.	____	____	____
e. Given consistent accounting treatment within and between accounting periods and not allocable to or included as a direct cost of a federal program if the same or similar costs are allocated to the federal program as an indirect cost.	____	____	____
f. Determined in accordance with generally accepted accounting principles.	____	____	____
g. Not included as a cost or used to meet cost sharing requirements of other federally-supported activity of the current or prior period.	____	____	____
h. Net of all applicable credits, e.g., volume or cash discounts, refunds, rental income, trade-ins, scrap sales, direct billings (in the case of indirect cost), etc.	____	____	____
i. Supported by underlying documentation, e.g., time and attendance payroll records, time and effort records for employees charged to more than one activity, approved purchase orders, receiving reports, vendor invoices, canceled checks, etc., as appropriate, and is correctly charged as to program, account, amount and period.	____	____	____

Compliance Requirement (Indirect Costs Only)

In order to get reimbursed for indirect costs or centralized services, recipients must prepare cost allocation plans (CAP) and/or indirect cost rate proposals (IDCRP) that provide a basis for allocating indirect costs to federal programs. Each state, state department and major local unit of government, as well as any other organization specifically requested to do so, must submit its CAP/IDCRP to its cognizant agency for approval. Other unlisted organizations must prepare the appropriate plans/proposals and maintain them on file for later review but may use their results in the mean time.

CAPs and IDCRPs are usually prepared on a prospective basis using actual financial data from a prior year or budgeted data for the current year. When the actual costs for the year are determined the difference between the originally-proposed costs and the actual costs are either carried forward to a subsequent CAP/IDCRP or adjusted with the granting federal agency on a

Done by	*Date*	*W/P Ref.*

retroactive basis. In cases where fixed rates are determined and approved by the cognizant federal agency, subsequent adjustments are not made.

There are three types of plans/proposals:

a. *State and Local-Government-wide Cost Allocation Plans*—which describe the methods to be used for billing centralized services (such as computer centers, fringe benefits, motor pools, etc.) to individual user organizations/activities (referred to as Section II costs) and which allocate the costs of unbilled central services (such as accounting, personnel, etc.) to the individual user departments or activities (Section I costs).

b. *Departmental or Local Indirect Cost Rate Proposals*—which combine the billed or allocated costs (if any) from the state- or local-wide plan with the departmental or local level indirect costs and compute an indirect cost rate(s) to be used in charging indirect costs to direct programs and activities.

c. *Public Assistance Cost Allocations Plans*—which describe the methods to be used to allocate state- or local-wide allocated or billed indirect costs and departmental indirect, administrative, and operating costs of state or local welfare or human services organizations to the Medicaids, Food Stamps, Child Welfare programs, etc. These plans are required by the terms of 45 CFR Part 95 which incorporates Circular A-87 by reference and are required to be revised and submitted to the federal government whenever an organizational or programmatic change invalidates the currently approved approach.

Audit procedures must be tailored according to the size and type of organization being reviewed.

Auditing Procedures (General)

Determine whether indirect costs or centralized or administrative services are being charged to federal awards. If not, the rest of this section does not apply. If such costs are being charged, the following guidelines should be followed:

a. Obtain and read the current CAP and or Negotiation Agreement and determine the types of rates and procedures required. ____ ____ ____

b. Select a sample of claims for reimbursement submitted to the federal agency and determine if the amounts charged and rates used are in accordance with the plan and if rates are being properly applied to the appropriate base. ____ ____ ____

c. Determine whether the CAPs or IDCRPs have been approved by the appropriate federal agency and whether or not the resultant rates or amounts charged are final or are still open to adjustment or revision, either immediately or as a carryover adjustment in a future period. If approved and final, the results of the audit work shall be reflected, if appropriate, in recommendations for future procedural improvements. ____ ____ ____

	Done by	Date	W/P Ref.
d. Review on a test basis supporting documentation to determine whether:			
(1) The indirect cost pool or centralized service costs contain only items that are consistent with the applicable cost principles and negotiated agreements.	____	____	____
(2) The methods of allocating the costs are in accordance with the provisions of Circular A-87, other applicable regulations and negotiated agreements.	____	____	____
(3) Statistical data (e.g., square footage, population, operating time, miles driven, case counts, salaries and wages) in the proposed allocation or rate bases are reasonable, updated as necessary and do not contain any material omissions.	____	____	____
(4) Time studies or time and effort reports (where and if utilized) are mathematically and statistically accurate, are implemented as approved, and are based on the actual effort devoted to the various functional and programmatic activities to which the salary and wage costs are charged.	____	____	____
(5) The indirect costs charged to federal programs are supported by amounts recorded in the accounting records from which the most recently-issued financial statements were prepared.	____	____	____
(6) Other adjustments are made to compensate for differences between actual and estimated costs of fiscal years.	____	____	____
Auditing Procedures—State-Wide and Local-Wide Plans			
a. For Section II (direct billed) services, determine whether:			
(1) The rate base includes all users and treats them in a consistent manner.	____	____	____
(2) Any retained earning or unexpended earnings (including reserves) are present and, if so, determine: (*a*) if they have been computed in accordance with the applicable cost principles, (*b*) if they are excessive in amount, and (*c*) whether a refund has been made to the federal government for its fair share of any amounts thereof which have been removed (transferred out) or borrowed from the fund.	____	____	____
(3) Fringe benefit allocations, charges or rates deal fairly with differing levels, if any, of benefits provided to different classes of employees.	____	____	____
(4) Independent actuarial studies appropriate for self-insurance programs and certain types of fringe benefit programs are performed and, if so, are kept current.	____	____	____
b. Costs chargeable directly to federal grants or any other direct activity (including any costs required for matching or cost sharing) have been excluded from the pool of indirect costs and have been included in the base.	____	____	____

	Done by	*Date*	*W/P Ref.*

c. The users of services are billed in a consistent manner and billing rates (or charges) have been adjusted to eliminate profits and unallowable costs. ____ ____ ____

8. **Drug-Free Workplace Act**

Compliance Requirement

All grantees receiving grants, including cooperative agreements, from any federal agency must certify that they will provide a drug-free workplace, or, in the case of a grantee who is an individual, certify to the agency that his or her conduct of grant activity will be drug-free. Making the required certification has been a precondition of receiving a grant from a federal agency since March 18, 1989. Every grantee, except a state or state agency, is required to make this certification for each grant. A state or state agency may elect to make a single annual certification to each federal agency from which it obtains grants if the federal agency has designated a central location for submission.

The grantee certifies that it will provide a drug-free workplace by:

a. Publishing a policy statement notifying employees that the unlawful manufacture, distribution, dispensing, possession or use of a controlled substance is prohibited in the grantee's workplace and specifying the actions that will be taken against employees for violation of such prohibition;

b. Establishing an ongoing drug-free awareness program to inform employees about:

(1) The dangers of drug abuse in the workplace;

(2) The grantee's policy of maintaining a drug-free workplace;

(3) Any available drug counseling, rehabilitation, and employee assistance programs; and,

(4) The penalties that may be imposed upon employees for drug abuse violations occurring in the workplace;

c. Making it a requirement that each employee to be engaged in the performance of the grant be given a copy of the statement required by paragraph *a*;

d. Notifying the employee in the statement required by paragraph *a* that, as a condition of employment under the grant, the employee will:

(1) Abide by the terms of the statement; and

(2) Notify the employer in writing of any criminal drug statute conviction for a violation occurring in the workplace no later than five calendar days after such conviction;

	Done by	Date	W/P Ref.

e. Notifying the agency in writing within ten calendar days after receiving notice under subparagraph *d*(2) from an employee or otherwise receiving actual notice of such conviction;

f. Taking one of the following actions, within 30 calendar days of receiving notice under subparagraph *d*(2), with respect to any employee who is so convicted:

(1) Taking appropriate personnel action against such an employee, up to and including termination; or

(2) Requiring such employee to participate satisfactorily in a drug abuse assistance or rehabilitation program approved for such purposes by a federal, state, or local health, law enforcement, or other appropriate agency.

[Public Law 100-690 Title V, Subtitle D, 41 USC 701 et seq.]

Auditing Procedures

	Done by	Date	W/P Ref.
a. Determine through discussions with employees and written communications to employees whether the grantee has taken action to provide a copy of the policy statement to each employee engaged in the performance of a grant.	____	____	____
b. Ascertain whether the statement contains all the necessary notifications.	____	____	____
c. Determine whether the grantee had established an ongoing drug-free awareness program which meets the requirements outlined above.	____	____	____
d. Determine whether the report made to federal grantor agencies on convictions of employees is filed and complete.	____	____	____
e. Test a sample of employee files and determine whether the report made to federal grantor agencies on convictions of employees is complete and if convictions were reported within 10 calendar days after the employer received any notice of an employee's conviction.	____	____	____
f. Ascertain whether the grantee took the required personnel or treatment referral action within 30 calendar days after receiving notice of an employee conviction.	____	____	____

9. Administrative Requirements

Federal assistance programs, with certain exceptions, are subject to the provisions of "Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments" (Common Rule). The Common Rule does not apply to grants and subgrants to state and local institutions of higher education or state and local hospitals; block grants authorized by the Omnibus Budget Reconciliation Act of 1981;

	Done by	*Date*	*W/P Ref.*

entitlement grants and other grants or payment programs specified in the Common Rule. These exceptions are specified in the Common Rule under the Applicability provisions of Subpart A.

Three Common Rule administrative requirements, financial reporting, cost principles and cash management principles, are covered elsewhere in this section. The auditor should also consider those common agency administrative requirements listed below from Subpart C of the Common Rule. Agency regulations for those grant program requirements not covered by the Common Rule are addressed in departmental regulations.

a. Interest earned on advances

b. Period of availability of funds

c. Program income

d. Real property

e. Equipment

f. Supplies

g. Subawards to debarred and suspended parties

h. Procurement

i. Subgrants

j. Revolving fund repayments

Auditing Procedures

	Done by	Date	W/P Ref.
a. Determine the applicable administrative requirements that are material to the federal awards.	____	____	____
b. Review and evaluate internal controls in the administrative areas selected for review.	____	____	____
c. Test transactions for compliance.	____	____	____

This audit program has been completed in accordance with firm policy.

	Date
Done by	____
Reviewed by	____

.170 XVII. Appendix A—Auditing and Reporting Concerns

During an audit engagement, the auditor should be aware that often there are signals that may indicate a potential audit or reporting problem. Some signals or indicators may suggest the need to modify audit procedures.

Listed below are examples of indicators the auditor may encounter in an audit of a governmental unit. It should be noted that the existence of a particular indicator does not necessarily mean there is a problem requiring extended audit procedures. The list, however, should be considered by the auditor in performing analytical procedures and in designing his/her audit procedures.

Items Highlighted Through Review of Financial Ratios or Statistics

- Revenue-based indicators:
  - Decreasing value of taxable property.
  - Increasing ratios of delinquent taxes to total tax levy.
  - Increasing ratios of maximum legal tax rates.
  - Increasing ratios of actual revenue below budgets.
  - Litigation relative to equalization of assessment actions.
- Expenditure-based indicators:
  - Increasing excesses of expenditures over revenues.
  - Increasing incidence of actual expenditures in excess of budgets.
  - Continuing increases in amount of unfunded vested benefits of pension programs.
- Cash management indicators:
  - Increasing amounts of aggregate short-term investments.
  - Increasing amounts of unpaid current obligations.
  - Decreasing income from short-term investments (that are not a result of falling interest rates).
- Debt Indicators:
  - Increasing ratio of bond indebtedness to total property value.
  - Increasing need to borrow to meet debt service requirements.
  - Increasing use of long-term debt to fund current expenditures.
  - Increasing amount of short-term borrowing remaining unpaid at the end of the fiscal year.

Nonfinancial Indicators

- Client Personnel:
  - Rapid turnover.
  - Management changes.
  - Weak financial personnel.
  - Unfilled positions due to budget limitations.

- — Internal auditors performing "special tasks" rather than auditing.
- Client relationships with auditors:
  - — Accounting and reporting disputes.
- Weaknesses in accounting information system.
  - — Lack of controls.
  - — Poor cutoffs.
  - — Reports not issued on a timely basis.
  - — Inability to reconcile detailed records to general ledger balances.
  - — Large number of exceptions in transactions or confirmations.
  - — Client's inability to prepare meaningful analyses of activity.
  - — Lack of timely or no budget status reports.
- External Considerations (e.g., economy, industry):
  - — Large industrial plant closing or moving from community.
  - — Environmental legislation or pressures.

.180 XVIII. Appendix B—Federal Transaction Test Criteria

The following criteria are those that often are applied during the audit of federal transactions. Those criteria are presented as examples only. Judgment must be used to determine the test criteria to be applied to a particular federal program or transaction.

1. Was the expenditure contemplated in the approved budget?
2. Were only costs applicable to the Federal Financial Assistance Program charged?
3. Was the expenditure made in accordance with specific program compliance requirements and other limitations or exclusions in the federal assistance agreement?
4. Was the classification of direct or indirect charges in accordance with cost allocation plan(s) or grant agreements?
5. Was prior approval obtained from the federal granting agency, if appropriate?
6. Was there adequate documentation supporting the expenditure, including all authorization signatures, evidence of preaudits, etc.?
7. Does the expenditure appear to be necessary and reasonable and "benefit" or assist in the accomplishment of the goals of the federally assisted program?
8. Was the expenditure properly coded and recorded?
9. Were capital expenditures properly recorded in the property records and identified as required by federal administrative guidelines, specific program compliance requirements, and federal assistance agreements?
10. Do assets acquired with the sample federal expenditure exist and are they being used for the purpose for which they were acquired?
11. Was the expenditure given consistent accounting treatment and applied uniformly and equitably to all benefiting activities/programs, both federally assisted and otherwise?
12. Was the expenditure net of any applicable credits?
13. Was the expenditure incurred during the authorized grant period or authorized extension thereto?
14. Were the charges incurred in accordance with competitive purchasing procedures, if applicable?
15. If an expenditure was a violation of any federal regulations or grant agreement terms and the auditee has asserted that such violations were approved by the federal grantor agency, was such approval documented in writing by the federal agency?

.190 XIX. Appendix C—Criteria for Determining Questioned Costs

Criteria established to determine and report questioned costs vary from one federal agency to another. Many of the criteria are imposed by Congress at the time programs are authorized and funds are provided; however, other criteria are established through federal agency regulations. Generally, the criteria for determining and reporting questioned costs are as follows:

- *Unallowable costs.* Certain costs are specifically unallowable under the general and special award conditions or agency instructions. (They include, but are not limited to, pregrant and postgrant costs and costs in excess of the approved grant budget either by category or in total.)
- *Undocumented costs.* Costs are charged to the grant for which adequate detailed documentation does not exist, for example, to demonstrate their relationship to the grant or the amounts involved.
- *Unapproved costs.* Costs that are not provided for in the approved grant budget, or costs for which the grant or contract provisions or applicable cost principles require the awarding agency's approval, but for which the auditor finds no evidence of approval.
- *Unreasonable costs.* Costs incurred that may not reflect the actions that a prudent person would take in the circumstances, or assigning an unreasonably high valuation to in-kind contributions.

[*The next page is 12,371.*]

AAM Section 12,210

Suggested Supplemental Reference Materials for Use With Illustrative Audit Program for State and Local Governmental Units

.01 **Suggested Supplemental Reference Materials**

American Institute of Certified Public Accountants (AICPA)

Codification of Statements on Auditing Standards

Audit and Accounting Guide—*Audits of State and Local Governmental Units*—1996

Audit and Accounting Guide—*Audit Sampling*

Audit Guide—*Consideration of Internal Control in a Financial Statement Audit*—1996

Audit and Accounting Guide—*Audits of Employee Benefit Plans*—1996

Audit Risk Alert—*State and Local Governmental Developments*—1996

Ethics Interpretation 101-10—"The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements" (reissued in 1996)

Ethics Interpretation 501-3—"Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits"

Statement of Auditing Standards No. 74—*Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*

Statements on Quality Control Standards—*System of Quality Control for a CPA Firm*

Checklists and Illustrative Financial Statements for State and Local Governmental Units

Governmental Accounting Standards Board

Codification of Governmental Accounting and Financial Reporting Standards, June 30, 1995

GASB Implementation Guides

Office of Management and Budget

Circular A-21: *Cost Principles for Educational Institutions* (May 1996 revision)

Circular A-50 Revised: *Audit Follow-up* (September 1982 revision)

Circular A-87 Revised: *Cost Principles for State and Local Governments* (Formerly FMC 74-4) (May 1995 revision)

Circular A-102: *Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments* (October 1994 revision)

Circular A-110: *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Nonprofit Organizations* (November 1993)

Circular A-128: *Audits of State and Local Governments*

Questions and Answers on the Single Audit Provisions of OMB Circular A-128 "Audits of State and Local Governments"—November 1987

Catalog of Federal Domestic Assistance

Compliance Supplement for Single Audits of State and Local Governments—*Uniform Requirements for Grants to State and Local Governments* (Revised September 1990)

General Accounting Office

Government Auditing Standards (1994 Revision)

Interpretation of Continuing Education Training Requirements (April 1991)

U.S. Department of Education

Audits of Student Financial Assistance Programs (March 1990)

President's Council on Integrity and Efficiency (Single Audit Committee)

Federal Cognizant Agency Audit Organization Guidelines (including PCIE Position Statements)

Study on Improving the Single Audit Process (September 1993)

Other

Public Law 98-502, Single Audit Act of 1984

Intergovernmental Cooperation Act

Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments—"Common Rule"—Published March 11, 1988, Federal Register with Individual Federal Agency Actions

Applicable Federal Rules and Regulations

Applicable State Laws and Administrative Rules and Regulations

Local Government Charter

Local Laws, Rules, and Regulations

[*The next page is 12,391.*]

AAM Section 12,300

Partner's Engagement Review Program Supplement for Local Governmental Units

To be completed in conjunction with Partner's Engagement Review Program [AAM section 9210]

	Yes	No	N/A
I. General Audit Procedures			
A. .010 General			
1. In planning the audit engagement, were the following matters properly considered?			
a. Matters affecting the government, such as specialized accounting practices, economic conditions, federal and state laws and regulations, and technological changes. (SAS No. 22 [AU section 311])	____	____	____
b. Definition of the reporting entity indicating the related organizations, functions, and activities which are either included or excluded from the financial statements in accordance with GASB Cod. Sec. 2100.	____	____	____
c. Factors affecting the continued functioning of the government, such as legal limitations on revenue, expenditures, or debt service.	____	____	____
2. If statistical or nonstatistical sampling was used for tests of applicable laws and regulations, if appropriate (SAS No. 39, paragraphs 15 through 30 [AU section 350.15–.30]):			
a. Was consideration given, in planning the sampling application, to the relationship of the sample to the audit objective, preliminary judgments about materiality levels, auditor's allowable level of risk of incorrect acceptance, and characteristics of the population?	____	____	____
b. Was the sample selected in such a way that it could be expected to be representative of the population?	____	____	____
c. Were the misstatement results of the sample projected to the items from which the sample was selected?	____	____	____
d. Was consideration given, in evaluating the sample, to items for which the planned substantive tests or appropriate alternate procedures could not be performed?	____	____	____
e. Was consideration given, in the aggregate, to projected misstatement results from all audit sampling applications and to all known misstatements from nonsampling applications in evaluating material misstatements in the financial statements?	____	____	____

	Yes	No	N/A
f. Was the documentation of the foregoing considerations in accordance with firm policy?	____	____	____
3. If applicable, were adequate tests of controls with applicable laws and regulations made?	____	____	____
4. Were all reportable conditions in the internal control structure, all identified instances of noncompliance with applicable laws and regulations, and all illegal acts:			
a. Adequately evaluated and documented?	____	____	____
b. Appropriately reported in accordance with applicable standards? (SAS No. 60 [AU section 325]; GAO's *Government Auditing Standards*, paragraphs 5-26 through 5-28; OMB Circular A-128, paragraph 13)	____	____	____

II. Working Paper Areas

A. .020 Cash

	Yes	No	N/A
1. Do the working papers indicate that the following were considered:			
a. Confirmation of liabilities and contingent liabilities to banks?	____	____	____
b. Approval of interfund cash transactions?	____	____	____
c. Verification of collateral required of depository institutions for public funds?	____	____	____
d. Compliance with the laws and regulations governing the deposit of public funds?	____	____	____
e. Determination that all cash accounts have been identified and appropriately recorded?	____	____	____
f. Review of repurchase security transactions for consistency with the disclosures of the terms or circumstances of the transactions?	____	____	____

B. .030 Receivables

	Yes	No	N/A
1. Was a summary classifying receivables prepared or obtained (i.e., notes and accounts receivable, tax revenues, interfund transactions, and other related party receivables, etc.)?	____	____	____
2. Were procedures performed to provide evidence that taxes receivable and the related revenues have been recorded in the correct period in accordance with GASB Cod. Sec. P70?	____	____	____
3. Was the reasonableness of allowances for doubtful accounts covered in the working papers and collectibility for receivables, including interfund receivables, adequately considered?	____	____	____
4. Was receivable work coordinated with tests of revenues, including cutoff tests?	____	____	____

	Yes	No	N/A
C. .040 Investments			
1. Was a review made to determine whether the investments are of the types authorized by law or comply with the applicable statutes and investment policy?			
2. Were income, gains and losses from investments examined for proper allocation to the individual funds?			
3. For repurchase and reverse repurchase agreements, were appropriate audit procedures performed (e.g., confirmation, inspection of collateral, etc.)?			
D. .050 Property, Plant, and Equipment			
1. Was a review made to determine that capital expenditures are classified in the proper fund accounts and made in accordance with budgetary requirements?			
E. .060 Liabilities			
1. Were liabilities properly classified as current or included in the general long-term debt account group?			
2. Was consideration given to expenditures and expenses that might require accrual (e.g., pensions, compensated absences—see GASB Cod. Sec. 1600), and to whether accrued expenses were reasonably stated?			
3. Were procedures performed to determine whether deferred compensation plans are appropriately disclosed or reported? (GASB Statement No. 2)			
4. Do the working papers include evidence regarding compliance with loan restrictions?			
5. Was an examination made to determine that:			
a. New debt issues are properly issued as required by the state constitution or state/local statute and are recorded in the correct fund and/or account group?			
b. Debt restrictions, guarantees, and other debt commitments are properly disclosed?			
6. Do the tests of interfund borrowings appear adequate with respect to:			
a. Legal restrictions, if any, on such borrowings?			
b. Authorization?			
c. Classification?			
d. Appropriateness of interest accruals and payments?			
F. .070 Deferred Revenue			
1. Do the working papers reflect consideration of whether the basis of deferring revenue is reasonable and consistent with restrictions imposed by the grantor or by the special assessment?			

	Yes	No	N/A
2. Was consideration given to matching requirements, if any?	____	____	____
G. .080 Commitments and Contingencies			
1. Do the working papers include indication of the following?			
a. Inspection of minutes of meetings of the governmental body and key committees thereof, provisions of the governmental unit's charter, and applicable statutes and changes therein.	____	____	____
b. Inspection of long-term contracts with non-governmental entities, such as construction contractors.	____	____	____
2. Have all material contingencies been properly considered, documented, and reported (SFAS No. 5 [AC C59]; GASB Cod. Sec. C50)?	____	____	____
H. .090 Fund Equity			
1. Were authorizations of changes in reserves and designated balances examined?	____	____	____
2. Do the working papers indicate that there were inquiries, where appropriate, as to proper classification, description, and disclosures of components of fund equity?	____	____	____
3. Do the working papers indicate that fund transfers were properly approved and recorded?	____	____	____
4. Based on the assessed level of control risk, do the substantive tests of fund equity appear adequate?	____	____	____
I. .100 Revenues and Expenditures/Expenses			
1. Were revenues and expenditures and/or expenses for the period compared with those of the preceding period and reviewed for reasonableness and were significant fluctuations explained?	____	____	____
2. Was adequate consideration given to the entity's revenue recognition policy?	____	____	____
3. Do the working papers indicate that revenues and interfund transactions have been recognized in the accounting period in which they became available and measurable under the applicable basis of accounting?	____	____	____
4. Do the working papers indicate that the auditor considered the effect of program income on federal grants and any related activities?	____	____	____
5. Has it been determined that:			
a. Expenditures are in accordance with the approved budget as to amounts and purpose?	____	____	____
b. Encumbrances are properly identified, supported, and recorded?	____	____	____
6. Were tests of payrolls performed, including account distribution?	____	____	____

	Yes	No	N/A
7. With regard to pension plans, do tests of expenditures and liabilities appear adequate?	___	___	___
8. If the entity is reimbursed by a third party for costs incurred in connection with providing services to others:			
a. Were pertinent sections of significant third party contracts reviewed to determine the basis for reimbursement?	___	___	___
b. Were cost reimbursement reports and the underlying support reviewed?	___	___	___
c. Were appropriate allocations made of indirect costs among the entity's programs?	___	___	___
d. Was the effect of audits, either required or performed by third party grantors, considered?	___	___	___
9. If grants are awarded to other organizations, did the auditor review:			
a. The classification of the grants?	___	___	___
b. The effects of the grantees' compliance or noncompliance with performance requirements?	___	___	___
10. Based upon the assessed level of control risk, did the substantive tests (review, analysis, and testing) of revenues and expenditures/expense appear adequate?	___	___	___

J. .110 Other

1. Have leases been examined to determine that capital, sales, and direct financing leases have been properly accounted for? (GASB Cod. Sec. L20)	___	___	___

III. Compliance With the Requirements of the Single Audit Act of 1984

A. .120 The Single Audit Act

1. If required or deemed necessary, is there any indication that the firm discussed and agreed on the scope of the engagement with the auditee?	___	___	___
2. Did the firm, by reviewing contract files and receipts and disbursements, obtain reasonable assurance that the auditee appropriately identified all federal financial assistance and included that assistance within the audit scope?	___	___	___
3. If required, does the schedule of federal financial assistance program expenditures present the following?			
a. Identification of each program as indicated in the *Catalog of Federal Domestic Assistance* (CFDA).	___	___	___
b. Other federal assistance from programs not included in the CFDA.	___	___	___
c. Total expenditures for each federal financial assistance program by grantor, department, or agency.	___	___	___

	Yes	No	N/A
d. Total federal financial assistance.	____	____	____
e. Other information, required by federal program managers or otherwise deemed appropriate.	____	____	____
4. Was consideration given to the accounting and auditing guidance issued by the Office of Management and Budget, including Circulars A-128 (*Audits of State and Local Governments*), A-87 (*Cost Principles Applicable to Grants and Contracts*), and A-102 (*Uniform Requirements for Assistance to State and Local Governments*)?	____	____	____
5. Did the firm obtain an understanding of the internal control structure policies and procedures, as it relates to:			
a. Administering major federal financial assistance programs, comparable to that which the auditor would perform if control risk was assessed at below the maximum level? (SAS No. 55 [AU section 319])	____	____	____
b. Administering non-major programs to the same extent as in question 5*a.* above so that over 50 percent of total federal assistance program expenditures are considered?	____	____	____
c. Other non-major federal financial assistance programs? (SOP 90-9)	____	____	____
6. For those programs where the control risk is assessed at the maximum level, is the firm's understanding of the internal control structure, as well as the conclusion of the control risk, documented? (SAS No. 55 [AU section 319])	____	____	____
7. For categories of controls for which the control risk is below the maximum level:			
a. Do the working papers document the firm's understanding of the internal control structure?	____	____	____
b. Were tests of controls performed for the internal control structure?	____	____	____
c. Was the nature and extent of testing sufficient to enable the firm to determine if the control procedures were being applied as described?	____	____	____
d. Did the auditor examine the recipient's control structure for ensuring subrecipients' compliance and obtaining and acting on subrecipients' audit reports?	____	____	____
e. Do the working papers adequately document the work performed and the conclusions reached? (GAO, paragraphs 4-34 through 4-38; SAS No. 41, paragraph 5 [AU section 339.05])	____	____	____
8. Were all reportable conditions in the internal control structure disclosed in the auditor's reports?	____	____	____
9. In determining whether the entity has complied with applicable laws and regulations that may have a material effect on each major federal financial assistance program, did the auditor:			
a. Consult appropriate sources, such as the Compliance Supplement for Single Audits of State and Local Governments, statutes, regu-			

	Yes	No	N/A
lations, and agreements covering individual programs, in order to identify the compliance requirements that apply to each major program and to determine which requirements to test?	____	____	____
b. Select a representative number of charges from each major program?	____	____	____
c. Perform tests to determine whether:			
(1) The amounts reported as expenditures were allowable under federal regulations and contracts?	____	____	____
(2) Only eligible persons or organizations received services or benefits?	____	____	____
(3) Matching requirements were met?	____	____	____
(4) Federal financial reports and claims for advances and reimbursements were supported by the records supporting the financial statements?	____	____	____
(5) The entity complied with each of the general requirements contained in the compliance supplement concerning:			
(a) Political activity?	____	____	____
(b) Civil rights?	____	____	____
(c) Davis-Bacon Act?	____	____	____
(d) Cash management?	____	____	____
(e) Relocation of assistance and real property acquisition?	____	____	____
(f) Federal financial reports?	____	____	____
(g) Allowable costs/cost principles?	____	____	____
(h) Drug-free workplace?	____	____	____
(i) Administrative requirements?	____	____	____
d. Consider projected misstatement results from all audit sampling applications and all known misstatements from non-sampling applications?	____	____	____
e. Consider whether tests of compliance with the program's requirements appear adequate to support the report(s) on compliance?	____	____	____
10. Where transactions related to non-major federal financial assistance programs have been selected during other audit procedures, have they been appropriately tested for compliance with applicable laws and regulations in connection with the audit of financial statements and evaluations of internal control structure?	____	____	____
11. If warranted, did the firm communicate with the cognizant agency to avoid or minimize any disagreements or problems?	____	____	____
12. Did the firm submit the report(s) to the organization audited and to those requiring or arranging for the audit within the required time?	____	____	____

	Yes	No	N/A
13. Has the firm established policies or procedures for complying with the additional requirements concerning:			
a. Retaining working papers and reports for a minimum of three years from the date of the audit report, unless the auditor is notified in writing by the cognizant agency to extend the retention period?	____	____	____
b. Making the working papers available upon request to the cognizant agency or its designee of the GAO at the completion of the audit?	____	____	____

The audit engagement has been completed in accordance with professional standards and firm policy.

Partner ______________________________ Date ______________

[*The next page is 12,401.*]

AAM Section 12,400

Auditors' Reports on Basic or General-Purpose Financial Statements for State and Local Governmental Units

.01 Unqualified Opinion on General-Purpose Financial Statements[1]

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.[2] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.[3]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.1, with conforming changes as of May 1, 1995.]

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[1] The financial statements of a component unit should acknowledge that the component unit is a component unit of another government; for example, "We have audited the accompanying general-purpose financial statements of Sample County School District, component unit of Sample County, as of and for the year ended June 30, 19X1." In addition, the notes to the component unit's financial statements should identify the primary government of the financial reporting entity and the component unit's relationship to the primary government. For reporting on the financial statements of a primary government that omit the financial data of each component unit, see AAM section 12,400.04, "Report on Primary Government Financial Statements That Omit the Financial Data of Each Component Unit."

[2] When the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for an audit in accordance with *Government Auditing Standards,* insert the phrase "and *Government Auditing Standards* issued by the Comptroller General of the United States."

[3] When the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for an audit in accordance with *Government Auditing Standards,* a paragraph similar to the following should be added after the opinion paragraph:

> In accordance with *Government Auditing Standards,* we have also issued a report dated [*date of report*] on our consideration of City of Example's internal control structure and a report dated [*date of report*] on its compliance with laws and regulations.

.02 Unqualified Opinion on General-Purpose Financial Statements Submitted Together With Combining, Individual Fund, and Account Group Financial Statements and Supporting Schedules as Supplementary Data

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose[1] financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.[2] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of June 30, 19X1, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.[3]

Our audit was made for the purpose of forming an opinion on the general-purpose financial statements taken as a whole. The combining and individual fund and account group financial statements and schedules listed in the table of contents are presented for purposes of additional analysis and are not a required part of the general-purpose financial statements of City of Example, Any State. Such information has been subjected to the auditing procedures applied in the audit of the general-purpose financial statements and, in our opinion, is fairly presented in all material respects in relation to the general-purpose financial statements taken as a whole.[4]

[*Signature*]

[*Date*]

Note: As of the date of this publication, the AICPA Federal Government Division was in the process of revising this auditor's report to conform it to the requirements of the 1994 revision of *Government Auditing Standards* (the Yellow Book). Auditors should ascertain the status of those revisions before issuing this report.

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.2.]

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[1] See AAM section 12,400.01, footnote 1.

[2] See AAM section 12,400.01, footnote 2.

[3] See AAM section 12,400.01, footnote 3.

[4] When reporting on supplementary data, the auditor should consider the effect of any modifications in the report on the general-purpose financial statements on the supplementary data. Guidance on reporting in such circumstances is provided in SAS No. 29 and SAS No. 52 (AU section 551) and SAS No. 42 (AU section 552). See also AAM section 10,245.

.03 Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements, Presented Together With Supporting Schedules Reported on as Supplementary Data

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose[1] financial statements and the combining and individual fund and account group financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.[2] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles. Also, in our opinion, the combining and individual fund and account group financial statements referred to above present fairly, in all material respects, the financial position of each of the individual funds and account groups of City of Example, Any State, as of June 30, 19X1, and the results of operations of such funds and the cash flows of individual proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.[3]

Our audit was made for the purpose of forming an opinion on the general-purpose financial statements taken as a whole and on the combining and individual fund and account group financial statements. The accompanying financial information listed as supporting schedules in the table of contents is presented for purposes of additional analysis and is not a required part of the financial statements of City of Example, Any State. Such information has been subjected to the auditing procedures applied in the audit of the general-purpose, combining and individual fund and account group financial statements and, in our opinion, is fairly presented in all material respects in relation to the financial statements of each of the respective individual funds and account groups taken as a whole.[4]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.3.]

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[1] See AAM section 12,400.01, footnote 1.

[2] See AAM section 12,400.01, footnote 2.

[3] See AAM section 12,400.01, footnote 3.

[4] See AAM section 12,400.02, footnote 4.

.04 Report on Primary Government Financial Statements That Omit the Financial Data of Each Component Unit

Independent Auditor's Report

Addressee:

We have audited the accompanying primary government financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.[1] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

A primary government is a legal entity or body politic and includes all funds, organizations, institutions, agencies, departments, and offices that are not legally separate. Such legally separate entities are referred to as component units. In our opinion, the primary government financial statements present fairly, in all material respects, the financial position of the primary government of City of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

However, the primary government financial statements, because they do not include the financial data of component units of City of Example, Any State, do not purport to, and do not, present fairly the financial position of the City of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.[2]

[*Signature*]

[*Date*]

Note: As of the date of this publication, the AICPA Federal Government Division was in the process of revising this auditor's report to conform it to the requirements of the 1994 revision of *Government Auditing Standards* (the Yellow Book). Auditors should ascertain the status of those revisions before issuing this report.

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.4.]

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[1] See AAM section 12,400.01, footnote 2.

[2] See AAM section 12,400.01, footnote 3.

.05 Qualified Opinion on General-Purpose Financial Statements That Omit One or More, But Not All, Component Units of the Financial Reporting Entity

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose[1] financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.[2] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general-purpose financial statements referred to above do not include financial data of the [*identify the component unit(s) omitted*], which should be included in order to conform with generally accepted accounting principles. If the omitted component unit(s) had been included,[3] the assets and revenues of the [*identify fund type(s), e.g., special revenue fund type—or component unit columns*] would have been increased by $XXX,XXX and $XXX,XXX, respectively, there would have been an excess of expenditures over revenues in that fund type [*or component unit(s)*] of $XXX,XXX for the year, and the [*identify fund type(s) or discretely presented component unit column*] fund balance would have been a deficit of $XXX,XXX.

In our opinion, except for the effects on the financial statements of the omission described in the preceding paragraph, the general-purpose financial statement referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.[4]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.5.]

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[1] See AAM section 12,400.01, footnote 1.

[2] See AAM section 12,400.01, footnote 2.

[3] If the amounts applicable to the omitted component unit have not been audited, insert the phrase "based on unaudited information."

[4] See AAM section 12,400.01, footnote 3.

.06 Adverse Opinion on General-Purpose Financial Statements That Omit One or More, But Not All, Component Units of the Reporting Entity

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose financial statements[1] of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.[2] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general-purpose financial statements referred to above do not include financial data of the [*identify the component unit(s) omitted*], which should be included in order to conform with generally accepted accounting principles.

Because of the departure from generally accepted accounting principles identified above, as of June 30, 19X1, the assets and revenues of the [*identify fund type(s), e.g., special revenue fund type—or component unit column(s)*] would have increased by $XXX,XXX and $XXX,XXX, respectively, there would have been an excess of expenditures over revenues in that fund type [*or component unit(s)*] for the year of $XXX,XXX, and the [*identify fund type(s) or component unit(s)*] fund balance would have been a deficit of $XXX,XXX.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the general-purpose financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of City of Example, Any State as of June 30, 19X1, or the results of its operations or cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.5, footnote 14.]

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[1] See AAM section 12,400.01, footnote 1.

[2] See AAM section 12,400.01, footnote 2.

.07 Qualified Opinion on General-Purpose Financial Statements That Omit a Fund Type or Account Group[1]

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose[2] financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.[3] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general-purpose financial statements referred to above do not include the [*identify the fund type (account group) omitted*], which should be included in order to conform with generally accepted accounting principles. The omitted fund type[4] has assets, liabilities, revenues, and expenditures of $XXX,XXX, $XXX,XXX, $XXX,XXX, and $XXX,XXX, respectively. [*The amount that should be recorded in the (identify account group) is not known.*]

In our opinion, except for the effect on the financial statements of the omission described in the preceding paragraph, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.6.]

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[1] There may be circumstances when, based on professional judgment, the auditor may determine that an adverse opinion on the general-purpose financial statements is appropriate. In such a case, a separate explanatory paragraph should state all the substantive reasons for the adverse opinion and the principal effects of those matters. If an adverse opinion is to be rendered, the last two paragraphs of this report should be replaced with the following paragraphs:

> The general-purpose financial statements referred to above do not include financial data of the [*identify the component unit(s) omitted*], which should be included in order to conform with generally accepted accounting principles.
>
> Because of the departure from generally accepted accounting principles identified above, as of June 30, 19X1, the assets and revenues of the [*identify fund type(s), for example, special revenue fund type—or component unit column(s)*] would have increased by $XXX,XXX and $XXX,XXX, respectively, there would have been an excess of expenditures over revenues in the fund type [*or component unit(s)*] for the year of $XXX,XXX and the [*identify fund type(s) or component unit(s)*] fund balance would have been a deficit of $XXX,XXX.
>
> In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the general-purpose financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of City of Example, Any State, as of June 30, 19X1, or the result of its operations or the cash flows of its proprietary fund types and nonexpendable trust funds of the year then ended.

[2] See AAM section 12,400.01, footnote 1.

[3] See AAM section 12,400.01, footnote 2.

[4] If the amounts applicable to the omitted fund type have not been audited, insert the phrase "based on unaudited information."

.08 Qualified Opinion on General-Purpose Financial Statements That Omit a Fund From a Fund Type[1]

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose[2] financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.[3] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general-purpose financial statements referred to above do not include the [*identify the omitted fund*], which should be included in order to conform with generally accepted accounting principles. If the omitted fund[4] had been included, the [*identify fund type*] assets, liabilities, revenues, and expenditures would have increased $XXX,XXX, $XXX,XXX, $XXX,XXX, and $XXX,XXX, respectively.

In our opinion, except for the effect on the general-purpose financial statements of the omission described in the preceding paragraph, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.[5]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.7.]

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[1] See AAM section 12,400.07, footnote 1.

[2] See AAM section 12,400.01, footnote 1.

[3] See AAM section 12,400.01, footnote 2.

[4] If the amounts applicable to the omitted fund have not been audited, insert the phrase "based on unaudited information."

[5] See AAM section 12,400.01, footnote 3.

.09 Unqualified Opinion on General Fund Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the general fund of City of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.[1] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X, the financial statements present only the general fund and are not intended to present fairly the financial position and results of operations of City of Example, Any State, in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the general fund of City of Example, Any State, as of June 30, 19X1, and the results of its operations for the year then ended in conformity with generally accepted accounting principles.[2]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.8.]

[1] See AAM section 12,400.01, footnote 2.

[2] See AAM section 12,400.01, footnote 3.

.10 Unqualified Opinion on an Enterprise Fund's Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of [*identify enterprise fund*] of City of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.[1] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X, the financial statements present only the [*identify enterprise fund*] and are not intended to present fairly the financial position of City of Example, Any State, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [*identify enterprise fund*] of City of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows for the year then ended in conformity with generally accepted accounting principles.[2]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.9.]

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[1] See AAM section 12,400.01, footnote 2.

[2] See AAM section 12,400.01, footnote 3.

.11 Unqualified Opinion on General-Purpose Financial Statements With an Explanatory Paragraph Calling Attention to a Financial Reporting Entity's Ability to Meet its Debts as They Come Due[1]

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose[2] financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.[3] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note X, [*include description of reason that a question has arisen about the ability of the governmental unit to meet its debts as they come due*]. The general-purpose financial statements do not include any adjustment relating to the amounts and classification of liabilities that might be necessary if City of Example, Any State, is not able to meet its debts as they come due or if such debts are adjusted under the provisions of chapter 9 of the Federal Bankruptcy Code.[4]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.10.]

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[1] See criteria in SAS No. 58, *Reports on Audited Financial Statements,* paragraphs 24 through 30, as amended by SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements (AU section 508.24 through .30), regarding uncertainties and see discussion of reporting considerations when the auditor has substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time in SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* paragraphs 12 through 16, as amended by SAS No. 64, *Omnibus Statement on Auditing Standards—1990* (AU section 341.12 through .16).

[2] See AAM section 12,400.01, footnote 1.

[3] See AAM section 12,400.01, footnote 2.

[4] See AAM section 12,400.01, footnote 3.

.12 Qualified Opinion on General-Purpose Financial Statements That Include an Unaudited Organization, Function, or Activity

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose[1] financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards.[2] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We were unable to obtain the audited financial statements supporting the financial activities of the [*identify the organization, function, or activity*] nor were we able to satisfy ourselves as to those financial activities by other auditing procedures. Those financial activities are included in the [*identify fund type, account group, or component unit column(s)*] and represent XX percent and XX percent of the assets and revenues, respectively, of [*identify fund type, account group, or component unit column*].

In our opinion, except for the effects of such adjustment, if any, as might have been determined to be necessary had we been able to obtain the audited financial statements of [*identify the organization, function, or activity*], the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.[3]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.11.]

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[1] See AAM section 12,400.01, footnote 1.

[2] See AAM section 12,400.01, footnote 2.

[3] See AAM section 12,400.01, footnote 3.

.13 Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of an Organization, Function, or Activity by Other Auditors

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose[1] financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit. We did not audit the financial statements of the [*identify organization, function, or activity*], which represent XX percent and XX percent, respectively, of the assets and revenues of the [*identify fund type, account group, or component unit column(s)*]. Those financial statements were audited by other auditors whose report has been furnished to us, and our opinion on the general-purpose financial statements, insofar as it relates to the amounts included for the [*identify organization, function, or activity*], is based on the report of the other auditors.

We conducted our audit in accordance with generally accepted auditing standards.[2] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.[3]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.12(A).]

[1] See AAM section 12,400.01, footnote 1.

[2] See AAM section 12,400.01, footnote 2.

[3] See AAM section 12,400.01, footnote 3.

.14 Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements When One Fund or Component Unit Representing Less Than All of a Fund Type Has Been Audited by Other Auditors

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose[1] financial statements and the combining and individual fund and account group financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit. We did not audit the financial statements of the [*identify fund or component unit*] which statements reflect total assets of $XXX,XXX as of June 30, 19X1, and total revenues of $XXX,XXX for the year then ended. Those financial statements were audited by other auditors whose report has been furnished to us, and our opinion on the general-purpose financial statements, insofar as it relates to the amounts included for the [*identify fund or component unit*] in the [*identify fund type or component unit column(s)*], is based on the report of the other auditors.

We conducted our audit in accordance with generally accepted auditing standards.[2] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles. Also, in our opinion, the combining, individual fund, and account group financial statements referred to above (other than than the [*identify fund or component unit*], whose financial statements were audited by other auditors whose report expressed an unqualified opinion) present fairly, in all material respects, the financial position of each of the individual funds and account groups of City of Example, Any State, at June 30, 19X1, and the results of operations of such funds and the cash flows of individual proprietary fund types and nonexpendable trust funds for the year then in conformity with generally accepted accounting principles.[3]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.12(B).]

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[1] See AAM section 12,400.01, footnote 1.

[2] See AAM section 12,400.01, footnote 2.

[3] See AAM section 12,400.01, footnote 3.

.15 Unqualified Opinion on General-Purpose Financial Statements with Reference to an Audit of All of a Fund Type by Other Auditors

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose[1] financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These general-purpose financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit. We did not audit the financial statements of the [*identify fund type*]. Those financial statements were audited by other auditors whose report has been furnished to us, and our opinion on the general-purpose financial statements, insofar as it relates to the amounts included for the [*identify fund type*], is based on the report of the other auditors.

We conducted our audit in accordance with generally accepted auditing standards.[2] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.[3]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.13.]

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[1] See AAM section 12,400.01, footnote 1.

[2] See AAM section 12,400.01, footnote 2.

[3] See AAM section 12,400.01, footnote 3.

.16 Unqualified Opinion on Financial Statements Prepared in Accordance With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of City of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.[1] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X, City of Example, Any State, prepares its financial statements on the cash basis which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the cash and unencumbered cash balances of City of Example, Any State, as of June 30, 19X1, and the revenues it received and expenditures it paid for the year then ended on the basis of accounting described in Note X.[2, 3]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.14.]

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[1] See AAM section 12,400.01, footnote 2.

[2] If the financial statements are prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject, the opinion paragraph should be followed by a paragraph that restricts the distribution of the report solely to those within the entity and for filing with the regulatory agency. See paragraphs 5*f* and 8 of SAS No. 62, *Special Reports*, as amended by SAS No. 77, *Amendments to Statements on Auditing Standards No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, *and No. 62,* Special Reports (AU section 623.05*f* and .08).

[3] See AAM section 12,400.01, footnote 3.

.17 Unqualified Opinion on Financial Statements of a Department Constituting Less Than a Fund

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of Department of Example, Any State, as of and for the year ended June 30, 19X1. These financial statements are the responsibility of Department of Example, Any State, management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.[1] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X, the financial statements of the Department of Example, Any State, are intended to present the financial position and results of operations and cash flows of proprietary fund types of only that portion of the financial reporting entity of the State that is attributable to the transactions of the Department.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Department of Example, Any State, as of June 30, 19X1, and the results of its operations and cash flows for the year then ended in conformity with generally accepted accounting principles.[2]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.15.]

[1] See AAM section 12,400.01, footnote 2.

[2] See AAM section 12,400.01, footnote 3.

.18 Unqualified Opinion on Supplementary Schedule of Federal Financial Assistance

Independent Auditor's Report

Addressee:

We have audited the general-purpose[1] financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[2] These general-purpose financial statements are the responsibility of City of Example, Any State's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Our audit was made for the purpose of forming an opinion on the general-purpose financial statements of City of Example, Any State, taken as a whole. The accompanying Schedule of Federal Financial Assistance is presented for purposes of additional analysis and is not a required part of the general-purpose financial statements. The information in that schedule has been subjected to the auditing procedures applied in the audit of the general-purpose financial statements and, in our opinion, is fairly presented in all material respects in relation to the general-purpose financial statements taken as a whole.[3]

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.16.]

[1] See AAM section 12,400.01, footnote 1.

[2] Describe any departure from the standard report.

[3] See AAM section 12,400.02, footnote 4.

.19 Unqualified Report on Compliance Based on an Audit of General-Purpose Financial Statements Performed in Accordance With *Government Auditing Standards*—No Reportable Instances of Noncompliance

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to City of Example, Any State, is the responsibility of City of Example, Any State's management. As part of obtaining reasonable assurance about whether the general-purpose financial statements are free of material misstatement, we performed tests of City of Example, Any State's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the general-purpose financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards.*[2,3]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.17(A), with conforming changes as of May 1, 1995.]

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[1] Describe any departure from the standard report.

[2] See *Government Auditing Standards,* Chapter 5, paragraphs 5.18 and 5.19, for reporting criteria.

[3] If the auditor has issued a separate letter to communicate irregularities, illegal acts, or other noncompliance that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards,* this paragraph should be modified to include a statement such as the following:

> We noted certain immaterial instances of noncompliance that we have reported to the management of [*name of entity*] in a separate letter dated August 15, 19X1.

.20 Qualified Report on Compliance Based on an Audit of General-Purpose Financial Statements Performed in Accordance With *Government Auditing Standards*—Reportable Instances of Noncompliance and Uncertainty About Noncompliance Exists

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to City of Example, Any State, is the responsibility of City of Example, Any State, management. As part of obtaining reasonable assurance about whether the general-purpose financial statements are free of material misstatement, we performed tests of City of Example, Any State's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the general-purpose financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed the following instances of noncompliance that are required to be herein reported under *Government Auditing Standards* for which the ultimate resolution cannot presently be determined.[2] Accordingly, no provision for any liability that may result has been recognized in City of Example, Any State's 19X1 financial statements.[3]

[*Include paragraphs describing the instances of noncompliance noted.*]

We considered these instances of noncompliance in forming our opinion on whether City of Example, Any State's 19X1 general-purpose financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19X1, on those general-purpose financial statements.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.17(B).]

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[1] Describe any departure from the standard report.

[2] See *Government Auditing Standards*, Chapter 5, paragraphs 5.18 and 5.19, for reporting criteria.

[3] The impact of the instance of noncompliance is considered when reporting on the general-purpose financial statements and, if material to the general-purpose financial statements, an explanatory paragraph similar to the following should be added in the auditor's report on the general-purpose financial statements after the opinion paragraph:

> As discussed in note X, City of Example, Any State, failed to comply with certain statutory requirements to obtain competitive bids on capital projects in amounts over $X,XXX that may be material to the capital projects fund. The general-purpose financial statements do not include an adjustment for any liability that may result from the actions of the entity in relation to not obtaining competitive bids.

Auditors should be aware that instances of noncompliance may be material, either individually or in the aggregate, warranting expression of other than an unqualified opinion on the general-purpose financial statements.

.21 Single Audit Unqualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[1]

We have also audited City of Example, Any State's compliance with the requirements governing [*list specific requirements tested*—see paragraph 23.40 of the Audit and Accounting Guide *Audits of State and Local Governmental Units*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance,[2] for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-128, *Audits of State Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about City of Example, Any State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.[3]

In our opinion, City of Example, Any State, complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.18(A).]

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[1] Describe any departure from the standard report.

[2] Major programs need to be clearly identified in the Supplementary Schedule of Federal Financial Assistance.

[3] When there are no instances of noncompliance, this paragraph should be deleted.

.22 Single Audit Qualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Uncertainties

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[1]

We have also audited City of Example, Any State's compliance with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance,[2] for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments*. Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about City of Example, Any State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures for the U.S. Department of Education's Impact Aid—Maintenance and Operations program disclosed that City of Example, Any State, did not comply with the requirements that the number of children in the program equal at least 400, or 3 percent of the total number of children in average daily attendance. In our opinion, City of Example, Any State's compliance with this requirement is necessary for City of Example, Any State, to comply with the requirements applicable to the Impact Aid—Maintenance and Operations program.

In addition, the results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to in the second paragraph of this report, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.[3]

In our opinion, except for those instances of noncompliance with requirements applicable to the U.S. Department of Education's Impact Aid—Maintenance and Operations program referred to in the fourth paragraph of this report and identified in the accompanying Schedule of Findings and Questioned Costs, City of Example, Any State, complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

Resolving instances of noncompliance identified in the fourth paragraph of this report is the responsibility of the U.S. Department of Education. The determination of whether the identified instances of noncompliance will ultimately result in a disallowance of costs cannot presently be made. Accordingly, no adjustment for any disallowances that may result has been made to the federal program amounts listed in the accompanying Schedule of Federal Financial Assistance and no provision for any liability that may result has been recognized in City of Example, Any State's 19X1 financial statements.

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[1] Describe any departure from the standard report.

[2] Major programs need to be clearly identified in the Supplementary Schedule of Federal Financial Assistance.

[3] If there are no immaterial instances of noncompliance relating to major programs noted, this paragraph should be deleted.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.18(B).]

.23 Single Audit Qualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Scope Limitation

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[1]

We have also audited the compliance of City of Example, Any State, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance,[2] for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

Except as discussed in the following paragraph, we conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about City of Example, Any State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

We were unable to obtain sufficient documentation supporting compliance of City of Example, Any State, with the requirements of Major Program ABC governing types of services allowed or unallowed; nor were we able to satisfy ourselves as to City of Example, Any State's compliance with those requirements of Major Program ABC by other auditing procedures.

In addition, the results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding City of Example, Any State's compliance with the requirements of Major Program ABC governing types of services allowed or unallowed, City of Example, Any State, complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.19.]

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[1] Describe any departure from the standard report.

[2] Major programs need to be clearly identified in the Supplementary Schedule of Federal Financial Assistance.

.24 Single Audit Disclaimer of Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Scope Limitation

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[1]

We were also engaged to audit the compliance of City of Example, Any State, with the requirements governing [*list requirements to have been tested*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance,[2] for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements.

The management of City of Example, Any State, has refused to provide us with written representations that generally accepted auditing standards require us to obtain.

Because of the matter described in the preceding paragraph, the scope of our audit work was not sufficient to enable us to express, and we do not express, an opinion on City of Example, Any State's compliance with the requirements governing [*list requirements to have been tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.20.]

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[1] Described any departure from the standard report.

[2] Major programs need to be clearly identified in the Supplementary Schedule of Federal Financial Assistance.

.25 Single Audit Qualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Noncompliance

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[1]

We have also audited the compliance of City of Example, Any State, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance,[2] for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments*. Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about City of Example, Any State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures for Major Program ABC disclosed that City of Example, Any State, did not comply with the requirement that City match the funds received from Major Program ABC. In our opinion, City of Example, Any State's matching of funds received from Major Program ABC is necessary for City of Example, Any State, to comply with the requirements applicable to Major Program ABC.

In addition, the results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to in the third paragraph, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, except for those instances of noncompliance with the requirements applicable to Major Program ABC referred to in the fourth paragraph of this report and identified in the accompanying Schedule of Findings and Questioned Costs, City of Example, Any State, complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example, A.21.]

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1 Describe any departure from the standard report.

2 Major programs need to be clearly identified in the Supplementary Schedule of Federal Financial Assistance.

.26 Single Audit Adverse Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs

Indépendent Auditor's Report

Addressee:

We have audited the financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[1]

We have also audited the compliance of City of Example, Any State, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance,[2] for the year ended June 30, 19X1. The management of City of Example, Any State, is responsible for City of Example, Any State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about City of Example, Any State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

[*Add a paragraph describing reasons for the adverse opinion.*]

In addition, the results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, because of those instances of noncompliance referred to in the fourth paragraph, City of Example, Any State, did not comply, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.22.]

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[1] Describe any departure from the standard report.

[2] Major programs need to be clearly identified in the Supplementary Schedule of Federal Financial Assistance.

.27 Single Audit Unqualified Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[1]

We have applied procedures to test City of Example, Any State's compliance with the following requirements applicable to its federal financial assistance programs, which are identified in the Schedule of Federal Financial Assistance, for the year ended June 30, 19X1 [*list the general requirements tested*].

Our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Single Audits of State and Local Governments [or describe alternative procedures performed*]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on City of Example, Any State's compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that City of Example, Any State, had not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.[2]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.23(A).]

[1] Describe any departure from the standard report.

[2] When there are no immaterial instances of noncompliance, this paragraph should be deleted.

.28 Single Audit Qualified Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs—Material Noncompliance[1]

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of [*name of entity*] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[2]

We have applied procedures to test City of Example, Any State's compliance with the following requirements applicable to its federal financial assistance programs, which are identified in the Schedule of Federal Financial Assistance, for the year ended June 30, 19X1 [*list general requirements tested*].

Our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Single Audits of State and Local Governments [or describe alternative procedures performed*]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on City of Example, Any State's compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

Material instances of noncompliance consist of failures to follow the general requirements that caused us to conclude that the misstatements resulting from those failures are material [*indicate program(s) or financial statements*]. The results of our tests of compliance disclosed material instances of noncompliance that are described in the accompanying Schedule of Findings and Questioned Costs.[3]

We considered these material instances of noncompliance in forming our opinion on whether City of Example, Any State's 19X1 general-purpose financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19X1, on those financial statements.

Except as described above, the results of our procedures to determine compliance indicate that, with respect to the items tested, City of Example, Any State, complied, in all material respects, with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention

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[1] See paragraph 23.81 of the Audit and Accounting Guide *Audits of State and Local Governmental Units*, which discusses materiality with respect to the general requirements.

[2] Describe any departure from the standard report.

[3] If, individually or collectively, the instances of noncompliance are also material to the general-purpose financial statements, the report on compliance required by *Government Auditing Standards* is modified as follows:

> [*First three paragraphs are the same as in the report illustrated in AAM section 12,400.18*].
>
> Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in laws, regulations, contracts, or grants, that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the general-purpose financial statements. The results of our tests of compliance disclosed the following material instances of noncompliance, the effects of which have been corrected in the 19X1 general-purpose financial statements of City of Example, Any State.
>
> [*Include paragraphs describing the material instances of noncompliance noted.*]
>
> We considered these material instances of noncompliance in forming our opinion on whether the 19X1 general-purpose financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19X1, on those general-purpose financial statements.
>
> Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, City of Example, Any State, complied, in all material respects, with the provisions referred to in the third paragraph of this report, and with respect to items not tested, nothing came to our attention that caused us to believe that City of Example, Any State, had not complied, in all material respects, with those provisions.
>
> This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.
>
> [*Signature*]
>
> [*Date*]

that caused us to believe that City of Example, Any State, had not complied, in all material respects, with those requirements.[4] However, the results of our procedures also disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.[5]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.23(B).]

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[4] The following is an illustration of the auditor's report when the auditor determines noncompliance is pervasive and the auditor is not able to provide negative assurance on general requirements.

> [*First three paragraphs and last paragraph are the same as in the report illustrated above*].
>
> With respect to the items tested, City of Example, Any State, complied with the requirements listed in the second paragraph, except as described in the attached schedule. However, the extent of noncompliance noted in our testing indicates that, with respect to items that were not tested by us, there is more than a relatively low risk that City of Example, Any State, may not have complied with the requirements referred to in the second paragraph. These matters were considered by us in evaluating whether the general-purpose financial statements are presented fairly in conformity with generally accepted accounting principles.

[5] When there are no immaterial instances of noncompliance noted, this sentence should be deleted.

.29 Single Audit Qualified Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs—Scope Limitation

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We have applied procedures to test City of Example, Any State's compliance with the following requirements applicable to its federal financial assistance programs, which are identified in the Schedule of Federal Financial Assistance, for the year ended June 30, 19XX [*list general requirements tested*].

Except as described in the following paragraph, our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Single Audits of State and Local Governments [or describe alternative procedures performed]*. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on City of Example, Any State's compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

We were unable to obtain sufficient documentation of City of Example, Any State's compliance with the cash management and relocation assistance and real property acquisition requirements of Program ABC, nor were we able to satisfy ourselves by alternative procedures as to City of Example, Any State's compliance with those requirements of Program ABC.

With respect to the items tested, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding City of Example, Any State's compliance with the cash management and relocation assistance and real property acquisition requirements of Program ABC, City of Example, Any State, complied, in all material respects, with the requirements listed in the first paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that City of Example, Any State, had not complied, in all material respects, with those requirements. The results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.[2]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.23(C).]

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[1] Describe any departure from the standard report.

[2] If there is pervasive noncompliance and negative assurance cannot be provided, the standard report should be modified as shown in AAM section 12,400.28, footnote 4.

.30 Single Audit Unqualified Report on Compliance With Specific Requirements Applicable to Nonmajor Federal Financial Assistance Programs Transactions[1]

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[2]

In connection with our audit of the general-purpose financial statements of City of Example, Any State, and with our consideration of City of Example, Any State's control structure used to administer federal financial assistance programs, as required by Office of Management and Budget Circular A-128, *Audits of State and Local Governments,* we selected certain transactions applicable to certain nonmajor federal financial assistance programs for the year ended June 30, 19XX. As required by OMB Circular A-128, we have performed auditing procedures to test compliance with the requirements governing [*list requirements tested*] that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on City of Example, Any State's compliance with these requirements. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us believe that City of Example, Any State, had not complied, in all material respects, with those requirements.[3] However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.[4]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.24.]

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[1] See AAM section 12,400.28, footnote 3, for modification when material noncompliance is detected.

[2] Describe any departure from the standard report.

[3] The following is an illustration of the auditor's report when the auditor determines noncompliance for nonmajor program transactions is pervasive and the auditor is not able to provide negative assurance.

> [*First two paragraphs and last paragraph are the same as in the report illustrated above.*]
>
> The results of our tests indicate that, with respect to the items tested, City of Example, Any State, complied with those requirements, except as described in the attached schedule. However, the extent of noncompliance noted in our testing indicates that, with respect to nonmajor program transactions not tested by us, there is more than a relatively low risk that City of Example, Any State, may not have complied with the requirements referred to in the preceding paragraph. These matters were considered by us in evaluating whether the general-purpose financial statements are presented fairly in conformity with generally accepted accounting principles.

[4] If there are no instances of noncompliance, this sentence should be deleted.

.31 Report on the Internal Control Structure Based on an Audit of General-Purpose Financial Statements Performed in Accordance With *Government Auditing Standards*

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general-purpose financial statements in accordance with generally accepted accounting principles.[2] Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the general-purpose financial statements of City of Example, Any State, for the year ended June 30, 19XX, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the general-purpose financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the general-purpose financial statements.

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the general-purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

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[1] Describe any departure from the standard report.

[2] If the financial statements are on a basis other than GAAP (for example, cash basis in accordance with the U.S. Department of Housing and Urban Development [HUD] Accounting Manual), the phrase "generally accepted accounting principles" should be modified.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.[3]

We also noted other matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State, in a separate letter dated August 15, 19XX.[4]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record, and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.25(A), with conforming changes as of May 1, 1995.]

[3] If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention. The last sentence of this paragraph should be modified as follows:

> However, we noted the following matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the financial statements of City of Example, Any State for the year ended June 30, 19XX.
>
> [*A description of the material weaknesses that have come to the auditor's attention would follow.*]

[4] If a separate letter has not been issued, this paragraph should be omitted.

.32 Report on the Internal Control Structure Based on an Audit of General-Purpose or Basic Financial Statements Performed in Accordance With *Government Auditing Standards*—No Material Weaknesses When There Are No Reportable Conditions

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement.

In planning and performing our audit of the general-purpose financial statements of City of Example, Any State, for the year ended June 30, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the general-purpose financial statements and not to provide assurance on the internal control structure.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general-purpose financial statements in accordance with generally accepted accounting principles.[2] Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories:

[*Identify internal control categories here.*]

For all of the internal control structure categories listed in the preceding paragraph, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors and irregularities in amounts that would be material in relation to the general-purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

---

[1] Describe any departure from the standard report.

[2] If the financial statements are on a basis other than GAAP, the phrase "generally accepted accounting principles" should be modified.

However, we noted certain matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State, in a separate letter dated August 15, 19XX.[3]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

Note: As of the date of this publication, the AICPA Federal Government Division was in the process of revising this report to conform it to the requirements of the 1994 revision of *Government Auditing Standards* (the Yellow Book). Auditors should ascertain the status of those revisions before issuing this report.

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.25(B).]

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[3] If a separate letter has not been issued, this paragraph should be omitted.

.33 Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1] We have also audited the compliance of City of Example, Any State, with requirements applicable to major federal financial assistance programs and have issued our report thereon dated August 15, 19XX.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments*. Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement and about whether City of Example, Any State, complied with laws and regulations, noncompliance with which would be material to a major federal financial assistance program.

In planning and performing our audits for the year ended June 30, 19XX, we considered the internal control structure of City of Example, Any State, in order to determine our auditing procedures for the purpose of expressing our opinions on the general-purpose financial statements of City of Example, Any State, and on the compliance of City of Example, Any State, with requirements applicable to major programs, and to report on the internal control structure in accordance with OMB Circular A-128. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial assistance programs. We have addressed internal control structure policies and procedures relevant to our audit of the general-purpose financial statements in a separate report dated August 15, 19XX.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general-purpose financial statements in accordance with generally accepted accounting principles,[2] and that federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal financial assistance programs in the following categories: [*identify internal control structure categories*].[3]

---

[1] Describe any departure from the standard report.

[2] If the financial statements are on a basis other than GAAP, the phrase "generally accepted accounting principles" should be modified.

[3] Following are examples of different ways in which internal control structure policies and procedures used in administering federal financial assistance programs might be classified. The auditor should modify these examples or use other classifications as appropriate for the particular circumstances on which the auditor is reporting. However, there is no need to present detailed internal control structure policies and procedures, even though test work may be performed at that level.

Activity Cycles

- Treasury or financing

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.[4]

During the year ended June 30, 19XX, City of Example, Any State, expended X percent of its total federal financial assistance under major federal financial assistance programs.

(Footnote continued)

- Revenue/receipts
- Purchases/disbursements
- External financial reporting
- Payroll/personnel

Financial Statement Captions

- Cash and cash equivalents
- Receivables
- Inventory
- Property and equipment
- Payables and accrued liabilities
- Debt
- Fund balance

Accounting Applications

- Billings
- Receivables
- Cash receipts
- Purchasing and receiving
- Accounts disbursements
- Payroll
- Inventory control
- Property and equipment
- General ledger

General Requirements

- Political activity
- Davis-Bacon Act
- Civil rights
- Cash management
- Relocation assistance and real property management
- Federal financial reports
- Allowable costs/cost principles
- Drug-free workplace
- Administrative requirements

Specific Requirements

- Types of services
- Eligibility
- Matching, level of effort, or earmarking
- Reporting
- Cost allocation
- Special requirements, if any
- Monitoring subrecipients

Claims for Advances and Reimbursements
Amounts Claimed or Used for Matching

[4] If a cyclical approach is used, this paragraph should be modified, and a paragraph that clearly describes the coverage provided for nonmajor programs should be added after it as follows:

> Because of the large number of nonmajor programs and the decentralized administration of these programs, we performed procedures to obtain an understanding of the internal control structure policies and procedures relevant to nonmajor programs on a cyclical basis. Our procedures during the current year covered X percent of the nonmajor programs administered by City of Example, Any State, as a whole. The nonmajor programs not covered during the current year have been or are expected to be subject to such procedures at least once during the X year cycle.

We performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of City of Example, Any State's major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect City of Example, Any State's ability to administer federal financial assistance programs in accordance with applicable laws and regulations.

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure policies and procedures used in administering federal financial assistance would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.[5]

We also noted other matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State, in a separate letter dated September 8, 19XX.[6]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record, and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.26(A).]

[5] If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the audit of compliance with requirements applicable to major federal financial assistance programs. The last sentence of this paragraph should be modified as follows:

> However, we noted the following matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the compliance of City of Example, Any State, with requirements applicable to its major federal financial assistance programs for the year ended June 30, 19XX, and this report does not affect our report thereon dated September 8, 19XX.
> [*A description of the material weaknesses that have come to the auditor's attention would follow.*]

[6] If a separate letter has not been issued, this paragraph should be omitted.

.34 Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—No Material Weaknesses When There Are No Reportable Conditions[1]

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX. We have also audited the compliance of City of Example, Any State, with requirements applicable to major federal financial assistance programs and have issued our report thereon dated August 15, 19XX.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement and about whether City of Example, Any State, complied with laws and regulations, noncompliance with which would be material to a major federal financial assistance program.

In planning and performing our audits for the year ended June 30, 19XX, we considered the internal control structure of City of Example, Any State, in order to determine our auditing procedures for the purpose of expressing our opinions on the general-purpose financial statements of City of Example, Any State, and on the compliance of City of Example, Any State, with requirements applicable to major programs, and to report on the internal control structure in accordance with OMB Circular A-128. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial assistance programs. We have addressed internal control structure policies and procedures relevant to our audit of the general-purpose financial statements in a separate report dated August 15, 19XX.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general-purpose financial statements in accordance with generally accepted accounting principles, and federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal financial assistance programs into the following categories.

[*Identify internal control structure categories.*]

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether the have been placed in operation, and we assessed control risk.

During the year ended June 30, 19XX, City of Example, Any State, expended X percent of its total federal financial assistance under major federal financial assistance programs.

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[1] See footnotes to AAM section 12,400.33.

We performed test of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the major federal financial assistance programs of City of Example, Any State, which are identified in the accompanying Schedule of Federal Financial Assistance. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

Our consideration of the internal control structure policies and procedures used in administering federal financial assistance would not necessarily disclose all matters in the internal control structure that might constitute material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

However, we noted certain matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State, in a separate letter dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.26(B).]

.35 Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—No Tests of Controls Are Performed for Certain Compliance Requirements[1]

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX. We have also audited the compliance of City of Example, Any State, with requirements applicable to major federal financial assistance programs and have issued our report thereon dated August 15, 19XX.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement and about whether City of Example, Any State, complied with laws and regulations, noncompliance with which would be material to a major federal financial assistance program.

In planning and performing our audits for the year ended June 30, 19XX, we considered the internal control structure of City of Example, Any State, in order to determine our auditing procedures for the purpose of expressing our opinions on the general-purpose financial statements of City of Example, Any State, and on the compliance of City of Example, Any State, with requirements applicable to major federal financial assistance programs, and to report on the internal control structure in accordance with OMB Circular A-128. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial assistance programs. We have addressed internal control structure policies and procedures relevant to our audit of the general-purpose financial statements in a separate report dated August 15, 19XX.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general-purpose financial statements in accordance with generally accepted accounting principles, and that federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures into the following categories: [*identify internal control structure categories*].

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.

During the year ended June 30, 19XX, City of Example, Any State, expended X percent of its total federal financial assistance under major federal financial assistance programs.

[1] See footnotes to AAM section 12,400.33.

Except as discussed in the following paragraph, we performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of City of Example, Any State's major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

For [*identify relevant federal financial assistance programs*], we performed no tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that could be relevant to preventing or detecting material noncompliance with [*identify relevant compliance requirements*]. We did not perform such tests because the results of procedures we performed to obtain an understanding of the design of internal control structure policies and procedures and whether they have been placed in operation indicated that [*describe the absence of relevant policies and procedures or the circumstances that cause the auditor to conclude that policies and procedures are unlikely to be effective*]. We consider this condition to be a reportable condition under standards established by the American Institute of Certified Public Accountants.

Reportable conditions involve matters coming to our attention concerning significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect City of Example, Any State's ability to administer federal financial assistance programs in accordance with applicable laws and regulations. In addition to the reportable conditions identified in the preceding paragraph, we noted other matters involving the internal control structure and its operation that we consider to be reportable conditions.

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which in the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe that none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operations that we have reported to the management of City of Example, Any State, in a separate letter dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record, and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.26(C).]

.36 Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—Total Assistance Expended Under Major Programs Is Less Than 50 Percent of Federal Financial Assistance

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1] We have also audited the compliance of City of Example, Any State, with requirements applicable to major federal financial assistance programs and have issued our report thereon dated August 15, 19XX.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement and about whether City of Example, Any State, complied with laws and regulations, noncompliance with which would be material to a major federal financial assistance program.

In planning and performing our audits for the year ended June 30, 19XX, we considered the internal control structure of City of Example, Any State, in order to determine our auditing procedures for the purpose of expressing our opinions on the general-purpose financial statements of City of Example, Any State, and on the compliance of City of Example, Any State, with requirements applicable to major programs, and to report on the internal control structure in accordance with OMB Circular A-128. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial assistance programs. We have addressed internal control structure policies and procedures relevant to our audit of the general-purpose financial statements in a separate report dated August 15, 19XX.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general-purpose financial statements in accordance with generally accepted accounting principles,[2] and that federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal financial assistance programs in the following categories: [*identify internal control structure categories*].[3]

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[1] Describe any departure from the standard report.

[2] If the financial statements are on a basis other than GAAP, the phrase "generally accepted accounting principles" should be modified.

[3] Following are examples of different ways in which internal control structure policies and procedures used in administering federal financial assistance programs might be classified. The auditor should modify these examples or use other classifications as appropriate for the particular circumstances on which the auditor is reporting. However, there is no need to present detailed internal control structure policies and procedures, even though test work may be performed at that level.

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.[4]

During the year ended June 30, 19XX, City of Example, Any State, expended X percent of its total federal financial assistance under major federal financial assistance programs and the following nonmajor federal

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Activity Cycles
- Treasury or financing
- Revenue/receipts
- Purchases/disbursements
- External financial reporting
- Payroll/personnel

Financial Statement Captions
- Cash and cash equivalents
- Receivables
- Inventory
- Property and equipment
- Payables and accrued liabilities
- Debt
- Fund balance

Accounting Applications
- Billings
- Receivables
- Cash receipts
- Purchasing and receiving
- Accounts disbursements
- Payroll
- Inventory control
- Property and equipment
- General ledger

General Requirements
- Political activity
- Davis-Bacon Act
- Civil rights
- Cash management
- Relocation assistance and real property management
- Federal financial reports
- Allowable costs/cost principles
- Drug-free workplace
- Administrative requirements

Specific Requirements
- Types of services
- Eligibility
- Matching, level of effort, or earmarking
- Reporting
- Cost allocation
- Special requirements, if any
- Monitoring subrecipients

Claims for Advances and Reimbursements
Amounts Claimed or Used for Matching

[4] If a cyclical approach is used, this paragraph should be modified, and a paragraph that clearly describes the coverage provided for nonmajor programs should be added after it as follows:

> Because of the large number of nonmajor programs and the decentralized administration of these programs, we performed procedures to obtain an understanding of the internal control structure policies and procedures relevant to nonmajor programs on a cyclical basis. Our procedures during the current year covered X percent of the nonmajor programs administered by City of Example, Any State, as a whole. The nonmajor programs not covered during the current year have been or are expected to be subject to such procedures at least once during the X year cycle.

financial assistance programs: [*list appropriate nonmajor federal financial assistance programs*]. However, we believe none of the reportable conditions described above is a material weakness.

We performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of City of Example, Any State's major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance, and the aforementioned nonmajor programs. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect City of Example, Any State's ability to administer federal financial assistance programs in accordance with applicable laws and regulations.

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure policies and procedures used in administering federal financial assistance would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.[5]

We also noted other matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State, in a separate letter dated September 8, 19XX.[6]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of a public record, and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.26(D).]

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[5] If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the audit of compliance with requirements applicable to major federal financial assistance programs. The last sentence of this paragraph should be modified as follows:

> However, we noted the following matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the compliance of City of Example, Any State, with requirements applicable to its major federal financial assistance programs for the year ended June 30, 19XX, and this report does not affect our report thereon dated September 8, 19XX.
> [*A description of the material weaknesses that have come to the auditor's attention would follow.*]

[6] If a separate letter has not been issued, this paragraph should be omitted.

.37 Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—No Major Programs[1]

Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated September 8, 19XX.

We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-128, *Audits of State and Local Governments.* Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement.

In planning and performing our audit for the year ended June 30, 19XX, we considered the internal control structure of City of Example, Any State, in order to determine our auditing procedures for the purpose of expressing our opinion on City of Example, Any State's general-purpose financial statements and to report on the internal control structure in accordance with OMB Circular A-128. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial assistance programs. We have addressed internal control structure policies and procedures relevant to our audit of the general-purpose financial statements in a separate report dated August 15, 19XX.

The management of City of Example, Any State, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general-purpose financial statements in accordance with generally accepted accounting principles, and that federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal financial assistance programs into the following categories: [*identify internal control structure categories*].

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.

During the year ended June 30, 19XX, City of Example, Any State, had no major federal financial assistance programs and expended X percent of its total federal financial assistance under the following nonmajor federal financial assistance programs: [*list appropriate nonmajor federal financial assistance programs*].

We performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we have considered relevant to pre-

[1] See footnotes in AAM section 12,400.33.

venting or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to the aforementioned nonmajor programs. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect City of Example, Any State's ability to administer federal financial assistance programs in accordance with applicable laws and regulations.

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure policies and procedures used in administering federal financial assistance would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.[2]

We also noted other matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State, in a separate letter dated September 8, 19XX.[3]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record, and its distribution is not limited.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.26(E).]

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[2] If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the audit of compliance with requirements applicable to major federal financial assistance programs. The last sentence of this paragraph should be modified as follows:

> However, we noted the following matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the compliance of City of Example, Any State, with requirements applicable to its major federal financial assistance programs for the year ended June 30, 19XX, and this report does not affect our report thereon dated September 8, 19XX.
> [*A description of the material weaknesses that have come to the auditor's attention would follow.*]

[3] If a separate letter has not been issued, this paragraph should be omitted.

.38 Report on Separately Issued Summary Financial Information Prepared in Accordance With the Guidance Provided in Paragraph 18.23 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*

Independent Auditor's Report

Addressee:

We have audited, in accordance with generally accepted auditing standards, the general-purpose financial statements of City of Example as of and for the year ended June 30, 19XX (not presented herein), and have issued our report thereon dated August 15, 19XX.[1]

As explained in Note X, the accompanying summary financial information of City of Example, as of and for the year ended June 30, 19XX, is not a presentation in conformity with generally accepted accounting principles. In our opinion, however, the accompanying summary financial information is fairly stated, in all material respects, in relation to the general-purpose financial statements from which it has been derived.

[*Signature*]

[*Date*]

[Source: AIPCA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Example A.27.]

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[1] Describe any departure from the standard report.

.39 Report on Separately Issued Summary Financial Information Prepared in a Manner Inconsistent With the Guidance Provided in Paragraph 18.23 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*

Independent Auditor's Report

Addressee:

We have audited, in accordance with generally accepted auditing standards, the general-purpose financial statements of City of Example as of and for the year ended June 30, 19XX (not presented herein), and have issued our report thereon dated August 15, 19XX.[1]

As explained in Note X, the accompanying summary financial information of City of Example, as of and for the year ended June 30, 19XX, is not a presentation in conformity with generally accepted accounting principles. Furthermore, the summary financial information has been prepared [*specify reason(s) for adverse report, for example, using a different measurement focus and basis of accounting*[2] *from the general-purpose financial statements*].

In our opinion, because of the significance of [*specify reason(s) for adverse report, for example, using a different measurement focus and basis of accounting*], the accompanying summary financial information, as of and for the year ended June 30, 19XX, is not fairly stated in relation to the general-purpose financial statements.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.28.]

[*The next page is 20,001.*]

[1] Describe any departure from the standard report.

[2] A different measurement focus and basis of accounting would include changing from a modified accrual basis of accounting to a cash basis, recording depreciation on general fixed assets through the operating statement of a governmental fund type, etc.

AAM TOPICAL INDEX

References are to section and paragraph numbers.

[*Reserved.*]