University of Mississippi

eGrove

Guides, Handbooks and Manuals

American Institute of Certified Public Accountants (AICPA) Historical Collection

1997

AICPA audit and accounting manual : nonauthoritative technical practice aids, as of June 1, 1997

American Institute of Certified Public Accountant. Accounting and Auditing Publications Team

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_guides

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation

American Institute of Certified Public Accountant. Accounting and Auditing Publications Team, "AICPA audit and accounting manual : nonauthoritative technical practice aids, as of June 1, 1997" (1997). *Guides, Handbooks and Manuals*. 975.
https://egrove.olemiss.edu/aicpa_guides/975

This Book is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Guides, Handbooks and Manuals by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

AICPA Audit and Accounting Manual

As of June 1, 1997

AICPA

AICPA

American Institute of Certified Public Accountants

AICPA Audit and Accounting Manual

Nonauthoritative Practice Aids

As of June 1, 1997

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA Audit and Accounting Manual

Nonauthoritative Practice Aids

Edited by:
AICPA Accounting and Auditing Publications Team

As of June 1, 1997

Copyright © 1997 by
American Institute of Certified Public Accountants, Inc.,
New York, NY 10036-8775

All rights reserved. Requests for permission to make copies of any part of this work for redistribution or for inclusion in another document or manuscript should be mailed to Permissions Department, AICPA, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.

1 2 3 4 5 6 7 8 9 0 AAP 9 9 8 7

ISBN 0-87051-191-2

TABLE OF CONTENTS

Section		*Page*
...	How to Use This Volume	1
AAM 1000	Introduction	1001
	1100 Introduction	
	1200 How to Use the Audit and Accounting Manual	
AAM 2000	Compilation and Review	2001
	2100 Introduction	
	2200 Engagement Planning and Administration	
	2300 Working Papers	
	2400 Form and Content of Financial Statements	
	2500 Accountants' Reports	
	2510 Accountants' Reports on Compilation of Financial Statements of a Nonpublic Entity	
	2520 Accountants' Reports on Review of Financial Statements of a Nonpublic Entity	
	2600 Special Areas	
	2610 Accountants' Reports on Prescribed Forms, BCIP, and Specified Elements	
AAM 3000	Engagement Planning and Administration	3001
	3100 Planning the Engagement	
	3105 Understanding the Assignment	
	3110 Assigning Personnel to the Engagement	
	3115 Independence	
	3120 Knowledge of the Entity's Business	
	3125 Consideration of Internal Control	
	3130 Preparing an Engagement Letter	
	3140 Assessing Audit Risk and Materiality	
	3145 Fraud	
	3150 Illegal Acts	
	3155 Analytical Procedures	
	3165 Illustrative Planning Program	
	3170 Audit Assignment Controls	
	3175 Sample Engagement Letters	
AAM 4000	Internal Control	4001
	4100 Introduction	
	4200 Internal Control Framework	
	4300 Illustrative Internal Control Forms—Small Business	
	4310 Control Environment Checklist—Small Business Computer Applications	
	4320 Financial Reporting Information Systems and Controls Checklist—Small Business	
	4400 Illustrative Internal Control Forms—Medium to Large Business	
	4410 Control Applications Checklist—Medium to Large Business	
	4420 Financial Reporting Information Systems and Controls Checklist—Medium to Large Business	
	4500 Flowcharting	
	4600 Assessing Control Risk Below the Maximum	
	4700 The Auditor's Assessment of Control Risk	

Section		*Page*
AAM 5000	Audit Approach and Programs	5001
	5100 Designing the Audit Program	
	5200 Timing of Substantive Audit Tests	
	5300 Extent of Testing	
	5400 Illustrative Audit Program for Corporations	
	5410 Suggested Supplemental Reference Materials for Use With Illustrative Audit Program for Corporations	
AAM 6000	Working Papers	6001
	6100 Working Papers—General	
	6200 Basic Elements of Format	
	6300 Content of Working Papers	
	6400 Organization and Filing (Indexing)	
	6500 Sample Working Papers	
AAM 7000	Correspondence, Confirmations & Representations	7001
	7100 Control of Confirmations and Correspondence	
	7200 Requests for Confirmations and Related Materials	
	7300 Inquiries to Legal Counsel	
	7400 Representation Letters	
	7500 Communication With Audit Committees	
	7600 Reliance Letter	
	7700 Proposal Letter	
AAM 8000	Audit Risk Alerts	8001
	8010 Audit Risk Alert—1996/97	
	8015 Compilation and Review Alert—1996/97	
	8020 Credit Union Industry Developments—1996/97	
	8030 Health Care Industry Developments—1996/97	
	8040 Insurance Industry Developments—1996/97	
	8050 Banks and Savings Institutions Industry Developments—1996/97	
	8060 Employee Benefit Plans Industry Developments—1997	
	8070 State and Local Governmental Developments—1997	
	8080 Agribusiness Industry Developments—1995/96	
	8090 Airline Industry Developments—1995/96	
	8100 Common Interest Realty Associations Industry Developments—1995/96	
	8110 Casino Industry Developments—1995/96	
	8120 Construction Contractors Industry Developments—1996/97	
	8130 Federal Government Contractors Industry Developments—1995/96	
	8140 Finance Companies Industry Developments—1995/96	
	8150 Investment Companies Industry Developments—1996/97	
	8160 Oil and Gas Producers Industry Developments—1995/96	
	8170 Securities Industry Developments—1996/97	
	8180 Not-for-Profit Organizations Industry Developments—1997	
	8190 FDIC Improvement Act Implementation Issues	
	8200 High-Technology Industry Developments—1996/97	
	8210 Real Estate Industry Developments—1996/97	
	8220 Public Utilities Industry Developments—1995/96	
	8230 Retail Industry Developments—1996/97	
AAM 9000	Supervision, Review and Report Processing	9001
	9100 Supervision and Review Procedures	
	9200 In-Charge's Engagement Review Program	
	9210 Partner's Engagement Review Program	

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Section *Page*

AAM 9000 Supervision, Review and Report Processing—continued
- 9220 Partner's Engagement Review Program Supplement for Not-for-Profit Organizations
- 9230 Partner's Engagement Review Program Supplement for Banks
- 9500 Report Processing

AAM 10,000 Accountants' Reports 10,001
- 10,100 Format of Accountants' Reports
- 10,210 Unqualified Opinions
- 10,220 Adverse Opinions
- 10,230 Disclaimers of Opinion
- 10,240 Qualified Opinions
- 10,245 Information Accompanying Audited Financial Statements
- 10,250 Engagements to Report on Internal Control
- 10,260 Special Reports
- 10,270 Unaudited Financial Statements of a Public Entity
- 10,280 Lack of Independence
- 10,300 Review of Interim Financial Information
- 10,400 Accountants' Reports on Condensed Financial Statements and Selected Financial Data
- 10,500 Reports on Personal Financial Statements
- 10,600 Reports on Employee Benefit Plans
- 10,650 Reports on Financial Statements of Brokers and Dealers in Securities
- 10,700 Reports for Investment Companies

AAM 11,000 Quality Control 11,001
- 11,100 Quality Control—General
- 11,200 Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice
- 11,300 Sample Quality Control Forms

AAM 12,000 State and Local Governments 12,001
- 12,010 Illustrative Internal Control Questions—State and Local Governmental Units
- 12,100 Designing the Audit Program
- 12,200 Illustrative Audit Program for State and Local Governmental Units
- 12,210 Suggested Supplemental Reference Materials for Use With Illustrative Audit Program for State and Local Governmental Units
- 12,300 Partner's Engagement Review Program Supplement for Local Governmental Units
- 12,400 Auditors' Reports on Basic or General-Purpose Financial Statements for State and Local Governmental Units

HOW TO USE THIS VOLUME

NEW CHANGES

This edition contains the following significant additions:

- SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AU section 316), has been incorporated into the Audit and Accounting Manual (the Manual), including:
  - — A new "Fraud" section (see AAM section 3145)
  - — A new "Fraud Risk Factor Memory Jogger" (see AAM section 3165)
  - — A new "Fraud Communication Checklist" (see AAM section 5400—general program)
  - — Engagement letters appropriately modified to reflect new "fraud-related" language (see AAM sections 2200 and 3175)
  - — A revised section on assessing audit risk and materiality, in light of SAS No. 82 (see AAM section 3140)
  - — Modified audit programs and planning program reflecting SAS No. 82 requirements (see AAM sections 3165 and 5400)
- SAS No. 81, *Auditing Investments*, has been incorporated into the Manual (see the "Investments and Derivatives" audit program at AAM section 5400)
- SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter, has been incorporated into the Manual
- SOP 96-1, *Environmental Remediation Liabilities*, has been incorporated into the Manual (see the "Accrued Liabilities" audit program at AAM section 5400 and the "Planning Program" at AAM section 3165)
- FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, has been incorporated into the Manual (see the "Investments and Derivatives," "Trade Accounts and Notes Receivable," and "Notes Payable and Long-Term Debt" audit programs at AAM section 5400)

Scope of the Volume . . .

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 Team 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
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*.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

AAM Section 1000
Introduction

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

TABLE OF CONTENTS

Section		*Paragraph*
1100	Introduction	.01-.06
1200	How to Use the Audit and Accounting Manual	.01-.17
	Overview	.01
	Audits	.02-.06
	Compilation and Review Services	.07-.16
	Audit Risk Alerts	.17

[*The next page is 1101.*]

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:

Banks and Savings Institutions
Cash- and Tax-Basis Financial Statements
Common Interest Realty Associations
Construction Contractors
Corporations
Defined Benefit Pension Plans
Defined Contribution Pension Plans
Development Stage Enterprises
Health and Welfare Benefit Plans
Health Care Organizations
Investment Companies
Life Insurance Companies
Not-for-Profit Organizations
Oil and Gas Producers
Personal Financial Statements
Property and Liability Insurance Companies
Prospective Financial Statements
Real Estate Ventures
State and Local Governmental Units

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

To order the *Financial Statement Preparation Manual*, write to:

Subscriptions Administration
AICPA
P.O. Box 2208
Jersey City, NJ 07303-9948

Or call the order department at (800) 862-4272.

Gerard Yarnall, Director—Accounting and Auditing Publications

Richard Walker, Publisher—Professional Publications

Mary Schantz, Vice President—Professional Publications

AICPA TECHNICAL HOTLINE

The Technical Hotline answers inquiries about specific audit or accounting problems.

Call Toll Free

(800) TO-AICPA ((800) 862-4272)

This service is free to AICPA members.

[*The next page is 1201.*]

AAM Section 1200

How to Use the Audit and Accounting Manual

Overview

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

- Independence, Integrity, and Objectivity
- Personnel Management
- Acceptance and Continuance of Clients and Engagements
- Engagement Performance
- Monitoring

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 a planning program.

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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 [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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

AAM Section 2000
Compilation and Review

This manual is a nonauthoritative practice aid and 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.

TABLE OF CONTENTS

Section		*Paragraph*
2100	Introduction	.01-.16
2200	Engagement Planning and Administration	.01-.31
	Understanding the Engagement	.04-.14
	Engagement Letters	.06-.14
	Change in Engagement Level of Service	.15-.22
	Predecessor and Successor Accountant	.23-.26
	Client Acceptance and Continuance Form	.27
	Illustrative Engagement Letter for a Compilation	.28
	Illustrative Engagement Letter for a Review	.29
	Illustrative Engagement Letter for Compilation of Personal Financial Statements	.30
	Illustrative Engagement Letter for Review of Personal Financial Statements	.31
2300	Working Papers	.01-.19
	Compilation Engagements	.01-.04
	Compilation Procedures	.02-.03
	Compilation Checklists	.04
	Review Engagements	.05-.13
	Review Procedures—Inquiry	.06-.07
	Review Procedures—Analytical	.08-.11
	Representation Letters	.12
	Review Checklists	.13
	Short-Form Checklist for a Compilation Engagement	.14
	Review of Financial Statements—Illustrative Inquiries	.15
	Illustrative Ratio Analysis Worksheet	.16
	Illustrative Analytical Procedures Comparative Report	.17
	Review of Financial Statements—Illustrative Representation Letter	.18
	Short-Form Checklist for a Review Engagement	.19

Section		*Paragraph*
2400	Form and Content of Financial Statements	.01-.16
	Statements Prepared	.01-.04
	Comparative Financial Statements	.05-.07
	Notes to Financial Statements	.08-.09
	Supplementary Information	.10-.13
	Subsequent Discovery of Facts	.14-.16
2500	Accountants' Reports	.01-.29
	Compilation Report	.07-.11
	Review Report	.12-.17
	Modifications to Standard Report	.18-.29
	Omission of Substantially All Disclosures	.18-.20
	Omission of Statement of Cash Flows	.21
	GAAP Departures	.22-.24
	Scope Limitations	.25-.26
	Going-Concern Uncertainties	.27-.29
2510	Accountants' Reports on Compilation of Financial Statements of a Nonpublic Entity	.01-.21
	Accountants' Standard Report	.01
	Omission of Substantially All Disclosures	.02
	Accountant Not Independent	.03
	Departure From GAAP—Omission of Statement of Cash Flows	.04
	Departure From GAAP—Accounting Principles Not Generally Accepted	.05
	Cash Basis Statements—Full Disclosures	.06
	Cash Basis Statements—Omission of Substantially All Disclosures, With No Reference to Basis	.07
	Income Tax Basis Statements—Full Disclosure	.08
	Income Tax Basis Statements—Omission of Substantially All Disclosures, With No Reference to Basis	.09
	Continuing Accountant's Report on Comparative Statements—Both Periods Compiled	.10
	Continuing Accountant's Report on Comparative Statements—Current Period Compiled With Reference to Review Report on Prior-Period	.11
	Continuing Accountant's Report on Comparative Statements—Both Periods Compiled With Restatement of Prior-Period Financial Statements	.12
	Successor Accountant's Compilation Report on Current-Period Financial Statements That Refers to a Predecessor Accountant's Compilation Report on Prior-Period Financial Statements	.13
	Successor Accountant's Compilation Report on Current-Period Financial Statements That Refers to a Predecessor Accountant's Review Report on Prior-Period Financial Statements	.14
	Continuing Accountant's Report on Comparative Statements—Current Period Compiled With Reference to Audit Report on Prior Period	.15
	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	.16
	Compilation Report—Financial Statements Accompanied by Supplementary Information	.17

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Section		*Paragraph*
2510	Accountants' Reports on Compilation of Financial Statements of a Nonpublic Entity—continued	
	Compilation Report—Emphasis of a Going-Concern Uncertainty	.18
	Interim Historical Financial Statements Accompanied by a Financial Forecast Labeled as a "Budget"	.19
	Comparative Statements—Current Year Compiled and Prior Year Audited by a Different Accountant Who Has Ceased Operations	.20
	Comparative Statements—Both Years Compiled; However, Prior Year by a Different Accountant Who Has Ceased Operations	.21
2520	Accountants' Reports on Review of Financial Statements of a Nonpublic Entity	.01-.17
	Accountant's Standard Report	.01
	Departure From GAAP—Accounting Principle Not Generally Accepted	.02
	Departure From GAAP—Change in Accounting Principle Without Reasonable Justification	.03
	Departure From GAAP—Omission of Statement of Cash Flows	.04
	Cash Basis Statements—Full Disclosure	.05
	Income Tax Basis Statements—Full Disclosure	.06
	Continuing Accountant's Report on Comparative Statements—Both Periods Reviewed	.07
	Continuing Accountant's Report on Comparative Statements—Current Period Reviewed and Prior Period Compiled	.08
	Continuing Accountant's Report on Comparative Statements—Both Periods Reviewed With Restatement of Prior-Period Financial Statements	.09
	Successor Accountant's Review Report on Current-Period Financial Statements That Refers to a Predecessor Accountant's Review Report on Prior-Period Financial Statements	.10
	Successor Accountant's Review Report on Current-Period Financial Statements That Refers to a Predecessor Accountant's Compilation Report on Prior-Period Financial Statements	.11
	Continuing Accountant's Report on Comparative Statements—Current Period Reviewed With Reference to Audit Report on Prior Period	.12
	Review Report—Supplementary Information Subjected to Review Procedures	.13
	Review Report—Supplementary Information Not Subjected to Review Procedures	.14
	Review Report—Emphasis of a Going Concern Uncertainty	.15
	Comparative Statements—Both Years Reviewed; However, Prior Year by a Different Accountant Who Has Ceased Operations	.16
	Comparative Statements—Current Year Reviewed and Prior Year Audited by a Different Accountant Who Has Ceased Operations	.17
2600	Special Areas	.01-.06
	Prescribed Forms	.01-.05
	Specified Elements	.06
2610	Accountants' Reports on Prescribed Forms, BCIP, and Specified Elements	.01-.04
	Financial Statements Included in Certain Prescribed Forms	.01
	Financial Statements Included in Certain Prescribed Forms—Departure From GAAP Not Called for by the Prescribed Forms	.02

Section *Paragraph*

2610 Accountants' Reports on Prescribed Forms, BCIP, and Specified Elements—continued

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

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

[*The next page is 2101.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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*). Thus, if an entity does not fall into either category (*a*), (*b*), or (*c*) in the above definition, it is a nonpublic entity.

.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. 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. SSARSs also gives the following specific 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).

Practice Tip

If prior-period financial statements are not presented in columnar form, they do not meet the SSARS 2 definition of comparative financial statements, and are not subject to the reporting requirements of SSARS 2. In addition, the requirements of SSARS 2 do not apply to prior-period financial statements in a client-prepared document that are presented on separate pages from the financial statements that are reported on by the accountant. However, the document should include an indication (generally, on the face of the financial statements) that the accountant has not compiled or reviewed the prior-period financial statements and assumes no responsibility for them.

.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

---

[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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.).

.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. This alternative form of reporting is available for a compilation service only and not for a review report.

.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).

.11 SSARS 6 (AR section 600) provides an exemption from SSARS 1 (AR section 100) for personal financial statements included in personal financial plans.

.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 and 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 Examples of implementation of a personal financial plan by a client's advisers include use of the plan by—

- An insurance broker who will identify specific insurance products.
- An investment adviser who will provide specific recommendations about the investment portfolio.
- An attorney who will draft a will or trust documents.

.14 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.

.15 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.

.16 Illustrative reports to be issued under the provisions of SSARS 1 through 7 can be found in AAM sections 2510, 2520, and 2610.

[*The next page is 2201.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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, fraudulent financial reporting, and misappropriation of assets, with an indication that the accountant will inform the client of all matters of fraud and material errors, and all illegal acts, unless they are clearly inconsequential, that come to his or her attention.
- 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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:

Part I: 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 completed by the in-charge of the engagement and approved by the engagement partner as a basis for initially accepting the client. Part I should be updated and reviewed annually as a basis for deciding to retain the client.

Part II: Part II should be completed by the engagement partner and concurring partner to document the firm's decision to either accept or reject the client.

CLIENT'S LEGAL NAME:

ADDRESS:

PHONE:	FISCAL YEAR END:

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

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

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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Client Acceptance and Continuance Form—Part I (continued)

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

Name	Percentage 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 accountants regarding the following:

a. Reasons for change of accountant: _____

_____

_____

b. Integrity of management: _____

_____

_____

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

_____

_____

d. Fee disputes: _____

_____

_____

(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 our firm is to provide: _____

	How Often?			Report Deadlines
Service	Monthly	Quarterly	Annually	

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:

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 and owners' reputation, attitude, ability, and integrity:

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

(continued)

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

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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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)?	☐	☐
8.	Is the required staffing or expertise necessary for this engagement beyond our capabilities?	☐	☐

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

TRALKA & ZAWORSKI, P.S. Certified Public Accountants

[*Date*]

Mr. Samuel Kirk, President
Safari Adventures
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 Safari Adventures for the year 19XX. We will not audit or review such financial statements. Our report on the annual financial statements of Safari Adventures is presently expected to read as follows:

   > We have compiled the accompanying balance sheet of Safari Adventures 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 Safari Adventures for the fiscal year ended December 31, 19XX.

Our engagement cannot be relied upon to detect all misstatements that might exist due to error, fraudulent financial reporting, or misappropriation of assets. The Company's management is responsible for establishing and maintaining a sound system of internal control, which is the best means of preventing or detecting errors, fraudulent financial reporting, and misappropriation of assets. We will inform you of all matters of fraud and material errors, and all illegal acts, unless they are clearly inconsequential, that come to our attention.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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:

Safari Adventures

_____

[*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. Daniel Williams
Island Security
50 Main Street
Honolulu, Hawaii 00000

Dear Mr. Williams:

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 Island Security 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 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 detected in an audit. Our engagement cannot be relied upon to detect all misstatements that might exist due to error, fraudulent financial reporting, or misappropriation of assets. The Company's management is responsible for establishing and maintaining a sound system of internal control, which is the best means of preventing or detecting errors, fraudulent financial reporting, and misappropriation of assets. We will inform you of all matters of fraud and material errors, and all illegal acts, unless they are clearly inconsequential, that come to our attention. 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 Island Security 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 Island Security.
>
> 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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 Island Security 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:

Island Security

_____

[*President*]

_____

[*Date*]

.30 Illustrative Engagement Letter for Compilation of Personal Financial Statements

LONGSTREET, JACKSON & 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 the 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 detect all misstatements that might exist due to error, fraudulent financial reporting, or misappropriation of assets. We will inform you of all matters of fraud and material errors, and all illegal acts, unless they are clearly inconsequential, that come to our attention.

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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.31 Illustrative Engagement Letter for Review of Personal Financial Statements

LONGSTREET, JACKSON & 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 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 the 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 detect all misstatements that might exist due to error, fraudulent financial reporting, or misappropriation of assets. We will inform you of all matters of fraud and material errors, and all illegal acts, unless they are clearly inconsequential, that come to our attention. 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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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, committies 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:

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

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

c. 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 test 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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.15 Review of Financial Statements—Illustrative Inquiries

a. General

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

(2) 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)?

(3) Have accounting principles been applied on a consistent basis?

b. Cash

(1) Have bank balances been reconciled with book balances?

(2) Have old or unusual reconciling items between bank balances and book balances been reviewed and adjustments made where necessary?

(3) Has a proper cutoff of cash transactions been made?

(4) Are there any restrictions on the availability of cash balances?

(5) Have cash funds been counted and reconciled with control accounts?

c. Receivables

(1) Has an adequate allowance been made for doubtful accounts?

(2) Have receivables considered uncollectible been written off?

(3) If appropriate, has interest been reflected?

(4) Has a proper cutoff of sales transactions been made?

(5) Are there any receivables from employees and related parties?

(6) Are any receivables pledged, discounted, or factored?

(7) Have receivables been properly classified between current and noncurrent?

d. Inventories

(1) Have inventories been physically counted? If not, how have inventories been determined?

(2) Have general ledger control accounts been adjusted to agree with physical inventories?

(3) 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?

(4) Were consignments in or out considered in taking physical inventories?

(5) What is the basis of valuation?

(6) Does inventory cost include material, labor, and overhead where applicable?

(7) Have write-downs for obsolescence or cost in excess of net realizable value been made?

(8) Have proper cutoffs of purchases, goods in transit, and returned goods been made?

(9) Are there any inventory encumbrances?

e. Prepaid Expenses

(1) What is the nature of the amounts included in prepaid expenses?

(2) How are these amounts amortized?

f. Investment, Including Loans, Mortgages, and Intercorporate Investments

(1) Have gains and losses on disposal been reflected?

(2) Has investment income been reflected?

(3) 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?

(4) Have consolidation or equity accounting requirements been considered?

(5) What is the basis of valuation of marketable equity securities?

(6) Are investments unencumbered?

g. Property and Equipment

(1) Have gains or losses on disposal of property or equipment been reflected?

(2) What are the criteria for capitalization of property and equipment? Have such criteria been applied during the fiscal period?

(3) Does the repairs and maintenance account only include items of an expense nature?

(4) Are property and equipment stated at cost?

(5) What are the depreciation methods and rates? Are they appropriate and consistent?

(6) Are there any unrecorded additions, retirements, abandonments, sales, or trade-ins?

(7) Does the entity have material lease agreements? Have they been properly reflected?

(8) Is any property or equipment mortgaged or otherwise encumbered?

h. Other Assets

(1) What is the nature of the amounts included in other assets?

(2) Do these assets represent costs that will benefit future periods? What is the amortization policy? Is it appropriate?

(3) Have other assets been properly classified between current and noncurrent?

(4) Are any of these assets mortgaged or otherwise encumbered?

i. Accounts and Notes Payable and Accrued Liabilities

(1) Have all significant payables been reflected?

(2) Are all bank and other short-term liabilities properly classified?

(3) Have all significant accruals, such as payroll, interest, and provisions for pension and profit-sharing plans been reflected?

(4) Are there any collateralized liabilities?

(5) Are there any payables to employees and related parties?

j. Long-Term Liabilities

(1) What are the terms and other provisions of long-term liability agreements?

(2) Have liabilities been properly classified between current and non-current?

(3) Has interest expense been reflected?

(4) Has there been compliance with restrictive covenants of loan agreements?

(5) Are any long-term liabilities collateralized or subordinated?

k. Income and Other Taxes

(1) Has provision been made for current and prior-year federal income taxes payable?

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

(2) Have any assessments or reassessments been received? Are there tax examinations in process?

(3) Are there temporary differences? If so, have deferred taxes been reflected?

(4) Has provision been made for state and local income, franchise, sales, and other taxes payable?

l. Other Liabilities, Contingencies, and Commitments

(1) What is the nature of the amounts included in other liabilities?

(2) Have other liabilities been properly classified between current and noncurrent?

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

(4) 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?

m. Equity

(1) What is the nature of any changes in equity accounts?

(2) What classes of capital stock have been authorized?

(3) What is the par or stated value of the various classes of stock?

(4) Do amounts of outstanding shares of capital stock agree with subsidiary records?

(5) Have capital stock preferences, if any, been disclosed?

(6) Have stock options been granted?

(7) Has the entity made any acquisitions of its own capital stock?

(8) Are there any restrictions on retained earnings or other capital?

n. Revenue and Expenses

(1) Are revenues from the sale of major products and services recognized in the appropriate period?

(2) Are purchases and expenses recognized in the appropriate period and properly classified?

(3) Do the financial statements include discontinued operations or items that might be considered extraordinary?

o. Other

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

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

(3) Have there been any material transactions between related parties?

(4) 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 24 financial ratios. These financial ratios include liquidity, activity, and efficiency ratios. Accountants should use the ratios deemed necessary and use additional ones as needed.

Ratio Name	Formula	Calculation	Explanation
Current ratio	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$		measures ability to meet short term obligations
Quick ratio (or Acid test ratio)	$\frac{\text{Current Assets - Inventory}}{\text{Current Liabilities}}$		a more conservative measure of a firm's ability to meet short term obligations
Operating cash flows to current liabilities	$\frac{\text{Cash Provided by Operations}}{\text{Average Current Liabilities}}$		liquidity calculation
Days Sales in Accounts Receivable	$\frac{\text{Net Accounts Receivable}}{\text{Net Sales/360}}$		measures length of time average sales is a receivable
Allowance for bad debts as a % of accounts receivable	$\frac{\text{Allowance for Bad Debts}}{\text{Accounts Receivable}}$		calculation is compared to prior periods and other comparable companies
Bad debt expense as a % of net sales	$\frac{\text{Bad Debt Expense}}{\text{Net Sales}}$		calculation is compared to prior periods and other comparable companies
Inventory Turnover	$\frac{\text{Cost of Sales}}{\text{Inventory}}$		activity ratio – indication of efficiency of operation
Fixed Asset Turnover	$\frac{\text{Net Sales}}{\text{Average Fixed Assets}}$		activity ratio
Receivable Turnover	$\frac{\text{Net Credit Sales}}{\text{Average Receivables}}$		activity ratio
Net Sales to Inventory	$\frac{\text{Net Sales}}{\text{Inventory}}$		activity ratio
Days in Inventory	$\frac{\text{Inventory} \times \text{(Days in a cycle)}}{\text{Cost of Sales}}$		identifies how many days of inventory is available
Accounts Payable to Net Sales	Accounts Payable × (Days in a cycle)/Net Sales × (Days in a year)		compares A/P balance to net sales
Return on Total Assets	Net Income × (Days in a year)/Total Assets × (Days in a cycle)		measures profitability at a point in time
Return on Net Worth	Net Income × (Days in a year)/Net Worth × (Days in a cycle)		profitability measure
Return on Net Sales	$\frac{\text{Net Income}}{\text{Net Sales}}$		profit margin
Net Sales to Accounts Receivable	$\frac{\text{Net Sales} \times \text{(Days in a year)}}{\text{Net A/R} \times \text{(Days in a cycle)}}$		identifies how many times A/R will turn over per year of the operating cycle
Net Sales to Net Fixed Assets	$\frac{\text{Net Sales} \times \text{(Days in a year)}}{\text{Fixed Assets} \times \text{(Days in a cycle)}}$		identifies efficiency of capital investment

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Ratio Name	Formula	Calculation	Explanation
Days Payables in Cost of Sales	$\frac{A/P \times (\text{Days in a cycle})}{\text{Cost of Sales}}$		
Income Before Tax to Net Worth	$\frac{EBIT \times (\text{Days in a year})}{\text{Net Worth} \times (\text{Days in a cycle})}$		ratio of earnings to net worth per year
Gross Profit Percentage	$\frac{\text{Net Sales - Cost of Sales}}{\text{Net Sales}}$		profitability calculation
Operating Expenses as a % of Net Sales	$\frac{\text{Operating Expenses}}{\text{Net Sales}}$		efficiency calculation
Times Interest Earned	$\frac{EBIT}{\text{Interest Expense}}$		profitability calculation
Income Before Tax to Assets	$\frac{EBIT \times (\text{Days in a year})}{\text{Assets} \times (\text{Days in a cycle})}$		measure of profitability
Altman Z Score	See Below		A composite formula that is widely used to measure the financial "health" of a company. The formula takes financial ratios and multiplies each by a specific constant. The amounts computed are added together to obtain an overall score. This score is then compared to scores from other companies to rate relative financial health.

For private companies (four variable):

$\frac{\text{Working Capital}}{\text{Total Assets}}$	×	6.56	=
$\frac{\text{Retained Earnings}}{\text{Total Assets}}$	×	3.26	=
$\frac{\text{Income before Interest and Taxes}}{\text{Total Assets}}$	×	6.72	=
$\frac{\text{Net Worth}}{\text{Total Liabilities}}$	×	1.05	=
		Altman Z Score	

For private companies (five variable):

$\frac{\text{Working Capital}}{\text{Total Assets}}$	×	.717	=
$\frac{\text{Retained Earnings}}{\text{Total Assets}}$	×	.847	=
$\frac{\text{Income before Interest and Taxes}}{\text{Total Assets}}$	×	3.107	=
$\frac{\text{Net Worth (Book Value)}}{\text{Total Liabilities}}$	×	.420	=
$\frac{\text{Sales}}{\text{Total Assets}}$	×	.998	=
		Altman Z Score	

For public companies:

$\frac{\text{Working Capital}}{\text{Total Assets}}$	×	.012	=
$\frac{\text{Retained Earnings}}{\text{Total Assets}}$	×	.014	=
$\frac{\text{Income before Interest and Taxes}}{\text{Total Assets}}$	×	.033	=
$\frac{\text{Market Value Equity}}{\text{Book Value of Total Liabilities}}$	×	.006	=
$\frac{\text{Sales}}{\text{Total Assets}}$	×	.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 and Sons.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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 balance sheet of (*name of client*) as of (*financial statement date*) and the related statements of income, retained earnings, and cash flows for the (*period*) then ended, 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 (or other comprehensive basis of accounting), 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) 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)

Note: This representation letter should be modified when the financial statements are prepared in accordance with an other comprehensive basis of accounting.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 Financial Statement Preparation Manual/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 by containing a reference such as "See 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. Oftentimes 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 client should understand the statements and related notes 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 or she 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 basic financial statements are reviewed, the accountant may indicate the degree of responsibility he or she is taking with respect to the other information by an explanation in the review report or in a separate report on the other data. The explanation should state that the review has been made for the purpose of expressing limited assurance and 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

---

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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

[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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

---

* 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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

* 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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

* 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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

---

* 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.

---

* 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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

[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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

---

* 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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

AAM Section 3000
Engagement Planning and Administration

Sections 3165, 3170, and 3175 include illustrative audit assignment control forms, engagement letters, and an illustrative planning program 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.

TABLE OF CONTENTS

Section		*Paragraph*
3100	Planning the Engagement	.01-.06
3105	Understanding the Assignment	.01-.06
3110	Assigning Personnel to the Engagement	.01-.09
	General Comments	.01-.02
	Engagement Planning Procedures	.03-.09
3115	Independence	.01-.08
	General Comments	.01-.03
	Engagement Planning Procedures	.04-.08
3120	Knowledge of the Entity's Business	.01-.06
	Engagement Planning Procedures	.02-.06
3125	Consideration of Internal Control	.01-.49
	Introduction	.01-.05
	What Auditors Should Understand About Internal Control	.06-.24
	How an Auditor Obtains an Understanding of Internal Control	.25-.34
	Using Internal Control Information to Plan the Audit	.35-.44
	Choosing an Audit Strategy	.45-.49
3130	Preparing an Engagement Letter	.01-.16
	Special Considerations	.07
	Contents of Engagement Letters	.08-.11

Section		Paragraph
3130	Preparing an Engagement Letter—continued	
	Investigatory Procedures for Individuals	.12-.13
	Filing of Engagement Letters	.14-.16
3140	Assessing Audit Risk and Materiality	.01-.44
	General	.01-.02
	Material Misstatements	.03-.08
	Errors and Fraud	.06-.08
	Consideration at the Financial Statements Level	.09-.21
	Materiality	.12-.15
	Quantifying Materiality	.16-.18
	Example	.19
	Exhibit I	.20-.21
	Consideration at the Individual Account-Balance or Class-of-Transactions Level	.22-.28
	Components of Risk	.24-.28
	Risk Assessment	.29-.31
	Quantifying Risk	.32-.33
	Evaluating Audit Findings	.34-.44
	Likely Misstatements	.35-.38
	Known Misstatements	.39
	Misstatements from the Prior Year	.40
	Summarizing and Evaluating Misstatements	.41-.44
3145	Fraud	.01-.29
	General	.01-.02
	Description and Characteristics of Fraud	.03-.05
	Misstatements Arising From Fraudulent Financial Reporting	.04
	Misstatements Arising From Misappropriation of Assets	.05
	Considering the Presence of Fraud Risk Factors	.06-.10
	Misstatements Arising From Fraudulent Financial Reporting	.08
	Misstatements Arising From Misappropriation of Assets	.09-.10
	Assessment of Risk of Material Misstatement Due to Fraud	.11-.14
	The Auditor's Response	.15-.18
	Overall Response	.16-.17
	Account Balance, Class of Transactions, Assertion Level Response	.18
	Evaluation of Audit Test Results	.19-.22
	Documentation	.23
	Communication	.24-.26
	Using the AICPA *Audit and Accounting Manual* in Considering Fraud	.27-.29
3150	Illegal Acts	.01-.11
	General Comments	.01-.02
	Direct and Material Effect Illegal Acts	.03-.05
	Other Illegal Acts	.06-.07
	Engagement Planning Procedures	.08-.11
3155	Analytical Procedures	.01-.07
	General Comments	.01-.03
	Engagement Planning Procedures	.04-.07
3165	Illustrative Planning Program	.01-.12
	A. Understanding the Assignment	.01

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Section *Paragraph*

3165 Illustrative Planning Program—continued
- B. Assigning Personnel to the Engagement 02
- C. Independence 03
- D. Knowledge of the Entity's Business 04
- E. Assessing Auditability 05
- F. Engagement Letter 06
- G. Assessing Audit Risk and Materiality 07
- H. Assessment of Control Risk 08
- I. Illegal Acts 09
- J. Analytical Procedures 10
- K. Audit Strategies and the Audit Program 11
- L. Fraud Risk Factor Memory Jogger 12

3170 Audit Assignment Controls 01-.05
- Audit Time Budget—Sample A 01
- Audit Time Budget—Sample B 02
- Audit Time Analysis (Short Form) 03
- Audit Time Analysis (Long Form) 04
- Weekly Progress Report 05

3175 Sample Engagement Letters 01-.08
- Audit Engagement Leading to Opinion 02
- SEC Engagement: Form 10-K and Annual Report to Shareholders 03
- Change in Circumstances From Those Contemplated in Original Engagement Letter 04
- Conditions Encountered Which Do Not Permit Expression of Opinion as Anticipated in Original Engagement Letter 05
- SEC Engagement: Initial Registration, Form S-1 06
- Sample Engagement Memorandum (When No Formal Engagement Letter Is Sent) 07
- Audit of Personal Financial Statements 08

[*The next page is 3101.*]

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 audibility 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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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, 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 AICPA 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* at AAM section 11,200. Sample quality control forms are available at AAM section 11,300, which are 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 knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the level of risk for the engagement (see AAM section 3140). 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 the conduct of the engagement.

.08 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.

.09 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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

[*The next page is 3181.*]

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, that 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 and corroborating evidential matter 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 or her 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 controls or to design and perform audit procedures. If specialized skills are needed, the accountant should seek assistance from a professional who may be or may not be on 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

[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).

the results of the procedures applied as they relate to the nature, timing, and extent of other planned 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 information in planning the audit because such methods influence the design of the accounting system and the nature of control procedures. Because of the growth in the use of computers and other information technology, many entities process significant information electronically. In those circumstances, the nature, timing, and extent of audit procedures will be affected in various ways depending upon a number of factors that the auditor should consider, including:

a. The extent to which computers and other information technology are used in every significant accounting application.

b. Whether or not the application generates a financial statement line item or provides a basis for an accounting estimate.

c. The significance of the financial statement line item(s) affected by the client's use of technology.

d. The controls placed over the application or system.

e. The effectiveness of the design and operation of those controls.

f. The complexity of the entity's information technology operations, including the use of an outside service center.[3]

g. The organizational structure of the information technology activities.

h. The availability of and access to evidence. Certain electronic evidence may exist at a certain point in time. However, such evidence may not be retrievable after a specified period of time if files are changed and if backup files do not exist.

i. The use of computer-assisted audit techniques to increase the efficiency of performing audit procedures. 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.

Practice Tip

The AICPA's Auditing Procedure Study entitled, *Auditing With Computers,* provides practical and helpful guidance in using technology to your advantage during an audit. Call the AICPA at 1 (800) 862-4272 and ask for product no. 021057.

In addition, certain information generated by the computer for management's internal purposes may be useful in performing substantive tests (particularly analytical procedures).[4]

---

[2] Since the use of a specialist who is effectively functioning as a member of the audit team is not covered by SAS No. 73, *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 Auditing Procedure Study, *Implementing SAS No. 70,* Reports on the Processing of Transactions by Service Organizations (product no. 021056), for guidance concerning the use of a service center for computer processing of significant accounting applications.

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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.06 It is recommended that all procedures discussed in this section be documented in the accountant's work papers. An illustrative planning program for documenting the procedures listed in this section is located in AAM section 3165.

[*The next page is 3201.*]

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 information 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 information about those transactions are entered into and flow through the financial reporting system.
- The files that are processed.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- 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 Controls designed to prevent or detect misappropriations of assets may include controls relating to financial reporting and operations objectives. For example, use of a lockbox system for collecting cash or 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 (e.g., 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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. The understanding often will affect the auditor's consideration of the significance of fraud risk factors. In addition, when considering the significance of fraud risk factors (see AAM section 3145), the auditor may wish to assess whether there are specific controls that mitigate the risk or whether specific control deficiencies may exacerbate the risk.

.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 (however, see paragraph .40 below), where control risk is assessed at or slightly below the maximum, or
- An approach where control risk is assessed below the maximum.

.40 In entities where significant information is transmitted, processed, maintained, or accessed electronically, the ability to perform an audit consisting entirely of substantive tests may be either absent or ineffective. When using electronic evidence, auditors need to question the appropriateness of the traditional approach

of increasing testing if ineffective controls exist, or if assessed control risk is at the maximum level. **If control risk is assessed at maximum, an auditor who performs only substantive tests of electronic evidence may not be able to obtain sufficient competent evidential matter.** For example, a purchase order transmitted electronically from a customer derives its credibility primarily from the controls within the electronic environment. A fraudulent or altered electronic purchase order exhibits no apparent difference, compared to a valid purchase order, when extracted from the electronic environment of the entity. Without testing the internal control surrounding the electronic evidence, a lack of credibility may not be recognized by the auditor. In such circumstances, the auditor should perform tests of controls surrounding the electronic environment to gather evidential matter to use in assessing control risk, or consider the effect on the auditor's report.

Practice Tip

The AICPA has published a practice aid entitled, *The Information Technology Age: Evidential Matter in the Electronic Environment* (product no. 021068). This publication provides valuable help for practitioners auditing in environments where electronic evidence is significant, by addressing the various issues concerning electronic evidence. Call 1 (800) 862-4272 for more information.

.41 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.

.42 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 (however, see paragraph .40 above), and for other assertions, the auditor may plan to assess control risk below the maximum.

.43 *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.*

.44 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

.45 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 audit approach. Nevertheless, even with a primarily substantive approach it is usually necessary to test controls surrounding electronic evidence, given the fact that the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness. See paragraph .40 above.

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

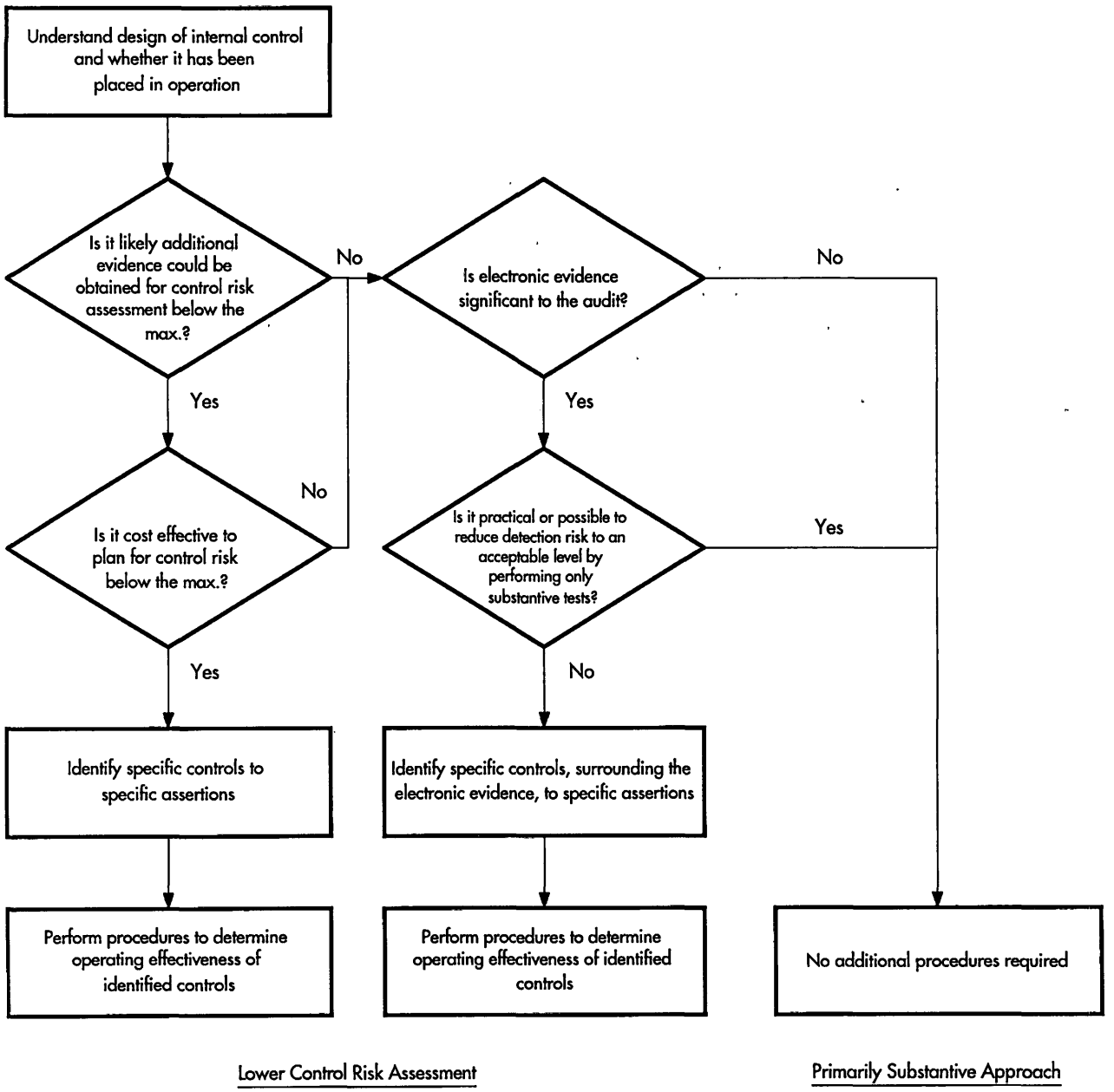
Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- 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.

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

.48 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. Furthermore, as stated above, the appropriateness of relying on substantive tests alone if control risk is assessed at maximum may not be appropriate in environments where electronic evidence is significant.

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



[*The next page is 3221.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- 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).

- Misstatements

  A statement that, "the audit is designed to provide reasonable assurance of detecting misstatements that, in the auditor's judgment, could have a material effect on the financial statements taken as a whole. Consequently, the audit will not necessarily detect all misstatements that might exist due to error, fraudulent financial reporting, or misappropriation of assets. The Company's management is responsible for establishing and maintaining a sound system of internal control, which is the best means of preventing or detecting errors, fraudulent financial reporting, and misappropriation of assets. We will inform you of all matters of fraud and material errors, and all illegal acts, unless they are clearly inconsequential, that come to our 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 of interim auditing procedures.

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 Related Matters Noted in an Audit*, as amended by SAS No. 78 [AU section 325].)

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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

General

.01 Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures. The existence of audit risk is recognized in the description of the responsibilities and functions of the independent auditor that states, "Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected."[1] Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. In other words, audit risk is the risk that the auditor will issue an unqualified opinion on financial statements that are materially incorrect.

.02 Financial statements are **materially** misstated when they contain misstatements whose effect, individually or in the aggregate, are important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles. Materiality is the criterion used by accountants and auditors to distinguish between unimportant and important matters. The auditor's consideration of materiality is a matter of professional judgment and is influenced by a perception of the needs of a reasonable person who will rely on the financial statements. The perceived needs of a reasonable person are recognized in the discussion of materiality in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, which defines materiality as:

> "The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

Material Misstatements

.03 Misstatements can result from errors or fraud.[2]

The risk that misstatements will occur results generally from weaknesses in internal control, inherent risks in certain transactions and account balances, material and unusual account balances, and the client's history of misstatements.

.04 Because the auditor's opinion is based on the concept of reasonable assurance, auditors cannot guarantee that financial statements are free from material misstatements due to errors and fraud. However, they must exercise due care in planning, performing, and evaluating the results of the audit and must apply the appropriate level of professional skepticism to achieve reasonable assurance that the material errors and fraud will be detected.

---

[1] See SAS No. 1, sections 110, *Responsibilities and Functions of the Independent Auditor*, as amended by SAS No. 82, and section 230, *Due Professional Care in the Performance of Work* (AU sections 110 and 230), for a further discussion of reasonable assurance.

[2] The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in SAS No. 54, *Illegal Acts by Clients* (AU section 317). See AAM section 3150, *Illegal Acts*. For those illegal acts that are defined in that Statement as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts if the same as that for errors or fraud.

.05 In planning auditing procedures, the auditor should also consider the nature, cause (if known), and amount of misstatements that he is aware of from the audit of the prior period's financial statements.

Errors and Fraud

.06 The term "errors" refers to unintentional misstatements or omissions of amounts or disclosures in financial statements. Errors may involve—

- Mistakes in gathering or processing information from which financial statements are prepared.
- Unreasonable accounting estimates arising from oversight or misinterpretation of facts.
- Mistakes in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure.

.07 See AAM section 3145 for a discussion on fraud.

.08 When considering the auditor's responsibility to obtain reasonable assurance that the financial statements are free from material misstatement, there is no important distinction between errors and fraud. There is a distinction, however, in the auditor's response to detected misstatements. Generally, an isolated, immaterial error in processing accounting information or applying accounting principles is not significant to the audit. In contrast, when fraud is detected, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

Consideration at the Financial Statements Level

.09 The auditor should plan the audit so that audit risk will be limited to a low level that is, in his professional judgment, appropriate for expressing an opinion on the financial statements. Audit risk may be assessed in quantitative or nonquantitative terms.

.10 An assessment of the risk of material misstatement (whether caused by error or fraud) should be made during planning. The auditor's understanding of internal control may heighten or mitigate the auditor's concern about the risk of material misstatement. The auditor should specifically assess the risk of material misstatement of the financial statements due to fraud (see AAM section 3145). The auditor should consider the effect of these assessments on the overall audit strategy and the expected conduct and scope of the audit.

.11 Whenever the auditor has concluded that there is significant risk of material misstatement of the financial statements, the auditor should consider this conclusion in determining the nature, timing, or extent of procedures; assigning staff; or requiring appropriate levels of supervision. Ordinarily, higher risk requires more experienced personnel or more extensive supervision. 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.

Materiality

.12 In planning the audit, the auditor should use his or her judgment as to the appropriately low level of audit risk and his or her preliminary judgment about materiality levels in a manner that can be expected to provide, within the inherent limitations of the auditing process, sufficient evidential matter to obtain reasonable assurance about whether the financial statements are free of material misstatement. Materiality levels include an overall level for each financial statement; however, because the statements are interrelated, and for reasons of efficiency, the auditor ordinarily considers materiality for planning purposes in terms of the smallest aggregate level of misstatements that could be considered material to any one of the financial

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

statements. Accordingly, auditors should establish a preliminary materiality threshold for the purpose of planning the appropriate auditing procedures to detect material misstatements in the financial statements.

.13 The auditor plans the audit to obtain reasonable assurance of detecting misstatements that he or she believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. Although the auditor should be alert for misstatements that could be qualitatively material, it ordinarily is not practical to design procedures to detect them. 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. 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.

.14 In some situations, the auditor considers materiality for planning purposes before the financial statements to be audited are prepared. In other situations, planning takes place after the financial statements under audit have been prepared, but the auditor may be aware that they require significant modification. In both types of situations, the auditor's preliminary judgment about materiality might be based on the entity's annualized interim financial statements or financial statements of one or more prior annual periods, as long as recognition is given to the effects of major changes in the entity's circumstances and relevant changes in the economy as a whole or the industry in which the entity operates.

.15 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 the sufficiency of the auditing procedures that were performed.

Quantifying Materiality

.16 Although no authoritative body has established specific guidelines for materiality, there are certain rules of thumb that can be used in making a preliminary assessment of materiality.

.17 Generally, 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 income before taxes, revenues, and total assets. Generally, misstatements become material to income before they become material to the balance sheet. As a consequence, net income before taxes is often selected as the base.

.18 In small business audits, auditors sometimes make a number of significant audit adjustments. Thus, income before taxes may vary too much to be useful as a base. When income before taxes is not used as a base, auditors sometimes use either total revenue or an average of net income for several prior periods.

Example

.19 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 line *1* or line *2*	_____
4.	Select a multiplier if audit risk is normal, or, if better than normal, select .01	_____
5.	Multiply line *3* by line *4*	_____
6.	Unaudited pretax income (or equivalent if not a for-profit entity)	_____
7.	Select a multiplier if audit risk is normal, or, if better than normal, select .1	_____
8.	Multiply line *6* by line *7*	_____
9.	Evaluate line *5* and line *8* along with other relevant factors and determine materiality for audit planning purposes	_____

.20 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 not-for-profit organization, for example, the auditor would probably use total assets or revenues as a base, since pretax income is not meaningful.

.21 A sample checklist documenting procedures listed in this section is located in AAM section 3165.

Consideration at the Individual Account-Balance or Class-of-Transactions Level

.22 The auditor needs to consider audit risk at the individual account-balance or class-of-transactions level because such consideration directly assists in determining the scope of auditing procedures for the balance or class and related assertions. The auditor should seek to restrict audit risk at the individual balance or class level in such a way that will enable him or her, at the completion of the audit, to express an opinion on the financial statements taken as a whole at an appropriately low level of audit risk. Auditors use various approaches to accomplish their objective.

.23 In determining the nature, timing, and extent of auditing procedures to be applied to a specific account balance or class of transactions, the auditor should design procedures to obtain reasonable assurance of detecting misstatements that he or she believes, based on the preliminary judgment about materiality,

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

could be material, when aggregated with misstatements in other balances or classes, to the financial statements, taken as a whole. Auditors use various methods to design procedures to detect such misstatements. In some cases, auditors explicitly estimate, for planning purposes, the maximum amount of misstatements in the balance or class, that, when combined with misstatements in other balances or classes, could exist without causing the financial statements to be materially misstated. In other cases, auditors relate their preliminary judgment about materiality to a specific account balance or class of transactions without explicitly estimating such misstatements.

Components of Risk

.24 At the account-balance or class-of-transaction level, audit risk consists of:

a. The risk (consisting of inherent risk and control risk) that the balance or class and related assertions contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other balances or classes, and

b. The risk (detection risk) that the auditor will not detect such misstatements.

The way the auditor considers these component risks and combines them involves professional judgment and depends on the audit approach.

.25 ***Inherent risk*** is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls. 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 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. In addition to those factors that are peculiar to a specific assertion for an account balance or a class of transactions, factors that relate to several or all of the balances or classes may influence the inherent risk related to an assertion for a specific balance or class. These later factors include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.

.26 ***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. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control.

.27 ***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 a 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.

.28 Inherent risk and control risk differ from detection risk in that they exist independently of the audit of 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. These components of audit risk may be assessed

in quantitative terms such as percentages or in nonquantitative terms that range, for example, from a minimum to a maximum (e.g., low, moderate, high).

Risk Assessment

.29 The process of assessing risk is aimed at evaluating the risk of the financial statements being materially misstated. During planning, the auditor considers numerous factors—risk at the financial statement level and at the account-balance and class-of-transaction level, inherent risk, control risk, materiality, risk of material misstatement due to fraud, preliminary analytical review, and other matters as appropriate and in accordance with his or her judgment. An audit strategy is devised and carried out. Reliance on and testing of internal control may or may not be a part of that strategy. Based on the outcome of any internal control testing, the nature, timing and extent of substantive tests are reassessed and possibly changed. Substantive tests are performed. At the end of the audit, the auditor considers the audit procedures performed and their results and evaluates the chance that material misstatements have gone undetected by his or her audit procedures. Generally, in an audit that is adequately planned and performed, the auditor will be able to conclude that the risk of the financial statements being materially misstated is acceptably low enough for an unqualified opinion to be issued.

.30 The auditor might make separate or combined assessments of inherent risk and control risk. If the auditor considers inherent risk or control risk, separately or in combination, to be less than the maximum, he should have an appropriate basis for these assessments. This basis may be obtained, for example, through the use of questionnaires, checklists, instructions, or similar generalized materials and, in the case of control risk, the understanding of internal control and the performance of suitable tests of controls. However, professional judgment is required in interpreting, adapting, or expanding such generalized material as appropriate in the circumstances.

.31 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

.32 The auditor's assessment of risk and its components of inherent risk, control risk, and detection risk are matters of professional judgment. The types of risk discussed above are difficult to quantify, given their subjective nature. Most auditors use ratings such as low, moderate, or high when judging risk levels.

.33 Generally accepted auditing standards do not require the auditor to quantify risks. Those standards require the auditor to plan the audit so that there is a low level of risk that an unqualified opinion will be expressed when the financial statements are materially misstated.

Evaluating Audit Findings

.34 In evaluating whether the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, the auditor should aggregate misstatements that the entity has not corrected in a way that enables him or her to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole. Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Likely Misstatements

.35 The auditor's best estimate of the total misstatements in the account balances or classes of transactions that he or she has examined is referred to as "likely misstatements."

.36 When the auditor tests an account balance or a class of transactions and related assertions by an analytical procedure, he or she ordinarily would not specifically identify misstatements but would only obtain an indication of whether a misstatement might exist in the balance or class and possibly its approximate magnitude. If the analytical procedure indicates that a misstatement might exist, but not its approximate amount, the auditor ordinarily would have to employ other procedures to enable him to estimate the likely misstatement in the balance or class.

.37 When an auditor uses audit sampling to test an assertion for an account balance or a class of transactions, he or she projects the amount of known misstatements identified in the sample to the items in the balance or class from which the sample was selected. For example, if a $1,000 loan receivable misstatement is found in a sample of 10 percent of the population, the projected misstatement would be $10,000. That projected misstatement also contributes to the auditor's assessment of likely misstatement.

.38 When auditing accounting estimates (e.g., allowance for inventory obsolescence, allowance for doubtful accounts, warranty obligations, etc.) the audit evidence gathered may support an amount for an estimate different from the amount the client has recorded. That difference may be considered reasonable by the auditor inasmuch as no one accounting estimate can be considered accurate with certainty. In that case, the difference between the estimate that the audit evidence supports and the estimate recorded in the financial statements would not be considered a likely misstatement. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he or she should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement.

Known Misstatements

.39 "Known misstatements" are those for which the amount of the error is relatively certain. Such misstatements are often supported by highly reliable evidence, such as third-party documents. An example of a known misstatement would be a failure to record an invoice for repairs expense.

Misstatements From the Prior Year

.40 Often overlooked is the consideration of misstatements detected in the prior year that affect the current year. For example, assume last year's aggregation of uncorrected misstatements included an item representing an overstatement of prepaid insurance and an understatement of insurance expense. This item would be included in the current year's aggregation of uncorrected misstatements because it affects the current year's insurance expense. Therefore, the prior year's aggregation of uncorrected misstatements should be reviewed for any items that may have an effect on the current year's financial statements.

Summarizing and Evaluating Misstatements

.41 Most firms prepare a summary of the uncorrected misstatements identified during the audit. This summary may be called the "Summary of Misstatements," or the "Summary of Possible Journal Entries," or other names. The summary presents known, likely, and prior period misstatements separately. The summary is used in evaluating the effect of uncorrected misstatements on the financial statements at the end of the audit.

.42 Some firms establish a predetermined dollar threshold below which misstatements need not be accumulated. This amount should be set so that any such misstatements, either individually, or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered.

.43 Concluding on the effect of misstatements on the financial statements is a matter of judgment and generally involves considering the nature of the misstatements, overall materiality, and their impact on the financial statements taken as a whole.

.44 If the auditor concludes, based on the accumulation of sufficient evidential matter, that the aggregation of uncorrected misstatements causes the financial statements to be materially misstated, the auditor should request management to eliminate the material misstatement. If the material misstatement is not eliminated, the auditor should issue a qualified or an adverse opinion on the financial statements.

[*The next page is 3291.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

AAM Section 3145
Fraud

General

.01 SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor*, as amended by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* [appendix A] (AU section 110), states that "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or *fraud*." Management is responsible for the prevention and detection of fraud. That responsibility is described in paragraph 3 of SAS No. 1, section 110 (AU section 110.03).

.02 An auditor's responsibilities relating to fraud are stated within the context of materiality to the financial statements taken as a whole. An auditor is not responsible for detecting fraud per se, but for obtaining reasonable assurance that *material* misstatements caused by fraud are detected. An auditor is not responsible for detecting immaterial misstatements caused by fraud. To fulfill his or her responsibilities related to fraud, an auditor is required by SAS No. 82 (AU section 316) to:

- Consider the presence of fraud risk factors during all stages of the audit process.
- Based on the risk factors present, make an assessment of the risk of material misstatement due to fraud.
- Based on that assessment, develop an appropriate response.

Description and Characteristics of Fraud

.03 The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement in financial statements is intentional or unintentional. Fraud frequently involves a pressure or an incentive to commit fraud and a perceived opportunity to do so. Fraud may be concealed through falsified documentation, including forgery, and it may be concealed through collusion among management, employees, or third parties. Two types of misstatements are relevant to the auditor's consideration of fraud in a financial statement audit—misstatements arising from fraudulent financial reporting, and misstatements arising from misappropriation of assets.

Misstatements Arising From Fraudulent Financial Reporting

.04 Misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve acts such as the following:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

Misstatements Arising From Misappropriation of Assets

.05 Misstatements arising from misappropriation of assets involve the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented in conformity with generally accepted accounting principles. Misappropriation can be accomplished in various ways, including embezzling receipts, stealing assets, or causing an entity to pay for goods or services not received. Misappropriation of assets may be accompanied by false or misleading records or documents and may involve one or more individuals among management, employees, or third parties.

Considering the Presence of Fraud Risk Factors

.06 Although fraud usually is concealed, the presence of risk factors or other conditions may alert the auditor to a possibility that fraud may exist. An auditor should become familiar with these risk factors and be alert to their presence at their clients. It is important to remember that the presence of risk factors or other conditions may be the result of circumstances *other than fraud.* Also, risk factors and conditions will be present in entities where the specific circumstances do not present a risk of material misstatement. Finally, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present.

.07 In fulfilling his or her responsibilities relating to fraud, an auditor should begin by identifying the presence of fraud risk factors. Fraud risk factors may be identified while performing procedures relating to acceptance or continuance of clients and engagements, during engagement planning or while obtaining an understanding of an entity's internal control, or while conducting fieldwork. SAS No. 82 (AU section 316) lists example fraud risk factors arranged in various categories. An auditor is not required to consider all of the risk factors listed in SAS No. 82 (AU section 316) since not all of the examples are relevant in all circumstances. Professional judgment should be used in determining which example risk factors are relevant in a specific audit engagement. An auditor *is required* to consider fraud risk factor categories that embody the substance of the categories listed in SAS No. 82 (AU section 316). These categories are:

Misstatements Arising From Fraudulent Financial Reporting

.08

- *Management's Characteristics and Influence Over the Control Environment.* These pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.
- *Industry Conditions.* These involve the economic and regulatory environment in which the entity operates.
- *Operating Characteristics and Financial Stability.* These pertain to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.

Misstatements Arising From Misappropriation of Assets

.09

- *Susceptibility of Assets to Misappropriation.* These pertain to the nature of an entity's assets and the degree to which they are subject to theft.
- *Controls.* These involve the lack of controls designed to prevent or detect misappropriations of assets.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Practice Tip

Identifying fraud risk factors, assessing fraud-related risk and complying with your responsibilities under SAS No. 82 (AU section 316) can be challenging. Valuable help can be found in the AICPA's practice aid, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (product no. 008883). This plain-speaking publication walks you through the issues likely to be encountered and provides valuable tools, such as sample documentation, descriptions of common frauds, and extended audit procedures. It also includes specific guidance on applying its concepts to eleven different industries, including specific *fraud risk factors tailored to those industries*. To obtain this worthwhile publication call the AICPA Order Department at 1 (800) 862-4272.

.10 Auditors should actively seek out the presence of fraud risk factor categories described above, or different categories with the same substance. Fraud risk factors can be identified by any audit team member at any stage of the audit. For that reason, it is important that all engagement members be properly trained to identify fraud risk factors when they are present.

Assessment of Risk of Material Misstatement Due to Fraud

.11 The auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider identified fraud risk factors which relate to the categories presented above. As part of the risk assessment, the auditor also should inquire of management (*a*) to obtain management's understanding regarding the risk of fraud in the entity and (*b*) to determine whether they have knowledge of fraud that has been perpetrated on or within the entity.

.12 The assessment of risk of material misstatement due to fraud, although a separate process, can be performed in conjunction with the assessments of inherent risk and control risk, since many of the example fraud risk factors listed in SAS No. 82 (AU section 316) are similar to the factors an auditor would consider when assessing inherent and control risk.

.13 Assessing the risk of material misstatement due to fraud is a cumulative process that includes a consideration of risk factors individually and in combination, using professional judgment. Fraud risk factors cannot be easily ranked in order of importance or combined into effective predictive models. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant risk factors. The auditor's understanding of the entity's internal control will also affect his or her consideration of the significance of fraud risk factors. Additionally, if the entity has established a program that includes steps to prevent, deter, and detect fraud, the auditor may consider its effectiveness.

.14 After an assessment of the risk of material misstatement due to fraud is made, other conditions (such as discrepancies in the accounting records, conflicting or missing evidential matter, or problematic or unusual relationships between the auditor and client) may be identified during fieldwork that change or support an auditor's judgment regarding that assessment.

The Auditor's Response

.15 After an assessment of the risk of material misstatement due to fraud is made, a suitable audit response must be developed. As with other risk assessments, the greater the risk, the more extensive the audit procedures need to be in order to obtain reasonable assurance that the financial statements are free of material misstatement. In some cases, even though fraud risk factors have been identified, the auditor's judgment may be that audit procedures otherwise planned are sufficient to respond to the risk factors. In other circumstances, the auditor may conclude that the conditions indicate a need to modify procedures. In these circumstances, the auditor's response can be (1) an overall response, (2) a response that is specific to a particular account balance, class of transaction, or assertion, or (3) a combination of (1) and (2).

Overall Response

.16 An auditor may perform an overall response to the risk of material misstatement due to fraud in the following ways:

- *Professional Skepticism.* An auditor may heighten his or her professional skepticism by (1) increasing sensitivity in the selection of the nature and extent of documentation to be examined, and by (2) increasing recognition of the need to corroborate management's explanations or representations.
- *Assignment of Personnel.* Decisions regarding the qualifications of the staff performing the audit work and the level of supervision required should take into account the assessment of the risk of material misstatement due to fraud.
- *Accounting Principles and Policies.* The auditor may intensify his or her consideration of the appropriateness of accounting principles selected and policies adopted by management in light of the fraud risk assessment.
- *Controls.* When a risk of material misstatement due to fraud relates to risk factors that have control implications, the auditor's ability to assess control risk below the maximum may be reduced. An auditor should understand and consider any controls (or lack thereof) the entity has in place to address the identified fraud risk factors. Management's ability to override such controls should also be considered.

.17 Additionally, in an overall response the *nature* of audit procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroboration. Also, the *timing* of substantive tests may need to be altered to be closer to or at year end. Finally, the *extent* of the procedures applied should reflect the assessment of the risk of material misstatement due to fraud.

Account Balance, Class of Transactions, Assertion Level Response

.18 Specific responses to the auditor's assessment of the risk of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified and the account balances, classes of transactions, and assertions they may affect. If these factors or conditions indicate a particular risk applicable to specific account balances or types of transactions, audit procedures addressing these specific areas should be considered that will, in the auditor's judgment, limit audit risk to an appropriate level in light of the risk factors or conditions identified. Presented below are some examples of specific responses to the risk of material misstatement due to fraud.

- Search for and examine unusual expense account activity close to the end of an accounting period (Cash).
- Analyze and review credit memos and other accounts receivable adjustments for the period subsequent to the balance sheet date (Revenue Recognition).
- Review receiving reports and look for indications of alternative shipping sites (Inventory).
- Expand the number of test counts (Inventory).
- Determine if vendors are listed in the yellow pages of the phone book. Call vendors if considered necessary (Purchasing).

Evaluation of Audit Test Results

.19 At the completion of the audit, the auditor should consider whether the accumulated results of audit procedures and other observations affect the assessment of the risk of material misstatement due to fraud

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

he or she made when planning the audit. This consideration may provide further insight into the risk of material misstatement due to fraud and whether there is a need for additional or different audit procedures to be performed.

.20 If audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. If the auditor has determined that misstatements are or may be the result of fraud, but the effect of the misstatements is not material, the auditor nevertheless should evaluate the implications for other aspects of the audit (e.g., nature, timing, extent of audit procedures, control effectiveness assessment).

.21 If the auditor has determined that the misstatement is, or may be, the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should:

- Consider the implications for other aspects of the audit.
- Discuss the matter and the approach to further investigation with an appropriate level of management.
- Attempt to obtain additional evidential matter.
- If appropriate, suggest that the client consult with legal counsel.

.22 The evaluation of audit test results may lead an auditor to consider withdrawing from the engagement due to the significance of the risk of fraud. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

Documentation

.23 In planning the audit, the auditor should document in the working papers evidence of the performance of the assessment of the risk of material misstatement due to fraud. Documentation should include:

- The risk factors identified as present.
- The auditor's response to those risk factors.
- Fraud risk factors or other conditions, if any, identified during the performance of fieldwork that caused the auditor to believe that an additional audit response is required (any additional responses should also be documented).

It is *not* required that the assessment of the risk of material misstatement due to fraud be labeled ("high," "medium," or "low" for example) *nor* is it required to describe the rationale used to make the assessment. An auditor is only required to document that a separate assessment of the risk of material misstatement due to fraud was performed.

Communication

Note: A *Fraud Communication Checklist* is provided at the end of the "General Procedures" program in AAM section 5400 to help auditors comply with their responsibilities to report fraud to management, the audit committee, and others.

.24 If the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee.

.25 If risk factors have been identified that have continuing control implications, the auditor should consider whether those risk factors represent reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit committee.

.26 The auditor should recognize that in the following circumstances a duty to disclose outside the entity may exist:

- To comply with certain legal and regulatory requirements.
- To a successor auditor when the successor makes inquiries in accordance with SAS No. 7, *Communications Between Predecessor and Successor Auditors* (AU section 315).
- In response to a subpoena.
- To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive governmental financial assistance.

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing matters of fraud or possible fraud with parties outside the client.

Using the AICPA *Audit and Accounting Manual* in Considering Fraud

.27 An auditor should complete the Illustrative Planning Program at AAM section 3165. That program includes steps that consider the presence of fraud risk factors, the assessment of material misstatement due to fraud, developing audit responses, and other matters related to a consideration of fraud in a financial statement audit. Included at the end of the program is a *Fraud Risk Factor Memory Jogger*, that (although its completion is not required) is helpful in identifying fraud risk factors and complying with the requirements of SAS No. 82 (AU section 316).

.28 The audit programs in AAM section 5400 require an auditor to consider the fraud risk assessment and to develop and document any additional audit procedures that may be needed. Referencing between the planning program and memory jogger at AAM section 3165 and the audit programs at AAM section 5400 will help to ensure that identified risks related to fraud are appropriately addressed.

.29 The "General Procedures" program at AAM section 5400 includes steps to evaluate the results of audit tests as they relate to fraud. Steps are also included to communicate fraud-related matters to the appropriate people. A *Fraud Communication Checklist* is presented at the end of the "General Procedures" program to help auditors comply with their communication responsibilities concerning fraud.

[*The next page is 3301.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

AAM Section 3150
Illegal Acts

General Comments

.01 The term "illegal acts" refers to violations of laws or governmental regulations. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.

.02 Whether an act is illegal is a determination that is normally beyond the auditor's professional competence. The auditor's training and experience may provide a basis for recognition that some client acts coming to his or her attention may be illegal.

Direct and Material Effect Illegal Acts

.03 The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts (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 errors or fraud. (See SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* [appendix C] (AU section 312), and see SAS No. 82 (AU section 316).) That is, the auditor should design the audit to provide reasonable assurance that financial statement amounts are free from material misstatement resulting from these direct-effect illegal acts.

Other Illegal Acts

.06 Entities may be affected by many other laws or regulations, including those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. Generally, these laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects and their financial statement effect is indirect.

.07 An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. An audit conducted in accordance with GAAS normally does not include audit procedures specifically designed to detect illegal acts having an indirect effect on financial statements.

Engagement Planning Procedures

.08 The auditor should assess the risks that the entity has not complied with laws and regulations 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 components designed to give management reasonable assurance that the entity complies with those laws and regulations.

e. The client's policy relative to the prevention of illegal acts.

.10 Normally, there is no need to include audit procedures specifically designed to detect illegal acts. However, if the auditor becomes aware of information that raises suspicions, he or she is obligated to apply additional procedures to determine whether an illegal act has, in fact, occurred.

.11 A sample program documenting the procedures listed in this section is located in AAM section 3165.

[*The next page is 3331.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 An illustrative program documenting procedures listed in this section is located in AAM section 3165.

[*The next page is 3361.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

AAM Section 3165
Illustrative Planning Program

	Done by (or "N/A")	*Date*	*W/P Ref.**
.01 **A. Understanding the Assignment**			
1. Consider 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:			
a. Discuss the type, scope, and timing of the audit with the entity's management, board of directors, or audit committee.			
b. Consider the effects of applicable accounting and auditing pronouncements, particularly new ones.			
c. Coordinate the assistance of entity personnel in information preparation.			
d. Determine the extent of involvement, if any, of consultants, other independent auditors, specialists, and internal auditors.			
e. Read reports and related correspondence of internal audit staff (if any) and consider the possible effect of internal audit work and findings on scope of the audit.			
3. Discuss the following matters (and others as appropriate) with client personnel:			
a. Changes in key personnel.			
b. Significant accounting or reporting problems.			
c. Changes in accounting methods or accounting principles.			
d. Principle findings of internal auditors.			
e. Changes in information processing methods or technology.			
f. Disposition of prior year's management letter points.			

* As applicable.

	Done by (or "N/A")	Date	W/P Ref.*
g. Closing information to be prepared, such as closing journal entries and post-closing trial balance.			
h. Timing of preliminary audit work, inventory observation, confirmation procedures, final audit work.			
i. Adequacy of working space for the audit team.			
j. Access to client records.			
k. Assistance to be provided by client personnel.			
4. Document engagement personnel's understanding of the assignment in the workpapers, as deemed necessary.			
.02 B. Assigning Personnel to the Engagement			
1. Prepare a time budget by audit area for the engagement to determine manpower requirements and to schedule fieldwork.			
2. Have the engagement partner approve the time budget prior to the beginning of fieldwork.			
3. Consider the following factors 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. Have the scheduling and staffing of the engagement 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, obtain written confirmation of the independence of other firms engaged to perform segments of the audit.			
2. Review annual independent questionnaires for all engagement personnel to assure that those individuals assigned to the engagement are independent.			
3. Review accounts receivable from the client to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.			

* As applicable.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by (or "N/A")	Date	W/P Ref.*
4. In situations in which the firm is not independent, discuss the issuance of a disclaimer of opinion 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

1. Obtain an initial, overall understanding of the clients' operations by—			
a. Reviewing the prior years' working papers, permanent file, auditor's report, and financial statements.			
b. Reviewing any interim financial statements or reports for the current year, including filings with regulatory agencies; or, if such statement 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, the board of directors, and relevant committees.			
f. Considering possible impact of nonaudit services rendered to client on the audit.			
2. Discuss the following matters with management:			
a. Changes in operations, including planned changes.			
b. Significant legal matters and contingencies.			
3. Obtain an understanding of the effect of laws, regulations, and ordinances having a direct and material effect on the financial statements, and if necessary prepare a list of such laws for the workpapers.			
4. Obtain 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.			

* As applicable.

	Done by (or "N/A")	Date	W/P Ref.*
g. Distribution methods.			
h. Compensation methods.			
5. Obtain 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.			
6. As appropriate, obtain an understanding of the accounting and disclosure requirements for environmental remediation liabilities, which are set forth in chapters 5 to 7 of AICPA Statement of Position 96-1, *Environmental Remediation Liabilities.*			
7. Obtain an understanding of the potential environmental remediation liabilities to which the client may be exposed. Gaining knowledge of the following matters will help provide that understanding:			
• The industry or industries 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.			
• Production and distribution processes.			
Useful sources of information about such matters include industry publications, financial statements, and other publicly available information from entities in the same industry, and information available from regulatory agencies.			
8. Consider other possible indicators of increased risk of environmental remediation liability, such as:			
a. Participation in a real estate transaction or corporate merger involving properties with environmental risks.			
b. The purchase of land for a price significantly below local market prices.			
c. The acquisition of new or increased insurance coverage against environmental risks or liability to third parties.			

* As applicable.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by (or "N/A")	Date	W/P Ref.*
9. Inquire of accounting, finance, operations, environmental, compliance, or legal personnel about their knowledge of the company's exposure to environmental remediation liabilities.			
10. Consult other sources of information that relate to the entity's business, such as the following:			
a. AICPA audit and accounting guides and other publications.			
b. Industry publications.			
c. Financial statements of other entities in the industry.			
d. Textbooks, periodicals, and individuals knowledgeable about the industry.			
11. Consider methods the entity uses to process accounting information in planning the audit.			
12. Consider the following matters in evaluating the effect of the entity's information technology on the audit of financial statements:			
a. The extent to which the computers and other information technology is used in every significant accounting application.			
b. Whether or not the application generates a financial statement line item or provides a basis for an accounting estimate.			
c. The significance of the financial statement line item(s) affected by the client's use of technology.			
d. The controls placed over the application or system.			
e. The effectiveness of the design and operation of those controls.			
f. The complexity of the entity's information technology operations, including the use of an outside service center.			
g. The organizational structure of the information technology activities.			
h. The availability of, and access to, evidence.			
i. The use of computer-assisted audit techniques to increase the efficiency of performing audit procedures.			
13. Consider whether specialized skills are needed to consider the effect of information technology on the audit.			
14. Document the matters listed above relating to a knowledge of the entity's business in the workpapers, as deemed necessary.			

* As applicable.

	Done by (or "N/A")	*Date*	*W/P Ref.**

.05 **E. Assessing Auditability**

1. Assess the adequacy of the accounting records for the following factors:
   - *a.* Transactions described in sufficient detail to permit appropriate classification in financial statements. _____ ____ ____
   - *b.* Transactions described in a manner that permits the recording of monetary value in the financial statements. _____ ____ ____
   - *c.* Accounting records include the period in which the transactions occurred to permit the recording of transactions in the appropriate accounting period. _____ ____ ____
2. Obtain sufficient knowledge of the design of the relevant controls pertaining to each of the five internal control components and whether they have been placed in operation. In completing this step, complete the "Internal Control" program at AAM section 5400, as appropriate. _____ ____ ____
3. Document the understanding of the entity's five components of internal control obtained to plan the audit. _____ ____ ____
4. Reform the following procedures 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. _____ ____ ____
5. Document the matters listed above relating to the auditability of the entity in the workpapers, as deemed necessary. _____ ____ ____

.06 **F. Engagement Letter**

1. Include the following items 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 all misstatements that might exist due to error, fraudulent financial reporting, or misappropriation of assets (see AAM section 3175). _____ ____ ____
   - *f.* Obligations of the client's staff to prepare schedule and statements. _____ ____ ____

* As applicable.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by (or "N/A")	Date	W/P Ref.*
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.			
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. Include the following optional items in the engagement letter, as deemed necessary:			
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 procedures.			
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 Related Matters Noted in an Audit*, as amended by SAS No. 78 [AU section 325].)			

* As applicable.

	Done by (or "N/A")	*Date*	*W/P Ref.**

.07 **G. Assessing Audit Risk and Materiality**

1. Determine a preliminary judgment about the dollar amount of misstatement that would be material to the financial statements. _____ ____ ____

2. Relate that amount to tolerable error for specific account balances in planning audit procedures. _____ ____ ____

3. Assess and document inherent risk and control risk to determine how much detection risk can be accepted while still restricting audit risk to an acceptably low level. _____ ____ ____

4. Assess and document, by considering the understanding obtained of the internal control components and by considering all other matters influencing audit risk, the risk of material misstatement due to error, illegal acts, and other factors. _____ ____ ____

5. Consider the presence of fraud risk factors in the following categories:

   a. Management's characteristics. _____ ____ ____

   b. Industry conditions. _____ ____ ____

   c. Operating characteristics and financial stability. _____ ____ ____

   d. Susceptibility of assets to misappropriation. _____ ____ ____

   e. Controls over the misappropriation of assets. _____ ____ ____

6. Complete the "Fraud Risk Factor Memory Jogger" maintained at the end of this planning checklist. (Auditors may decide, based on the circumstances, that completion of the memory jogger is not necessary. However, the risk factor categories in step 5 above should be considered.) _____ ____ ____

Practice Tip

Many firms use the helpful, "plain-english" guidance contained in the AICPA's *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* practice aid. This publication includes industry-specific example risk factors that may exist on your engagement. It also includes valuable help in assessing the risk of fraud (Call 1 (800) 862-4272, product no. 008883).

7. Inquire of management about their understanding regarding the risk of fraud in the entity. _____ ____ ____

8. Inquire of management about knowledge they may have of fraud that has been perpetrated on or within the entity. _____ ____ ____

* As applicable.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by (or "N/A")	Date	W/P Ref.*
9. Inquire of management about the existence of a program at the entity that includes proactive steps to prevent, deter, and detect fraud and whether the program has identified any fraud risk factors.			
10. Assess the risk of material misstatement due to fraud.			
11. For identified fraud risk factors, develop an appropriate audit response.			
12. Document in the workpapers evidence of the performance of the assessment of the risk of material misstatement due to fraud, including the following items:			
a. Fraud risk factors identified as present.			
b. Inquiries and responses made by the auditor of management regarding the risk of fraud in the entity.			
c. Inquiries and responses made by the auditor of management whether management has knowledge of fraud that has been perpetrated.			
d. Inquiries and responses made by the auditor of management about the existence of a program at the entity that includes proactive steps to prevent, deter, and detect fraud and whether the program has identified any fraud risk factors.			
e. Audit responses to the identified fraud risk factors.			
13. Consider the risk of material misstatement (due to error, fraud, illegal acts, and other factors) assessment in determining:			
a. Overall audit strategy.			
b. The nature, timing, and extent of audit procedures.			
c. Staff assignments.			
d. Appropriate levels of supervision.			
.08 H. Assessment of Control Risk			
1. Assess control risk. In assessing control risk, complete the "Internal Control" program at AAM section 5400.			
2. Document conclusions about the control risk assessment, including the bases for assessing control risk at the maximum or below the maximum for financial statement assertions.			
3. In circumstances where electronic evidence is significant, reconsider the appropriateness of assessing control risk at the maximum and performing only substantive testing, given the usual dependency of competent electronic evidence on effective internal control.			

* As applicable.

	Done by (or "N/A")	Date	W/P Ref.*
4. Perform the following procedures in assessing control risk at below the maximum level for some or all financial statement assertions (see "Internal Control" program at AAM section 5400):			
a. Identify specific control relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions.			
b. Perform tests of controls to evaluate the effectiveness of such controls.			
5. If a further reduction in the assessed level of control risk is desired for some financial statement assertions, perform additional tests of relevant controls.			

.09 I. Illegal Acts

1. Consider the following matters 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 components designed to give management reasonable assurance that the entity complies with those laws and regulations.			

.10 J. Analytical Procedures

1. Use analytical procedures 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.			

.11 K. Audit Strategies and the Audit Program

1. Use the information obtained or developed concerning materiality, internal control, the results of preliminary analytical procedures, risk assessments, and other matters used in assessing audit risk to plan:			
a. The overall strategy for the conduct and scope of the audit.			

* As applicable.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by (or "N/A")	Date	W/P Ref.*
b. The nature, timing, and extent of testing.			
c. Staffing requirements and related levels of supervision.			
(Utilize the audit programs maintained at AAM section 5400, as well as auditor-developed audit programs to meet specific situations.)			
2. Have the final audit programs approved by the engagement partner.			

* As applicable.

.12

Fraud Risk Factor Memory Jogger

An auditor may find this memory jogger helpful during planning and at other stages of the audit, when considering fraud risk factors and assessing the risk of material misstatement due to fraud. The example risk factors described in SAS No. 82 (AU section 316) have been included in the listing below. If used, this memory jogger should be tailored for the particular client being audited. Identified or possible risk factors should be added to the list. An auditor may also decide to remove the SAS No. 82 (AU section 316) example factors from the list, based on the circumstances. In any event, be sure to consider fraud risk factors that relate to fraudulent financial reporting and misappropriation of assets in every related category (A–E) presented below. This memory jogger will also be useful in documenting compliance with SAS No. 82 (AU section 316), as well as providing links to the workpapers and programs where responses and conclusions regarding the identified risk factors are documented. The memory jogger can be carried forward to succeeding years' audits to help assess fraud risk in those years. An auditor should feel free to use this practice aid as he or she sees fit (e.g., adding attachments, redesigning the form of the memory jogger). Finally, note that SAS No. 82 (AU section 316) does not require an auditor to use a memory jogger or checklist of fraud risk factors.

Fraud Risk Factors Considered	*Present at Client?*	*Audit Response Developed?*[1]	*Audit Response Documented? (W/P Ref.)*[2]	*Additional Information*
A. Management Characteristics				
1. A significant portion of management's compensation represented by bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position, or cash flow.				
2. An excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.				
3. A practice by management of committing to analysts, creditors, and other third parties to achieve what appear to be unduly aggressive or clearly unrealistic forecasts.				
4. An interest by management in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.				
5. An ineffective means of communicating and supporting the entity's values or ethics, or communication of inappropriate values or ethics.				
6. Domination of management by a single person or small group without compensating controls such as effective oversight by the board of directors or audit committee.				
7. Inadequate monitoring of significant controls.				
8. Management failing to correct known reportable conditions on a timely basis.				
9. Management setting unduly aggressive financial targets and expectations for operating personnel.				

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Fraud Risk Factors Considered	*Present at Client?*	*Audit Response Developed?*[1]	*Audit Response Documented? (W/P Ref.)*[2]	*Additional Information*
10. Management displaying a significant disregard for regulatory authorities.				
11. Management continuing to employ an ineffective accounting, information technology, or internal auditing staff.				
12. Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.				
13. High turnover of senior management, counsel, or board members.				
14. Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.				
15. Unreasonable demands on the auditor including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's reports.				
16. Formal or informal restrictions on the auditor including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's reports.				
17. Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work.				
18. Known history of securities law violations or claims against the entity or its senior management alleging fraud or violations of securities laws.				
B. Industry Conditions				
1. New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.				
2. High degree of competition or market saturation, accompanied by declining margins.				
3. Declining industry with increasing business failures and significant declines in customer demand.				
4. Rapid changes in the industry such as high vulnerability to rapidly changing technology or rapid product obsolescence.				

Fraud Risk Factors Considered	*Present at Client?*	*Audit Response Developed?*[1]	*Audit Response Documented? (W/P Ref.)*[2]	*Additional Information*
C. Operating Characteristics & Financial Stability				
1. Inability to generate cash flows from operations while reporting earnings and earnings growth.				
2. Significant pressure to obtain additional capital necessary to stay competitive considering the financial position of the entity—including need for funds to finance major research and development or capital expenditures.				
3. Assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity.				
4. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.				
5. Significant unusual, or highly complex transactions, especially those close to year end, that pose difficult "substance over form" questions.				
6. Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.				
7. Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose.				
8. Difficulty in determining the organization or individual(s) that control(s) the entity.				
9. Usually rapid growth or profitability, especially compared with that of other companies in the same industry.				
10. Especially high vulnerability to changes in interest rates.				
11. Unusually high dependence on debt or marginal ability to meet debt repayment requirements; debt covenants that are difficult to maintain.				
12. Unrealistically aggressive sales or profitability incentive programs.				
13. Threat of imminent bankruptcy or foreclosure, or hostile takeover.				
14. Adverse consequences on significant pending transactions, such as a business combination or contract award, if poor financial results are reported.				
15. Poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.				

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Fraud Risk Factors Considered	*Present at Client?*	*Audit Response Developed?*[1]	*Audit Response Documented? (W/P Ref.)*[2]	*Additional Information*
D. Susceptibility of Assets to Misappropriation				
1. Large amounts of cash on hand or processed.				
2. Inventory characteristics, such as small size, high value, or high demand.				
3. Easily convertible assets, such as bearer bonds, diamonds, or computer chips.				
4. Fixed asset characteristics, such as small size, marketability, or lack of ownership identification.				
E. Controls				
1. Lack of appropriate management oversight.				
2. Lack of job applicant screening procedures relating to employees with access to assets susceptible to misappropriation.				
3. Inadequate recordkeeping with respect to assets susceptible to misappropriation.				
4. Lack of appropriate segregation of duties or independent checks.				
5. Lack of appropriate system of authorization and approval of transactions.				
6. Poor physical safeguards over cash, investments, inventory, or fixed assets.				
7. Lack of timely and appropriate documentation for transactions.				
8. Lack of mandatory vacations for employees performing key control functions.				

Practice Tip

The AICPA's publication entitled, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, provides **industry-specific example fraud risk factors** that help practitioners consider the risk of material misstatement due to fraud on their engagements. Call the AICPA at 1 (800) 862-4272 and ask for product no. 008883.

[*The next page is 3381.*]

[1] Based on the assessment of risk of material misstatement due to fraud, an auditor may respond to identified risk factors individually or in combination.

[2] The auditor's response to identified risk factors should be documented. Documentation should be maintained at a place in the workpapers considered most suitable, depending upon the type of risk factor and the type of response. Generally, if a response is specific to a particular account balance or class of transactions, documentation of the audit procedures would be placed in the appropriate audit program (e.g., Cash, Investments). If it is determined that audit procedures already planned or normally carried out are a sufficient response to the identified risk factor, that fact should be documented.

AAM Section 3170
Audit Assignment Controls

.01

Audit Time Budget — Sample A

Client _____ Audit date _____

Prepared by _____

Approved:

Supervisor _____ Date _____ Partner _____ Date _____

Preliminary work: Final work:

Start _____ End _____ Start _____ End _____

	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)

Audit Time Budget — Sample B

.02

Date		Budget	Actual	
Total hours	Total			
Accountant's initials color-coded	Supervisor or manager			
	Senior			
	Assistant			
General	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			
	Time summary			
	Supervision			
	Correspondence and conferences			
Review in-house computer programs				
Audit of /with computer				
General ledger and journal entries				
Cash	In banks and on hand			
	Receipts and disbursements			
Notes/accts. rec. and allowance for losses				
Inventories	Observation			
	Comparison of quantities			
	Valuation			
	Clerical accuracy and analytical review			
Prepaid expenses				
Other current assets				
Fixed assets and depreciation				
Investments				
Other assets				
Notes payable and long-term debt				
Accounts payable				
Other current liabilities				
Other long-term liabilities and deferred income				
Stockholders equity				
Contingent liabilities				
Sales and revenue				
Payrolls				
Other expense and income tests and analyses				
Preparation of tax returns				
Other (describe)				

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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											Actual Daily Hours																								Next Year's Budget
			Total	Week Beginning																																				
																																								Total	
Administration																																							
Client conferences																																							
Plannning 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																																							

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Audit Time Analysis (*Long Form*)—continued

Client

Year Ended

| | Prior Years | | Budgeted Hours | | | | Actual Daily Hours | | | |

.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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 services we will provide to Anonymous Company, Inc., for the year ending December 31, 19XX.

We will audit the balance sheet of Anonymous Company, Inc., 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. Encompassed in that responsibility is the creation and maintenance of internal control and proper accounting records, the selection of appropriate accounting principles, the safeguarding of assets, and compliance with relevant laws and regulations. Our responsibility is to express an opinion on the financial statements based on our audit, and is limited to the period covered by our audit. If circumstances preclude us from issuing an unqualified opinion, we will discuss the reasons with you in advance. A report will not be issued for this engagement if we are unable to finish the 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. Accordingly, the areas and number of transactions selected for testing will involve judgment. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventory, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and related matters.

Our audit is designed to provide reasonable assurance of detecting misstatements that, in our judgment, could have a material effect on the financial statements taken as a whole. Consequently, our audit will not necessarily detect all misstatements that might exist due to error, fraudulent financial reporting, or misappropriation of assets. The Company's management is responsible for establishing and maintaining a sound system of internal control, which is the best means of preventing or detecting errors, fraudulent financial re-

porting, and misappropriation of assets. We will inform you of all matters of fraud and material errors, and all illegal acts, unless they are clearly inconsequential, that come to our attention.[1]

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 audit cannot be relied upon to disclose significant deficiencies in the design or operation of internal control ("reportable conditions"). Nevertheless, we will communicate to you all reportable conditions and potential areas for improvement that we become aware of during the course of our audit.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

Our fees will be billed as work progresses and are based on the amount of time required plus out-of-pocket expenses. Invoices are payable upon presentation. Our initial fee estimate assumes we will receive the aforementioned assistance from your personnel and unexpected circumstances will not be encountered. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees, which will range from $XX,XXX to $XX,XXX.

The working papers for this engagement are the property of Lacko, Lynch, Brown & Company 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 Lacko, Lynch, Brown & Company 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]

---

[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.

[2] This paragraph is optional depending upon the nature of the engagement.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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*]

.03 SEC Engagement: Form 10-K and Annual Report to Shareholders

RON TRACY & ASSOCIATES Certified Public Accountants

[*Date*]
Mr. Joshua Snyder
Lawnmowers & Snowblowers Unlimited
731 Nathan Road
Hatville, NJ 00000

Dear Mr. Snyder:

This letter confirms our understanding of the services we will provide to Lawnmowers & Snowblowers Unlimited for the year ended December 31, 19XX.

We will audit the balance sheet of Lawnmowers & Snowblowers Unlimited 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. Encompassed in that responsibility is the creation and maintenance of internal control and proper accounting records, the selection of appropriate accounting principles, the safeguarding of assets, and compliance with relevant laws and regulations. Our responsibility is to express an opinion on the financial statements based on our audit, and is limited to the period covered by our audit. If circumstances preclude us from issuing an unqualified opinion, we will discuss the reasons with you in advance. A report will not be issued for this engagement if we are unable to finish the 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. Accordingly, the areas and number of transactions selected for testing will involve judgment. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We also will audit the financial information necessary for the schedules required by Regulation S-X of the SEC.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventory, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and related matters.

Our audit is designed to provide reasonable assurance of detecting misstatements that, in our judgment, could have a material effect on the financial statements taken as a whole. Consequently, our audit will not necessarily detect all misstatements that might exist due to error, fraudulent financial reporting, or misappropriation of assets. The Company's management is responsible for establishing and maintaining a sound system of internal control, which is the best means of preventing or detecting errors, fraudulent financial reporting, and misappropriation of assets. We will inform you of all matters of fraud and material errors, and all illegal acts, unless they are clearly inconsequential, that come to our attention.

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 Lawnmowers & Snowblowers Unlimited. 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Our audit cannot be relied upon to disclose significant deficiencies in the design or operation of internal control ("reportable conditions"). Nevertheless, we will communicate to you all reportable conditions and potential areas for improvement that we become aware of during the course of our audit.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

Our fees will be billed as work progresses and are based on the amount of time required plus out-of-pocket expenses. Invoices are payable upon presentation. Our initial fee estimate assumes we will receive the aforementioned assistance from your personnel and unexpected circumstances will not be encountered. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees, which will range from $XX,XXX to $XX,XXX.

The working papers for this engagement are the property of Ron Tracy & Associates 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 Ron Tracy & Associates 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,

RON TRACY & 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

RATZINGER & 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 control activities allow us to use alternative procedures to satisfy ourselves on this part of the audit. However, this will require substantially more time than examining guest checks.

The fee for these additional services will be billed at our standard per diem rates and added to the fees quoted in our previous letter.

The situation has been discussed with your controller, who assured us that in the future all guest checks will be kept for two years.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Very truly yours,

RATZINGER & O'CONNOR, CPA'S

_____

[*Engagement Partner's Signature*]

Accepted and agreed to:

_____

[*Client Representative's Signature*]

_____

[*Title*]

_____

[*Date*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.05 Conditions Encountered Which Do Not Permit Expression of Opinion as Anticipated in Original Engagement Letter

GEROW, COLLINS & PATCH 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 & PATCH

_____

[*Engagement Partner's Signature*]

Note: The client is not asked to sign this letter. Its purpose is to inform the client of the altered circumstances and the effect on the opinion. There is no change in the terms of the engagement. However, it might be desirable to have the client acknowledge receipt of this letter by signing a copy and returning it where—for example—it is a problem, or when there has been a history of misunderstandings.

.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. Encompassed in that responsibility is the creation and maintenance of internal control and proper accounting records, the selection of appropriate accounting principles, the safeguarding of assets, and compliance with relevant laws and regulations. Our responsibility is to express an opinion on the financial statements based on our audit, and is limited to the period covered by our audit. If circumstances preclude us from issuing an unqualified opinion or we are otherwise unable to comply with the requirements of Form S-1, we will discuss the reasons with you in advance. A report will not be issued for this engagement if we are unable to finish the 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. Accordingly, the areas and number of transactions selected for testing will involve judgment. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We also will audit the financial information included in the schedules required by Regulation S-X of the SEC.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventory, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and related matters.

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.

---

* This should be modified to agree with the particular form to be filed.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Our audit is designed to provide reasonable assurance of detecting misstatements that, in our judgment, could have a material effect on the financial statements taken as a whole. Consequently, our audit will not necessarily detect all misstatements that might exist due to error, fraudulent financial reporting, or misappropriation of assets. The Company's management is responsible for establishing and maintaining a sound system of internal control, which is the best means of preventing or detecting errors, fraudulent financial reporting, and misappropriation of assets. We will inform you of all matters of fraud and material errors, and all 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.

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 audit cannot be relied upon to disclose significant deficiencies in the design or operation of internal control ("reportable conditions"). Nevertheless, we will communicate to you all reportable conditions and potential areas for improvement that we become aware of during the course 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. Our initial fee estimate assumes we will receive the aforementioned assistance from your personnel and unexpected circumstances will not be encountered. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees, which will range from $XX,XXX to $XX,XXX.

The working papers for this engagement are the property of Bellarmine, Perricone & Company 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 Bellarmine, Perricone & Company 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]

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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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*]. Encompassed in that responsibility is the creation and maintenance of proper accounting records, the selection of appropriate accounting principles, the safeguarding of assets, and compliance with relevant laws and regulations. My (Our) responsibility is to express an opinion on the financial statements based on our audit, and is limited to the period covered by our audit. If circumstances preclude us from issuing an unqualified opinion, we will discuss the reasons with you in advance. A report will not be issued for this engagement if we are unable to finish the 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. Accordingly, the areas and number of transactions selected for testing will involve judgment. 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.

- My (Our) audit is designed to provide reasonable assurance of detecting misstatements that, in our judgment, could have a material effect on the financial statements taken as a whole. Consequently, my (our) audit will not necessarily detect all misstatements that might exist due to error, fraudulent financial reporting, or misappropriation of assets. _____ [*client's name*] is responsible for establishing and maintaining a sound system of internal control, which is the best means of preventing or detecting errors, fraudulent financial reporting, and misappropriation of assets. We will inform you of all matters of fraud and material errors, and all illegal acts, unless they are clearly inconsequential, that come to 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*].

---

[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 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. Our initial fee estimate assumes no unexpected circumstances will be encountered. 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.

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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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

Section		*Paragraph*
4100	Introduction	.01-.07
	Overview	.01-.07
4200	Internal Control Framework	.01-.118
	Introduction	.01-.14
	Focus on the Small Business Entity	.15-.16
	Controls With a Pervasive Effect on the Organization	.17-.55
	Understanding the Control Environment	.18-.41
	Other Control Components With a Pervasive Effect on the Organization	.42-.55
	Application to Medium and Large Businesses	.56-.63
	Board of Directors or Audit Committee	.57-.59
	Internal Audit Function	.60-.62
	Formal Policies	.63
	Computer Applications	.64-.79
	Acquisition of Hardware and Software	.67-.76
	User Controls Over Computer Service Organization Applications	.77-.79
	Application to Medium or Large Businesses	.80-.88
	Obtaining an Understanding of Significant Account Balances and Transaction Cycles	.89-.105
	Segregation of Duties and Management Override	.106-.114
	Assessing Internal Control Strengths and Weaknesses	.115-.118
4300	Illustrative Internal Control Forms—Small Business	.01-.16
	Instructions	.02-.10
	Interpreting the Results	.11-.13
	Documenting a Conclusion	.14-.16
	I. Document Your Understanding of the Control Environment	
	II. Determine Other Areas for Evaluation	
	III. Assess Segregation of Duties	
	IV. Assess the Risk of Management Override	

Section *Paragraph*

4300 Illustrative Internal Control Forms—Small Business—continued
V. Interpret Results
VI. Document Your Conclusion With Respect to Internal Controls

4310 Control Environment Checklist—Small Business Computer Applications 01-.02
I. Microcomputer Hardware
II. Microcomputer Accounting Software
III. Other Microcomputer Software
IV. Local Area Network
V. Microcomputer Control Environment
VI. Outside Computer Service Organizations

4320 Financial Reporting Information Systems and Controls Checklist—Small Business 01-.72
Revenue Cycle 01-.12
Revenue, Accounts Receivable, and Cash Receipts 01-.02
Interpreting Results 03-.05
End User Computing in the Revenue Cycle 06-.09
Procedures and Controls Over End User Computing 10
Information Processed by Outside Computer Service Organizations 11-.12
Purchasing Cycle 13-.24
Purchasing, Accounts Payable, and Cash Disbursements 13-.14
Interpreting Results 15-.17
End User Computing in the Purchasing Cycle 18-.21
Procedures and Controls Over End User Computing 22
Information Processed by Outside Computer Service Organizations 23-.24
Inventory 25-.36
Inventory and Cost of Sales 25-.26
Interpreting Results 27-.29
End User Computing in the Inventory Cycle 30-.33
Procedures and Controls Over End User Computing 34
Information Processed by Outside Computer Service Organizations 35-.36
Financing 37-.48
Investments and Debt 37-.38
Interpreting Results 39-.41
End User Computing in the Financing Cycle 42-.45
Procedures and Controls Over End User Computing 46
Information Processed by Outside Computer Service Organizations 47-.48
Property, Plant, and Equipment 49-.60
Fixed Assets and Depreciation 49-.50
Interpreting Results 51-.53
End User Computing in the Property, Plant, and Equipment Cycle 54-.57
Procedures and Controls Over End User Computing 58
Information Processed by Outside Computer Service Organizations 59-.60
Payroll Cycle 61-.72
Payroll Expense 61-.62
Interpreting Results 63-.65
End User Computing in the Payroll Cycle 66-.69
Procedures and Controls Over End User Computing 70
Information Processed by Outside Computer Service Organizations 71-.72

4400 Illustrative Internal Control Forms—Medium to Large Business 01-.15
Instructions 02-.09

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Section *Paragraph*

4400 Illustrative Internal Control Forms—Medium to Large Business—continued
Interpreting the Results 10-.12
Documenting a Conclusion 13-.15
I. Document Your Understanding of the Control Environment
II. Determine Other Areas for Evaluation
III. Assess Lack of Segregation of Duties
IV. Assess the Risk of Management Override
V. Interpret Results
VI. Document Your Conclusion With Respect to Internal Controls

4410 Computer Applications Checklist—Medium to Large Business 01-.02
I. Computer Hardware
II. Computer Software
III. Computer Control Environment
IV. Outside Computer Service Organizations

4420 Financial Reporting Information Systems and Controls Checklist—Medium to Large Business 01-.72
Revenue Cycle 01-.12
Revenue, Accounts Receivable, and Cash Receipts 01-.02
Interpreting Results 03-.05
End User Computing in the Revenue Cycle 06-.09
Procedures and Controls Over End User Computing 10
Information Processed by Outside Computer Service Organizations 11-.12
Purchasing Cycle 13-.24
Purchasing, Accounts Payable, and Cash Disbursements 13-.14
Interpreting Results 15-.17
End User Computing in the Purchasing Cycle 18-.21
Procedures and Controls Over End User Computing 22
Information Processed by Outside Computer Service Organizations 23-.24
Inventory 25-.36
Inventory and Cost of Sales 25-.26
Interpreting Results 27-.29
End User Computing in the Inventory Cycle 30-.33
Procedures and Controls Over End User Computing 34
Information Processed by Outside Computer Service Organizations 35-.36
Financing 37-.48
Investments and Debt 37-.38
Interpreting Results 39-.41
End User Computing in the Financing Cycle 42-.45
Procedures and Controls Over End User Computing 46
Information Processed by Outside Computer Service Organizations 47-.48
Property, Plant, and Equipment 49-.60
Fixed Assets and Depreciation 49-.50
Interpreting Results 51-.53
End User Computing in the Property, Plant, and Equipment Cycle 54-.57
Procedures and Controls Over End User Computing 58
Information Processed by Outside Computer Service Organizations 59-.60
Payroll Cycle 61-.72
Payroll Expense 61-.62
Interpreting Results 63-.65

Section *Paragraph*

4420 Financial Reporting Information Systems and Controls Checklist—Medium to Large Business—continued
End User Computing in the Payroll Cycle 66-.69
Procedures and Controls Over End User Computing 70
Information Processed by Outside Computer Service Organizations 71-.72
4500 Flowcharting 01-.20
Introduction 01-.04
Example: Jones Grocery 05-.13
The Flowchart 14-.16
Analysis 17-.20
4600 Assessing Control Risk Below the Maximum 01-.25
Introduction 01-.08
Performing Tests of Controls 09-.25
Evidence From Prior Audits 16-.20
Computer Applications 21-.25
4700 The Auditor's Assessment of Control Risk 01-.10

[*The next page is 4101.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. In entities where significant information is transmitted, processed, maintained, or accessed electronically, the ability to perform entirely substantive procedures may be absent or ineffective. In those cases, additional tests to determine the operating effectiveness of controls surrounding the electronic environment are necessary.
- *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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.*

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- *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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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—

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- 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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- 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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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. However, in situations where electronic evidence (information transmitted, processed, maintained, or accessed by electronic means) is significant, testing of the related internal control generally will be necessary to obtain competent evidential matter.

.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 (see paragraph .08 below). 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—

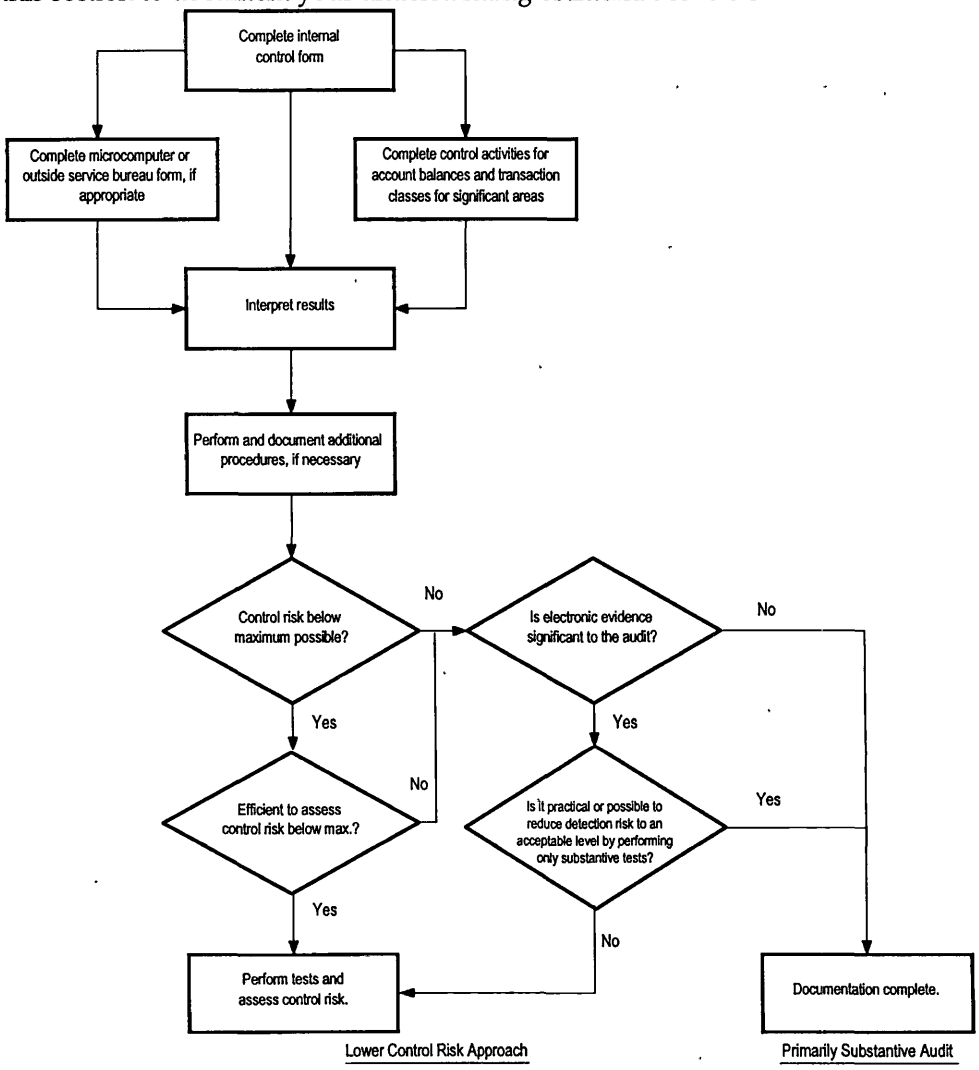
- Identify specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions, and

- Perform tests of controls to evaluate their effectiveness.

.08 In situations where a significant amount of audit evidence is transmitted, processed, maintained, or accessed electronically, it generally will be necessary to test the internal control surrounding the electronic evidence (for example, controls over generation, storage, manipulation, and transmission), even if a primarily substantive audit approach is followed. This is because the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness. In these situations the auditor should perform tests of controls to gather evidence to support an assessed level of control risk below the maximum for affected assertions. If the auditor concludes control risk must be assessed at the maximum in such situations or the evidence gathered through tests of controls and substantive tests is insufficient, the auditor should qualify or disclaim an opinion because of the scope limitation.

.09 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.

.10 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.



Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Interpreting the Results

.11 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.

.12 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.

.13 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

.14 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.

.15 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.

.16

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.	____	____	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	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, in-depth 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					
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.					

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	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. It is important to remember that in entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of the controls surrounding the electronic environment may not be enough. Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gain competent evidential matter—even in a primarily substantive approach. 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—			_____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

		No	Yes	W/P Ref.
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—			_____
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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- 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*

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.	_____	_____	_____	_____	_____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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.

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's report.

   _____

   _____

   _____

   _____

[*The next page is 4341.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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. In entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested 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.				
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.				

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Personnel	*N/A*	*No*	*Yes*
C. Estimates and Disclosures for Sales Transactions				
23. The accounting system generates a monthly aging of accounts receivable.	_____	____	____	____
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.

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.				

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

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. In entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). Since the competence of electronic evidence usually depends on the effectiveness of

internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested 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.	_____	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Personnel	N/A	No	Yes
C. Disclosures				
15. 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 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?

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- 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. In entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested 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.				
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.				

[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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Personnel	N/A	No	Yes
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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. In entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested 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.	_____	____	____	____

	Personnel	N/A	No	Yes
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.				
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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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.

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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. In entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	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. In entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested 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.	_____	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 and information technology 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 (see paragraph .07 below). 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.

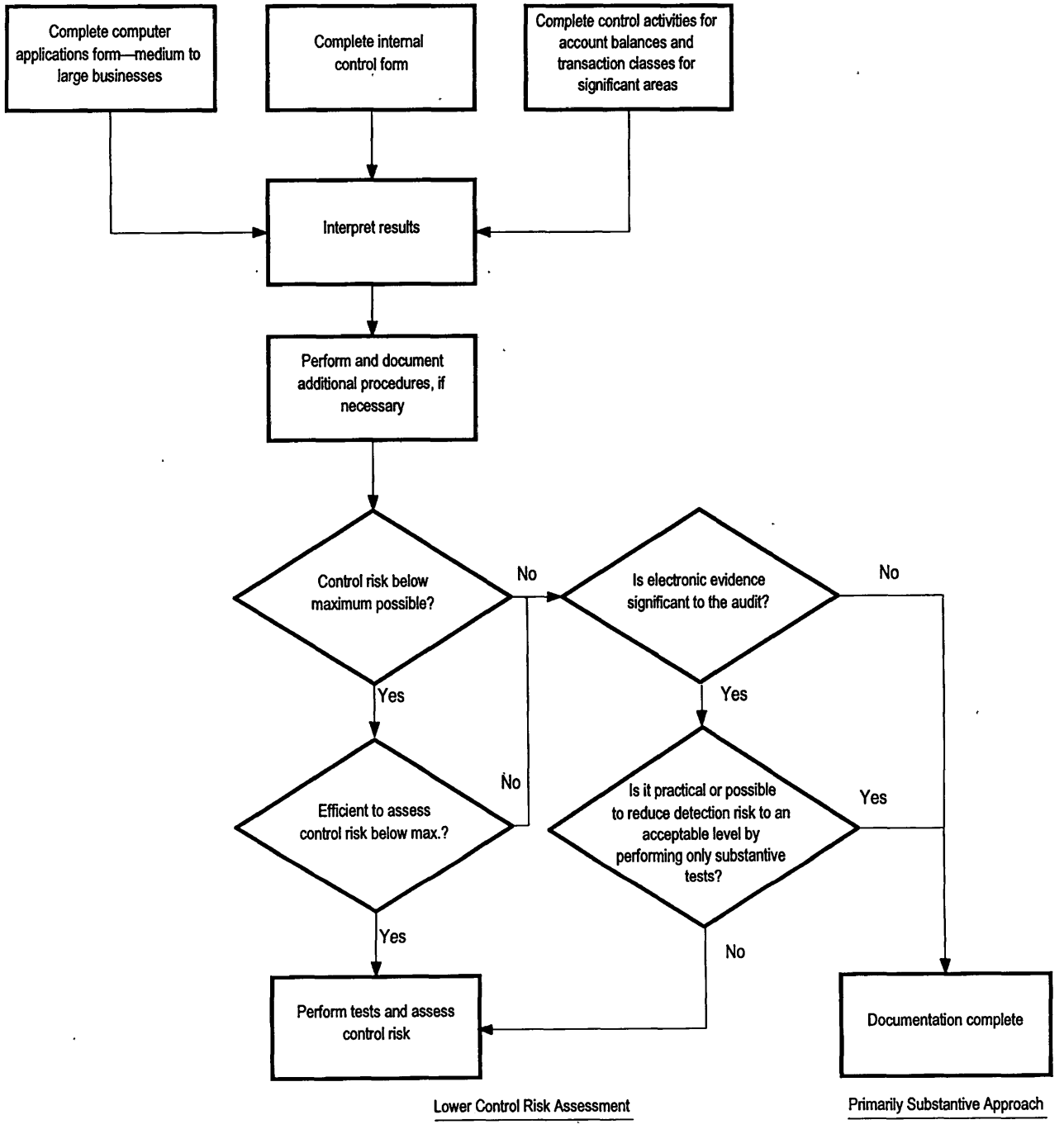
.06 If you plan a lower control risk assessment for certain assertions you are required to—

- 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 In situations where a significant amount of audit evidence is transmitted, processed, maintained, or accessed electronically, it generally will be necessary to test the internal control surrounding the electronic evidence (for example, controls over generation, storage, manipulation, and transmission), even if a primarily substantive audit approach is followed. This is because the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness. In these situations the auditor should perform tests of controls to gather evidence to support an assessed level of control risk below the maximum for affected assertions. If the auditor concludes control risk must be assessed at the maximum in such situations or the evidence gathered through tests of controls and substantive tests is insufficient, the auditor should qualify or disclaim an opinion because of the scope limitation.

.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 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.



Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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, 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.

.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 misstatement 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 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.

.14 If the completion of this form is not sufficient for you to obtain the necessary level of understanding listed in AAM section 4400.13, 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. 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.	_____	_____	_____	_____	_____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	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.					

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	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.					

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	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. It is important to remember that in entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of the controls surrounding the electronic environment may not be enough. Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gain competent evidential matter—even in a primarily substantive approach. 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.					

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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.					

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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. In entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested 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.	_____	___	___	___
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.	_____	___	___	___

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Personnel	*N/A*	*No*	*Yes*
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.				
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.				

	Personnel	*N/A*	*No*	*Yes*
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.				
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—

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- 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.

	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 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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

approach. In entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested 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.	_____	____	____	____
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	_____	____	____	____

	Personnel	*N/A*	*No*	*Yes*
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.				
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.				

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

	Personnel	*N/A*	*No*	*Yes*
Purchasing Cycle				
1. End user applications listed in paragraph .21 of this form have been adequately tested before use.	_____	____	____	____

	Personnel	N/A	No	Yes
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—

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- 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. In entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested 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.	_____	____	____	____

[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*
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.				
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.				

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Personnel	*N/A*	*No*	*Yes*
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.

	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 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. In entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested 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.	_____	____	____	____

	Personnel	*N/A*	*No*	*Yes*
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.				
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.				

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Personnel	N/A	No	Yes
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.

	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 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. In entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested 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.	_____	____	____	____

	Personnel	N/A	No	Yes
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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. In entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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.

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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	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.*

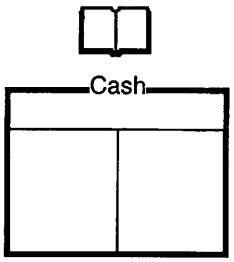
.12 *Once the checks are signed, they are coded and entered into the cash disbursements module of the accounting software package. The software updates the general ledger, the accounts payable subledger and aging, and produces a cash disbursements report. It also produces a cash management report that 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.*

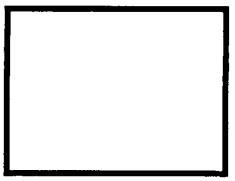
The Flowchart

.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.

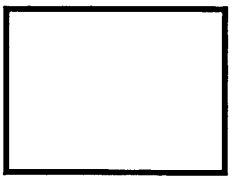
Copyright © 1996, American Institute of Certified Public Accountants, Inc.



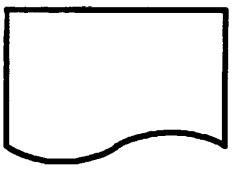
General ledger



Computer process



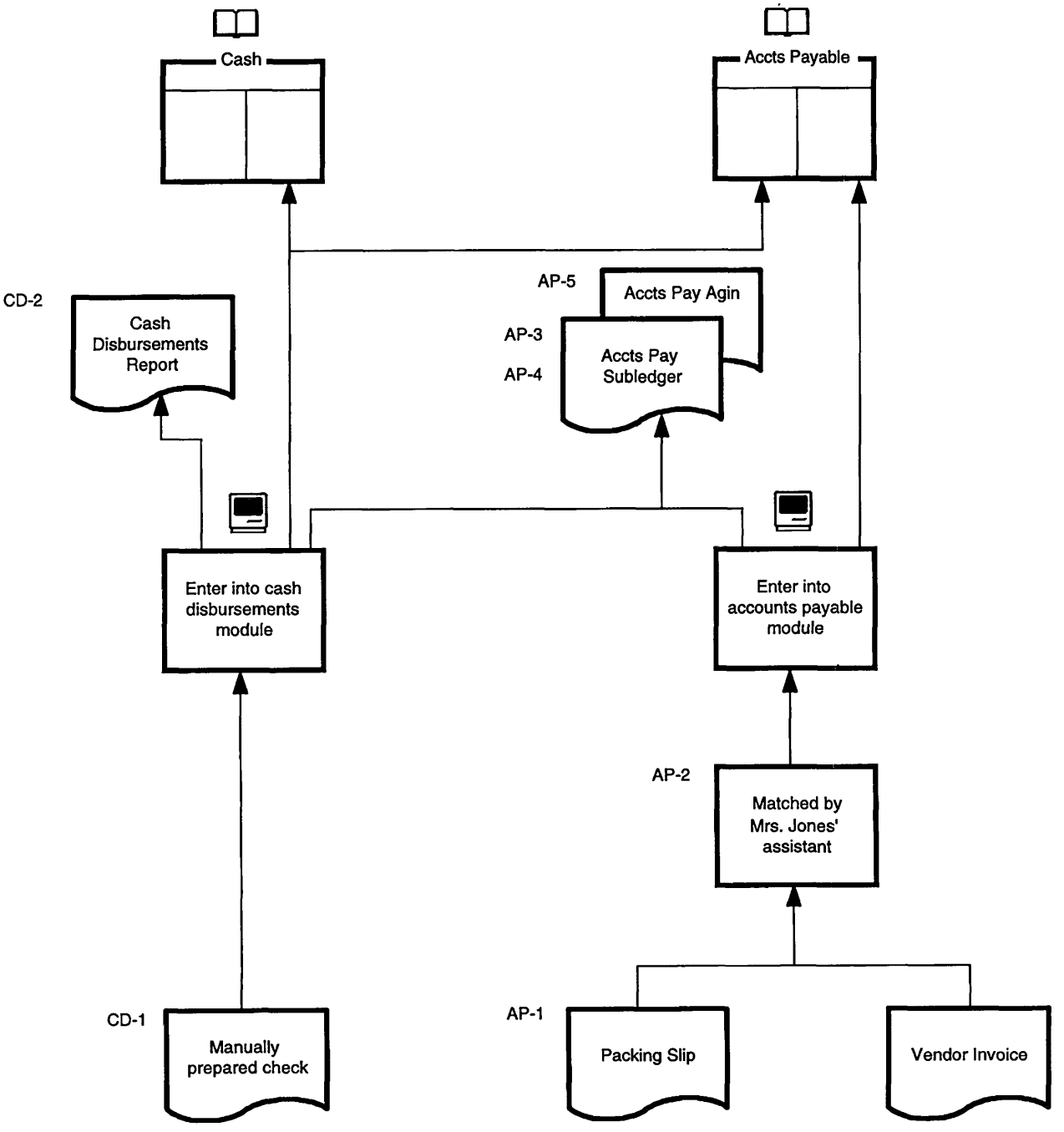
Manual process



Source document or subledger

AP-1 Control procedure

Jones Grocery
Accounts Payable



Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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 (however, see paragraph .03 below), 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 In entities where significant information is transmitted, processed, maintained, or accessed electronically, the auditor may determine that it is not practical or possible to reduce detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. The competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness. (The term electronic evidence means information transmitted, processed, maintained, or accessed by electronic means and used by an auditor to evaluate financial statement assertions.) Without testing the internal control surrounding the electronic evidence, a lack of credibility may not be recognized by the auditor. Therefore, when using electronic evidence, auditors need to question the appropriateness of the approach of performing only substantive testing if ineffective controls exist, or if assessed control risk is at the maximum level. Given the nature of electronic evidence, it usually will be necessary to test the surrounding internal control (to gather evidence to support an assessed level of control risk below the maximum) if that electronic evidence is significant in supporting an auditor's conclusion regarding certain financial statement assertions. If the auditor concludes control risk must be assessed at the maximum in such circumstances, or the evidence gathered through tests of controls and substantive tests is insufficient, the auditor should qualify or disclaim an opinion because of the scope limitation.

Practice Tip

Read the AICPA's Auditing Procedure Study entitled *The Information Technology Age: Evidential Matter in the Electronic Environment* for helpful and valuable guidance about the implications of electronic evidence on an audit. Call the AICPA at 1 (800) 862-4272 and ask for product number 021068.

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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- 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. The use of computer-assisted audit techniques expands the ability to analyze data, recognize patterns, and test the assertions contained in the financial statements. However, evidence produced for the auditor by software may not be competent due to the functionality of and processing used by the software. When used properly, computer-assisted audit techniques enhance auditor efficiency and effectiveness.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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*, as amended by SAS No. 80 (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, as amended (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:					

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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:					

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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:					

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

TABLE OF CONTENTS

Section		*Paragraph*
5100	Designing the Audit Program	.01-.47
	Financial Statement Assertions	.05
	Developing Audit Objectives	.06-.07
	Audit Tests	.08-.30
	Purpose of the Test	.11-.16
	Type of Test	.17
	Analytical Procedures	.18-.23
	Inquiry and Observation	.24-.25
	Tests of Transactions	.26-.28
	Tests of Balances	.29-.30
	Linking Audit Procedures to Objectives	.31-.32
	The Completeness Assertion	.33-.47
	Lack of Evidence	.38-.41
	Controls for Completeness	.42-.43
	Substantive Tests	.44-.47
5200	Timing of Substantive Audit Tests	.01-.10
	Substantive Tests That Can Generally Be Applied at an Interim Date	.05-.07
	Conditional Substantive Tests	.08-.10
5300	Extent of Testing	.01-.67
	Authoritative Standards	.02-.07
	When SAS No. 39 Applies	.03-.07
	Authoritative Guidance About the Application of Audit Sampling to Substantive Tests Provided by SAS No. 39	.08-.09
	Documentation Requirements in SAS No. 39	.09

Section *Paragraph*

5300 Extent of Testing—continued
Determining Extent of Testing in a Small Business Without Sampling 10-.24
Identification of Individual Items to Be Examined 16-.17
Is Extent of Evidential Matter Obtained Sufficient? 18-.19
Consider Contribution of Other Procedures 20-.22
Evaluation of Sufficiency of Evidence 23-.24
Audit Sampling for Tests of Controls 25-.36
Audit Sampling for Tests of Balances 37-.60
Selecting Samples 61-.67

5400 Illustrative Audit Program for Corporations 010-.200
I. General Procedures 020
Financial Statement Assertions
Procedures
A. Planning
B. Conclusion of Audit
C. Section Completion
II. Internal Control 030
Financial Statement Assertions
Procedures
A. Understanding the Client's Internal Control Components (Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring)
B–1. Revenues, Receivables, and Receipts—Understanding and Risk Assessment
B–2. Revenues, Receivables, and Receipts—Tests of Controls
B–3. Revenues, Receivables, and Receipts—Evaluation of Tests of Controls
C–1. Purchases, Accounts Payable, and Disbursements—Understanding and Risk Assessment
C–2. Purchases, Accounts Payable, and Disbursements—Tests of Controls
C–3. Purchases, Accounts Payable, and Disbursements—Evaluation of Tests of Controls
D–1. Payroll—Understanding and Risk Assessment
D–2. Payroll—Tests of Controls
D–3. Payroll—Evaluation of Tests of Controls
E–1. Inventories and Cost of Sales—Understanding and Risk Assessment
E–2. Inventories and Cost of Sales—Tests of Controls
E–3. Inventories and Cost of Sales—Evaluation of Tests of Controls
F. Section Completion
III. Cash 040
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures
B. Substantive Analytical Procedures
C. Cash in Banks—Detailed Tests
D. Cash Funds and Petty Cash—Detailed Tests
E. Additional Procedures (if any)
F. Section Completion

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Section *Paragraph*

5400 Illustrative Audit Program for Corporations—continued
IV. Investments and Derivatives 050
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures
B. Substantive Analytical Procedures
C. Detailed Tests
D. Accounting by a Transferor and Transferee for All Transfers of Financial Assets
E. Additional Procedures (if any)
F. Section Completion
V. Trade Accounts and Notes Receivable 060
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures
B. Substantive Analytical Procedures
C. Detailed Tests
D. Receivables Sold (Transferred) With Recourse
E. Additional Procedures (if any)
F. Section Completion
VI. Inventories 070
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures
B. Substantive Analytical Procedures
C. Detailed Tests—General
D. Before Observation of the Physical Inventory
E. Observation of the Physical Inventory
F. Summarization—Physical Quantities
G. Prices and Summarization—Monetary Units
H. Lower of Cost or Market Considerations
I. Other
J. Additional Procedures (if any)
K. Section Completion
VII. Property, Plant, and Equipment, and Related Depreciation 080
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures
B. Substantive Analytical Procedures
C. Detailed Tests
D. Leases
E. Additional Procedures (if any)
F. Section Completion
VIII. Prepaid Expenses, Deferred Charges, Intangibles, and Other Assets 090
Financial Statement Assertions

Section *Paragraph*

5400 Illustrative Audit Program for Corporations—continued
Objectives
Procedures
A. Preliminary Procedures
B. Substantive Analytical Procedures
C. Detailed Tests
D. Additional Procedures (if any)
E. Section Completion
IX. Accounts Payable 100
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures
B. Substantive Analytical Procedures
C. Detailed Tests
D. Additional Procedures (if any)
E. Section Completion
X. Accrued Liabilities Other Than Income Taxes and Deferred Credits 110
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures
B. Substantive Analytical Procedures
C. Detailed Tests
D. Additional Procedures (if any)
E. Section Completion
XI. Income Taxes Accrued and Provided 120
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures
B. Detailed Tests
C. Additional Procedures (if any)
D. Section Completion
XII. Notes Payable and Long-Term Debt 130
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures
B. Substantive Analytical Procedures
C. Detailed Tests
D. Extinguishments of Liabilities
E. Additional Procedures (if any)
F. Section Completion
XIII. Stockholders' Equity 140
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Section *Paragraph*

5400 Illustrative Audit Program for Corporations—continued
B. Substantive Analytical Procedures
C. Capital Stock and Additional Paid-In Capital—Detailed Tests
D. Retained Earnings—Detailed Tests
E. Other
F. Additional Procedures (if any)
G. Section Completion
XIV. Revenues and Other Income 150
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures
B. Substantive Analytical Procedures
C. Detailed Tests
D. Additional Procedures (if any)
E. Section Completion
XV. Operating and Other Expenses 160
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures
B. Substantive Analytical Procedures
C. Detailed Tests
D. Payroll
E. Additional Procedures (if any)
F. Section Completion
XVI. Contingencies, Commitments, and Litigation 170
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures
B. Contingencies
C. Commitments
D. Additional Procedures (if any)
E. Section Completion
XVII. Subsequent Events 180
Financial Statement Assertions
Objectives
Procedures
A. Substantive Test Procedures
B. Section Completion
XVIII. Related Parties 190
Financial Statement Assertions
Objectives
Procedures
A. Preliminary Procedures
B. Substantive Test Procedures
C. Additional Procedures (if any)
D. Section Completion

Section *Paragraph*

5400 Illustrative Audit Program for Corporations—continued
XIX. Risks and Uncertainties 200
Financial Statement Assertion
Objective
Procedures
A. Substantive Test Procedures
B. Section Completion

5410 Suggested Supplemental Reference Materials for Use With Illustrative Audit Program for Corporations 01
Suggested Supplemental Reference Materials 01

[*The next page is 5101.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 due to error or fraud.

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.

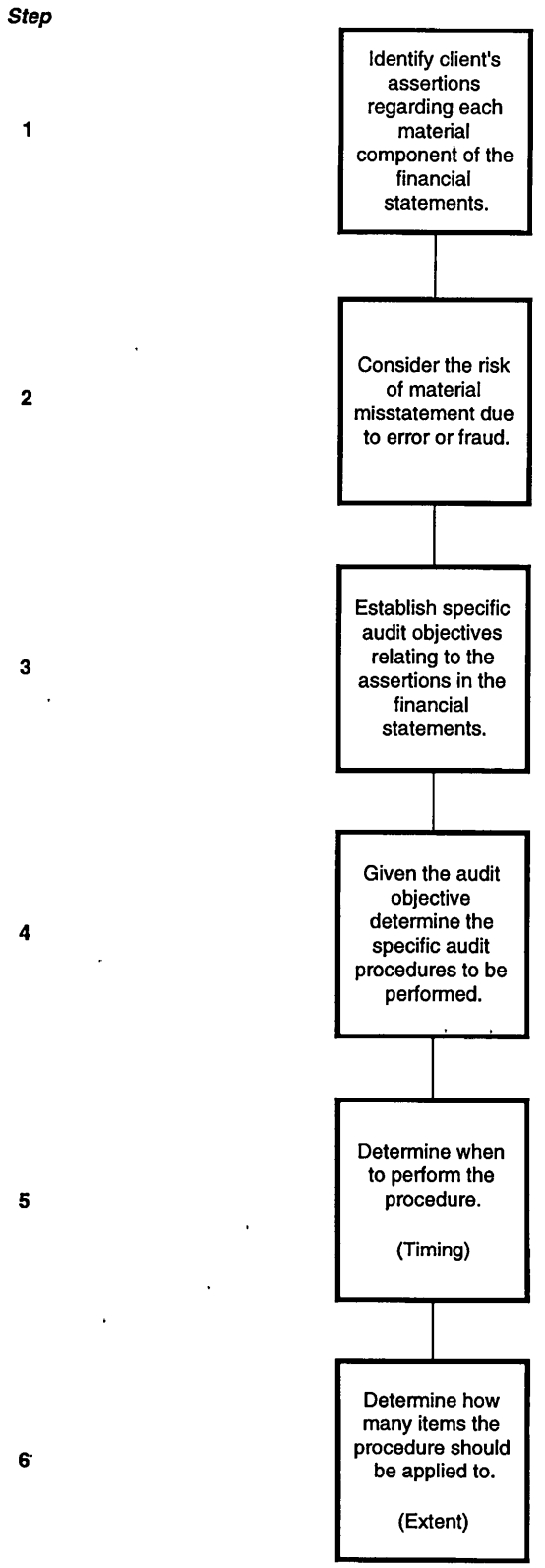
f. Determine which of many items to apply audit procedures to.

.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 and SAS No. 80 (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:

Flowchart 1
Audit Logic Process



Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 13, as amended (AU section 326.13), is that:

> The procedures adopted should be adequate to achieve the auditor's specific objectives and reduce detection risk to a level acceptable to the auditor. 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 risks, control risk, and other risk assessments 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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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, without a significant electronic environment, 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. In situations where electronic evidence (i.e., information transmitted, processed, maintained, or accessed by electronic means—for example, using a computer, scanner, sensor, or magnetic media) will be significant in gaining competent evidential matter regarding financial statement assertions, the ability to rely solely on substantive tests may not be present inasmuch as the competence of electronic evidence depends on the effectiveness of internal control over its validity and completeness. In such circumstances, the auditor should perform tests of controls to gather evidence to support an assessed level of control risk below the maximum for affected assertions. If the auditor concludes control risk must be assessed at the maximum in such circumstances, or the evidence gathered through tests of controls and substantive tests is insufficient, the auditor should qualify or disclaim an opinion because of the resulting scope limitation.

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. Typically, inquiry alone is not sufficient evidence of effective operation of controls.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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, I
	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

I—Extended walk-through of an application

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. Reperformance tests may also take the form of simulated processing, or processing of test data. 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 address 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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 any 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. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AU section 110.02), states:

> The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.

.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. Utilizing professional skepticism while performing the audit, the auditor should question transactions that are peculiar to the client or industry as well as question 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 representa-

tions 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. 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.

---

[1] D.D. Raiborn, Auditing Research Monograph No. 5, *Audit Problems Encountered in Small Business Engagements* (New York: AICPA, 1982), p. 74.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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 Substantive Audit Tests

.01 During the planning stage of the audit, the auditor should consider *when* to apply audit tests. 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.

.02 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.

.03 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.

.04 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

.05 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)

.06 In each of these tests, the auditor reviews information that is already available at an interim date. Even if 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.

.07 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

.08 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.

.09 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

.10 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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

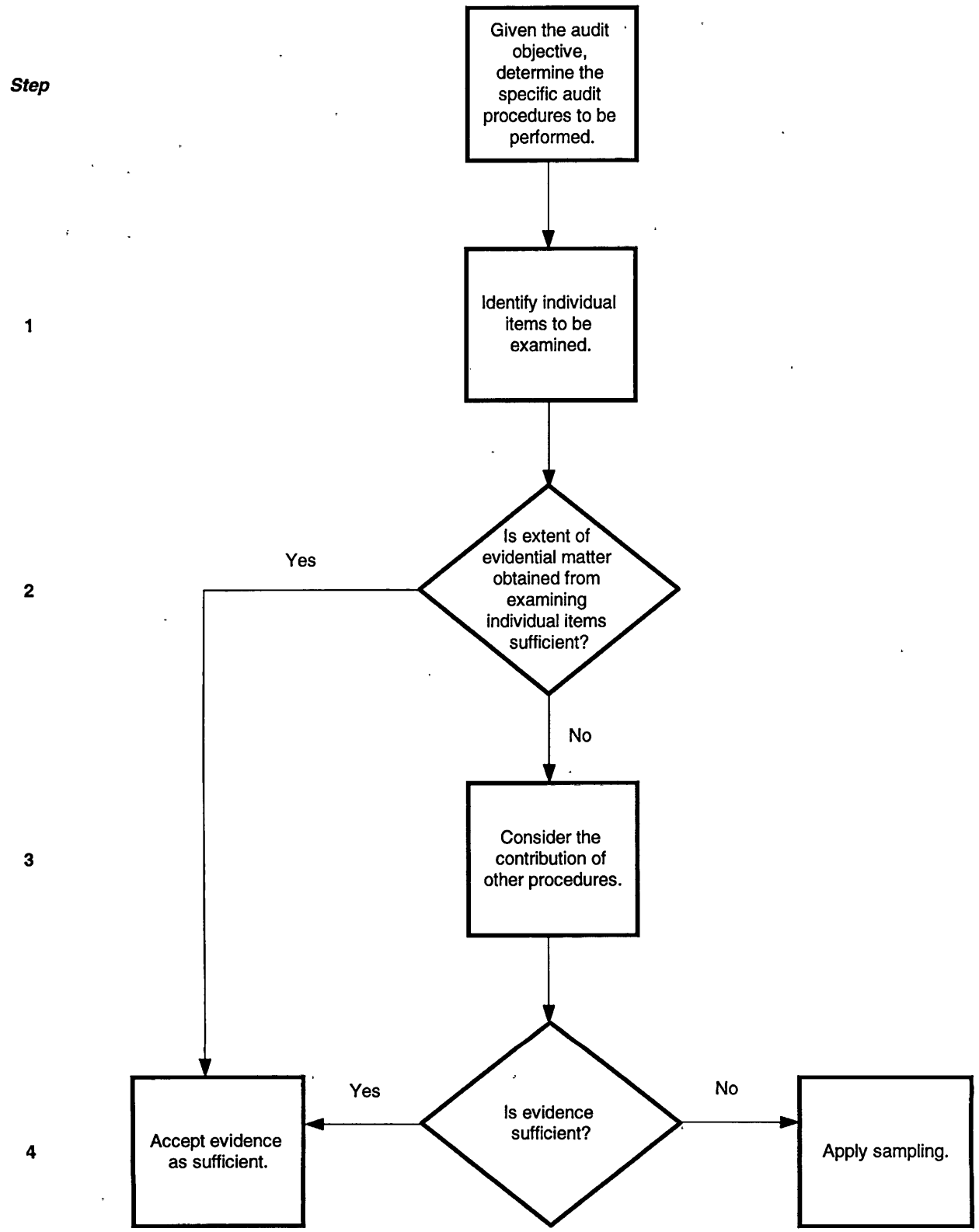
.17 For example, consider the following information for accounts receivable of a small business.

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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.36

Statistical Sample Results Evaluation
Table for Tests of Controls
Tolerable Deviation Rate at Ten 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
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:

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- *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

	Factor	*Conditions Leading to: 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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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:

$$N = \text{Sample Size} = 4{,}000$$
$$n = \text{Desired Units} = 50$$
$$I = \text{Interval}$$
$$I = \frac{N}{n} = \frac{4{,}000}{50} = 80$$

.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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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*, as amended by SAS No. 80 (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, equity, revenue, and expense components 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 The right mix of tests of details and analytical procedures should be made for each audit area, based on the auditor's risk assessment, and planning conclusions, the auditor's understanding of internal control components, materiality, and other relevant factors. 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 details. Accordingly, all of the substantive tests listed in a program may not 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. 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. Based on the auditor's understanding of internal control, it may be necessary to extend testing. See AAM section 3165 for an illustrative audit planning program.

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. Complete the illustrative planning program. (See AAM section 3165.)	____	____	____
2. Determine that the decision to accept the engagement (in case of new client) or to retain the 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. 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.	____	____	____
6. Discuss the audit plan with the engagement personnel. If considered necessary, prepare a planning memorandum for review by engagement staff.	____	____	____
7. Prepare listing of schedules/analyses to be prepared by the client (and working paper set-ups, if considered necessary) and deliver to client.	____	____	____
8. Update the permanent file(s) for new agreements, copies or extracts of minutes and other important documents.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by	Date	W/P Ref.
9. For trial balances and other schedules and analyses prepared by the client, document and perform the following (these steps can be performed during substantive testing):			
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."	____	____	____
10. If considered necessary, based on the assessment of audit risk, review journal and general ledger entries made during the period for propriety and accuracy.	____	____	____

B. Conclusion of Audit

1. 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.	____	____	____
2. Evaluate the effects of unadjusted misstatements on the financial statements.	____	____	____
3. If audit test results identify misstatements in the financial statements, consider whether such misstatements may be indicative of fraud.	____	____	____
4. Complete a subsequent events review. (See AAM section 5400.180.)	____	____	____
5. 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 for a reasonable period of time:			
a. Ascertain if any of the following negative trends exist:			
(1) Recurring operating losses	____	____	____
(2) Working capital deficiencies	____	____	____

	Done by	Date	W/P Ref.
(3) Negative cash flows from operations	____	____	____
(4) Adverse key financial ratios	____	____	____
(5) Calculate the Altman Z Score (the formula can be found in the AAM section 2300.16)	____	____	____
b. Ascertain if any of the following have occurred:			
(1) Default on loans or similar agreements	____	____	____
(2) Arrearages in dividends	____	____	____
(3) Denial of usual trade credit	____	____	____
(4) Restructuring of debt	____	____	____
(5) Noncompliance with statutory or contractual capital arrangements	____	____	____
(6) Need for new sources or methods of financing	____	____	____
(7) Need to dispose of substantial assets	____	____	____
c. Ascertain if the following internal matters have occurred:			
(1) Work stoppages	____	____	____
(2) Other labor difficulties	____	____	____
(3) Substantial dependence on a particular project or customer	____	____	____
(4) Uneconomic long-term commitments	____	____	____
(5) Need to revise operations significantly	____	____	____
d. Ascertain if the following external matters have occurred:			
(1) Legal proceedings	____	____	____
(2) Adverse legislation	____	____	____
(3) Loss of key franchise, license or plant	____	____	____
(4) Loss or principal customer or supplier	____	____	____
(5) Uninsured or underinsured catastrophe	____	____	____
6. Consider whether the accumulated results of audit procedures and other observations affect the assessment of the risk of material misstatement due to fraud made when planning the audit.	____	____	____
7. If, after considering the matters in step 4 above, a substantial doubt exists regarding the entity's ability to continue as a going concern for a reasonable period of time:			
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.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by	Date	W/P Ref.
8. Obtain written representation from management of the client (SAS No. 19 [AU section 333]) and the company's legal representatives.	____	____	____
9. 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.	____	____	____
10. Determine that all applicable disclosure checklists and review programs have been completed. (See Financial Statement Preparation Manual and AAM sections 9200-9500.)	____	____	____
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: Some 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.

15. Determine that any required communications in accordance with SAS No. 61, *Communication With Audit Committees* (AU section 380), have been made, including the following matters:			
a. The auditor's responsibility under generally accepted auditing standards (e.g., matters relating to internal control, whether the financial statements are free of material misstatement, etc.).	____	____	____
b. Significant accounting policies (initial selection of and changes in significant accounting policies, or their application).	____	____	____
c. Management judgments and accounting estimates (the process followed by management in formulating sensitive			

	Done by	Date	W/P Ref.
accounting estimates and, 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.	____	____	____
f. Disagreements with management, whether or not satisfactorily resolved, about 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 about any accounting or auditing matters.	____	____	____
h. Major issues discussed with management prior to retention (e.g., issues relating to the application of accounting principles and auditing standards).	____	____	____
i. Difficulties encountered in performing the audit (e.g., unreasonable delays in commencement of the audit, providing information, client personnel, etc.).	____	____	____
16. Communicate internal control related matters noted (SAS No. 60 [AU section 325]).	____	____	____
17. Determine that required communications, proper as to form and content, have been made as necessary to disclose fraud and/or illegal acts noted during the course of the audit (SAS No. 82 [AU section 316.38–.40] and SAS No. 54 [AU section 317]).	____	____	____

Practice Tip

To help comply with an auditor's communication responsibilities regarding fraud-related matters (SAS No. 82 [AU section 316]), a **checklist** has been provided at the end of this program. When fraud is identified, the auditor should complete the checklist to ensure that he or she has fulfilled his or her communication responsibilities.

C. Section Completion

This audit program section has been completed in accordance with firm policy.

Done by	____	____	____
Reviewed by	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Fraud Communication Checklist

When fraud is identified during an audit, an auditor should complete the appropriate checklist below to facilitate compliance with communication requirements.

SAS No. 82 Communication Requirements for Material Fraud and Any Fraud Involving Senior Management

No.	*Action*	*Sign-Off or N/A*
1.	Consider implications for other aspects of the audit.	
2.	Reevaluate the assessment of the risk of fraud.	
3.	Discuss matter and the approach to further investigation with appropriate level of management.	
4.	Obtain additional evidential matter, including suggesting that client consult with legal counsel.	
5.	Consider whether any risk factors identified represent reportable conditions (SAS No. 60).	
6.	Consider withdrawing from engagement and communicating reasons to audit committee (or board of directors, etc.).	
7.	Report the fraud to audit committee.*	
8.	Insist that the financial statement be revised and, if it is not, express a qualified or adverse opinion. If precluded from obtaining needed evidence, disclaim an opinion or withdraw.	

---

* *Notes:* (A) If perpetrator controls audit committee or board of directors, go directly to client's legal counsel.

(B) If perpetrator is general partner acting against interest of limited partners, obtain legal advice and consider communicating to limited partners.

(C) If perpetrator is owner-manager of a small business, auditor has little choice but to communicate with perpetrator and has no obvious course of action but to withdraw. However, first consult with legal counsel.

SAS No. 82 Communication Requirements for Immaterial Fraud, Not Involving Senior Management

No.	*Action*	*Sign-Off or N/A*
1.	Evaluate implications for other aspects of audit, especially organizational position of persons involved.	
2.	Bring to attention of and discuss with appropriate level of management (even if inconsequential).	
3.	Communicate matter to audit committee unless auditor has reached agreement concerning communication threshold with audit committee.	
4.	Consider whether any risk factors identified represent reportable conditions (SAS No. 60).	

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

.030

	Done by	*Date*	*W/P Ref.*

II. Internal Control

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Procedures:

A. Understanding the Client's Internal Control Components (Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring)

1. Obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment considering both the substance of controls and their collective effect. Knowledge of the control environment can be obtained from previous experience with the entity, inquiries of appropriate management, supervisory, and staff personnel, inspection of entity documents and records, and observation of entity activities and operations. ____ ____ ____

2. In obtaining knowledge of the control environment, consider the following factors:

   a. Integrity and ethical values ____ ____ ____

   b. Commitment to competence ____ ____ ____

   c. Board of directors or audit committee participation ____ ____ ____

   d. Management's philosophy and operating style ____ ____ ____

   e. Organizational structure ____ ____ ____

   f. Assignment of authority and responsibility ____ ____ ____

   g. Human resource policies and practices ____ ____ ____

	Done by	Date	W/P Ref.
3. Obtain sufficient knowledge of the entity's risk assessment process to understand how management considers risks relevant to financial reporting objectives and decides about actions to address those risks. Knowledge of the risk assessment process can be obtained from previous experience with the entity, inquiries of appropriate management, supervisory, and staff personnel, inspection of entity documents and records, and observation of entity activities and operations.	____	____	____
4. In obtaining knowledge of the entity's risk assessment process, consider the following:			
a. How management identifies risks.	____	____	____
b. How management estimates the significance of the risks.	____	____	____
c. How management assesses the likelihood of the occurrence of risks.	____	____	____
d. How management relates the risks to financial reporting.	____	____	____
5. Obtain an understanding of those control activities relevant to planning the audit. Knowledge about control activities will often be derived from considering the other components of internal control, previous experience with the entity, inquiries of appropriate management, supervisory, and staff personnel, inspection of entity documents and records, and observation of entity activities and operations.	____	____	____

Note: Ordinarily, audit planning does not require an understanding of the control activities related to every account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to them.

6. In obtaining an understanding of control activities, consider policies and procedures that pertain to the following:			
a. Performance reviews	____	____	____
b. Information processing	____	____	____
c. Physical controls	____	____	____
d. Segregation of duties	____	____	____
7. Obtain sufficient knowledge of the information system relevant to financial reporting to understand:			
a. The classes of transactions in the entity's operations that are significant to the financial statements.	____	____	____
b. How those transactions are initiated.	____	____	____
c. The accounting records, supporting information, and specific accounts in the financial statements involved in the processing and reporting of transactions.	____	____	____
d. The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, inclu-			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by	Date	W/P Ref.
ding electronic means (such as computers and electronic data interchange) used to transmit, process, maintain, and access information.			
e. The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.			
Knowledge of the information system relevant to financial reporting can be obtained from previous experience with the entity, inquiries of appropriate management, supervisory, and staff personnel, inspection of entity documents and records, and observation of entity activities and operations.			
8. Obtain sufficient knowledge of the means the entity uses to communicate financial reporting roles and responsibilities and significant matters relating to financial reporting.			
9. Obtain sufficient knowledge of the major types of activities the entity uses to monitor internal control over financial reporting, including how those activities are used to initiate corrective actions. Knowledge of monitoring activities can be obtained from previous experience with the entity, inquiries of appropriate management, supervisory, and staff personnel, inspection of entity documents and records, and observation of entity activities and operations.			
B–1. Revenues, Receivables, and Receipts—Understanding and Risk Assessment			
1. Obtain and document 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. An understanding can be obtained from previous experience with the entity, inquiries of appropriate management, supervisory, and staff personnel, inspection of entity documents and records, and observation of entity activities and operations (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 C–1. 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 B–2, below—Tests of Controls.	____	____	____

Remember: Assessing control risk and choosing 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. Consider the following matters as appropriate. Cross-reference to AAM section 5400.060.

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.).	____	____	____

B–2. 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	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.	____	____	____
B–3. 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 policy (completion of questionnaires, checklists, preparation or required memoranda, etc.).	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by	Date	W/P Ref.
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 the design and operation of controls. See AAM section 4600.15.

C–1. Purchases, Accounts Payable, and Disbursements—Understanding and Risk Assessment

1. Obtain and document 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 assets purchased have been placed in operation. An understanding can be obtained from previous experience with the entity, inquiries of appropriate management, supervisory, and staff personnel, inspection of entity documents and records, and observation of entity activities and operations (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 D–1. 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 C–2 below—Tests of Controls. ____ ____ ____

Remember: Assessing control risk and choosing 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.

	Done by	Date	W/P Ref.
3. Based on the assessed level of control risk the timing and extent of substantive tests may be affected. Consider the following matters as appropriate. Cross-reference to AAM section 5400.100 and 5400.160.			
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.	____	____	____

C–2. 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.

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).	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	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			

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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.

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.

C–3. 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.

D–1. Payroll—Understanding and Risk Assessment

1. Obtain and document 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. An understanding can be obtained from previous experience with the entity, inquiries of appropriate management, supervisory, and staff personnel, inspection of entity documents and records, and observation of entity activities and operations (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 E–1. 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 D–2—Tests of Controls. ____ ____ ____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by	Date	W/P Ref.

Remember: Assessing control risk and choosing an audit strategy is made at the assertion level, not a global level. A primarily substantive testing approach made 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. Consider the following matters as appropriate. Cross-reference to AAM section 5400.160.

   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. ____ ____ ____

D–2. 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 deposit 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.) ____ ____ ____

	Done by	Date	W/P Ref.
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.	____	____	____
5. Evidence in support of payroll withholdings. (For example, signed W-4 forms or other proper authorization.)	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by	Date	W/P Ref.
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.	____	____	____

D–3. 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.

E–1. Inventories and Cost of Sales—Understanding and Risk Assessment

1. Obtain and document a sufficient understanding of the design of relevant controls which relate to the inventory, cost of sales account balances and transactions and whether they have been placed in operation. An understanding can be obtained from previous experience with the entity, inquiries of appropriate management, supervisory, and staff personnel, inspection of entity documents and records, and observation of entity activities and operations (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.)	____	____	____

	Done by	Date	W/P Ref.
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 E–2—Tests of Controls.	____	____	____

Remember: Assessing control risk and choosing an audit strategy is made at the assertion level, not a global level. A primarily substantive testing approach made 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.	____	____	____

E–2. 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.

1. Tour the client's manufacturing or production facilities with a member of the client's organization familiar with production.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by	Date	W/P Ref.
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.

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.)	____	____	____
(3) Trace direct labor costs to account distributions of the payroll registers and on a test basis to individual time			

	Done by	Date	W/P Ref.
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.	____	____	____

E–3. Inventories and Cost of Sales—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.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by	Date	W/P Ref.
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.

F. 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.

.040

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 ____ ____ ____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	b. Internal control documentation and test results	____	____	____
	c. Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors)	____	____	____
	d. Other planning documents and risk assessments	____	____	____
	2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.	____	____	____
[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.	____	____	____

Obj.		Done By	Date	W/P Ref.
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.	____	____	____
	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			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	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 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			

Obj.			Done By	Date	W/P Ref.
		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.	____	____	____
		(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. Additional Procedures (if any)

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		*Done By*	*Date*	*W/P Ref.*
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 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.

.050

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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. Internal control documentation and test results	____	____	____
	c. Assessment of risk of material misstatement (due to error, fraud, illegal acts or other factors)	____	____	____
	d. Other planning documents and risk assessments	____	____	____
	2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.	____	____	____
[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 or cost methods.	____	____	____
	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.	____	____	____

Obj.			Done By	Date	W/P Ref.
		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.			
		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.			
A D E	6.	Read executed partnership, debt security, preferred stock and similar agreements to determine that management's assertions regarding those investments are consistent with their contractual terms.			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
E	7. Ascertain whether the accounting policies adopted by the entity for investments are in conformity with generally accepted accounting principles (i.e., certain investments should be accounted for under FASB Statement No. 115, other investments may require the application of the cost or equity methods of accounting).			
E	8. Obtain an understanding of the process used by management to classify investments.			
E	9. Determine that all debt and equity securities accounted for under FASB Statement No. 115, as amended by FASB Statement No. 125, are properly classified as either held-to-maturity, available-for-sale, or trading by:			
	a. Evaluating management's intent in purchasing and holding the investment.			
	b. Considering whether the client's actual investment activities corroborate or conflict with management's stated intent. Examine, as appropriate, evidence such as:			
	(1) Written and approved records of investment strategies			
	(2) Records of investment activities			
	(3) Instructions to portfolio managers			
	(4) Minutes of meetings of the board of directors or investment committee			
	c. Evaluating the client's ability to hold a debt security to maturity. Consider, as appropriate, factors such as:			
	(1) Financial position			
	(2) Working capital needs			
	(3) Operating results			
	(4) Debt agreements			
	(5) Guarantees and other relevant contractual obligations			
	(6) Laws and regulations			
	(7) Existing operating cash flow projections or forecasts			
E	10. For investments accounted for under FASB Statement No. 115, obtain written representations from management confirming that the client has properly classified securities as held-to-maturity, trading, or available-for-sale, and, with respect to held-to-maturity debt securities, obtain a representation that management has the intent and the client has the ability to hold such investments to maturity.			
E	11. For investments accounted for under the equity method (APB Opinion No. 18), determine the appropriateness of that accounting method (investor must exercise significant influence, but not control, over an investee). Procedures should include:			

Obj.		Done By	Date	W/P Ref.
	a. Inquiry of management as to:			
	(1) Whether the client has the ability to exercise significant influence over the operating and financial policies of the investee under the criteria set forth in paragraph 17 of APB Opinion No. 18.	____	____	____
	(2) The attendant circumstances that serve as a basis for management's conclusion.	____	____	____
E	12. If the client accounts for an investment in an investee contrary to the applicable presumption contained in paragraph 17 of APB Opinion No. 18, obtain sufficient competent evidential matter about whether that presumption has been overcome and whether appropriate disclosure is made regarding the reasons for not accounting for the investment in keeping with the presumption.	____	____	____
A B C E	13. For investments accounted for under the equity method, agree the investment to the proper audited financial statements of the investee (There may be a time lag in reporting between the date of the financial statements of the investor (client) and the investee.):			
	a. If the financial statements of the investee are not audited, apply (or have the investee's auditor apply) appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor (client).	____	____	____
	b. With respect to subsequent events and transactions of the investee occurring after the date of the investee's financial statements but before the date of the report of the investor (client), read available interim financial statements of the investee and make appropriate inquiries of the client to identify subsequent events and transactions that are material to the client's financial statements.	____	____	____
B C E	14. For investments accounted for using the equity method, obtain evidence relating to material transactions between the investor (client) and investee and evaluate the propriety of the elimination of unrealized intercompany profits and losses and the adequacy of the disclosures about material related-party transactions.	____	____	____
	15. For investments carried at cost or amortized cost (and for disclosures regarding the cost basis of investments):			
	a. Determine that they are valued at cost. Procedures may include inspection of documentation indicating the purchase price of the security, and confirmation with the issuer or custodian.	____	____	____
	b. Recalculate the amortized cost.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
B E	16. For investments carried at fair value (and for disclosures regarding the fair value of investments), obtain evidence corroborating their fair value by performing the following procedures as applicable:			
	a. For investments listed on national exchanges or over-the-counter markets, agree the fair value to quoted market prices listed in financial publications, the exchanges, or the National Association of Securities Dealers Automated Quotations System (NASDAQ).	____	____	____
	b. For other investments, agree the fair value to quoted market prices obtained from broker-dealers who are market makers in those investments.	____	____	____
	c. For investments which do not have available quoted market prices, obtain estimates of fair value from third-party sources based on proprietary models or obtain estimates of fair value from the client based on internally developed or acquired models.	____	____	____
	d. For fair-value estimates obtained from broker-dealers and other third-party sources, consider the applicability of the guidance in SAS No. 73 or SAS No. 70.	____	____	____
	e. For investments valued by the client using a valuation model, assess the reasonableness and appropriateness of the model, and determine whether the market variables and assumptions used are reasonable and appropriately supported.	____	____	____
	f. For investments valued by the client using a valuation model, determine whether the client has made appropriate disclosures about the method(s) and significant assumptions used to estimate the fair values of such investments.	____	____	____
	g. If debt securities have collateral assigned to them and that collateral is an important factor in evaluating fair value and collectibility of the investment, obtain evidence regarding the existence, fair value, and transferability of such collateral as well as the client's rights to the collateral.	____	____	____
B C E	17. For debt and equity securities classified as available-for-sale, recalculate unrealized gains and losses and determine whether they are properly included as a separate component of stockholders' equity.	____	____	____
B C E	18. For debt and equity securities classified as trading, recalculate unrealized gains and losses and determine whether they are properly included in earnings.	____	____	____
B E	19. Evaluate management's conclusions regarding whether a decline in fair value below the amortized cost basis of investments is other than temporary. In evaluating management's conclu-			

Obj.		Done By	Date	W/P Ref.
	sions, obtain evidence about conditions, such as those listed in paragraph 32 of SAS No. 81, that tend to corroborate or conflict with such conclusions.			

Practice Tip

The FASB has published a special report entitled, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities.* This publication may be helpful in answering questions regarding the application of FASB Statement No. 115.

[A]	20. Determine that sales and purchases were properly approved; trace transactions to minutes of the board of directors or finance committee meetings.			
A C E	21. Examine bank or broker's advices and custodian's reports in support of purchases and sales.			
C E	22. Determine that gain or loss on disposition of a security has been computed and accounted for properly.			
A C E	23. Trace payments for purchases to canceled checks and proceeds from sales to entries in cash book.			
	24. 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	25. Determine that the amortization of premium and discount on debt securities, where applicable, has been properly computed and accounted for.			
E	26. Determine that any transfers between categories of investments have been properly recorded.			
	27. Obtain a list of all derivative transactions.			
A D	*a.* Examine evidence of the transactions and directors' approval of the transactions.			
E	*b.* Obtain confirmations of outstanding transactions as of year end.			
A	*c.* Review subsequent transactions to determine completeness of the list.			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
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	28. Determine if any securities are pledged or restricted.			
A	29. Evaluate the credit quality of the investments and determine whether purchases and sales conform to policy.			
E	30. Ensure that all information needed for financial statement disclosures has been accumulated and documented in the working papers.			
E	31. 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:			

Note: Disclosures about the fair value of financial instruments prescribed in FASB Statement No. 107 are optional for nonpublic entities that meet certain criteria (see FASB Statement No. 126). Determine if the client is making FASB Statement No. 107 disclosures. Also, FASB Statement No. 107 does not apply to investments accounted for under the equity method.

	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.			

D. Accounting by a Transferor and Transferee for All Transfers of Financial Assets

Note: FASB Statement No. 127 has deferred for one year the effective date of FASB Statement No. 125 for repurchase agreements, dollar-rolls, securities lending, and similar transactions. See FASB Statement No. 127 for more details.

	1. Determine that the proceeds received from the transfer of financial assets have been recognized as a sale, if all of the following conditions are met:			
	a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.			

Obj.		Done By	Date	W/P Ref.
	b. Each transferee has either obtained the right, free of conditions that constrain it from taking advantage of that right, to pledge or exchange the transferred assets, or the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right, to pledge or exchange those interests.	____	____	____
	c. The transferor does not maintain effective control over the transferred assets through either an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.	____	____	____
	2. Determine that the proceeds received from the transfer of financial assets that do not meet the aforementioned conditions of a sale have been accounted for as a secured borrowing with a pledge of collateral.	____	____	____
	3. Upon completion of any transfer of financial assets, determine that the transferor has:			
	a. Continued to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization, and retained undivided interests.	____	____	____
	b. Allocated the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer.	____	____	____
	4. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (see step 1 above), determine that the *transferor* has:			
	a. Derecognized all assets sold.	____	____	____
	b. Recognized all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (e.g., guarantee or recourse obligations), forward commitments (e.g., commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (e.g., provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable.	____	____	____
	c. Initially measured at fair value assets obtained and liabilities incurred in a sale or, if it is not practicable to estimate the fair value of an asset or a liability, applied alternative measures.	____	____	____
	d. Recognized in earnings any gain or loss on the sale.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	5. If the client is the *transferee*, determine that upon the completion of a transfer of assets that satisfies the conditions to be accounted for as a sale, the *transferee* recognizes all assets obtained and any liabilities incurred and initially measures them at fair value (in aggregate, presumptively the price paid).			
	6. If it is not practicable to estimate the fair values of assets, determine that the transferor recorded those assets at zero.			
	7. If it is not practicable to estimate the fair values of liabilities, determine that the transferor recognizes no gain on the transaction and records those liabilities at the greater of:			
	a. The excess, if any, of (1) the fair values of assets obtained less the fair values of other liabilities incurred, over (2) the sum of the carrying values of the assets transferred.			
	b. The amount that would be recognized in accordance with FASB Statement No. 5, as interpreted by FASB Interpretation No. 14.			
	8. Determine that all the necessary disclosures have been made (see FASB Statement No. 125, paragraph 17).			

E. Additional Procedures (if any)

F. Section Completion

	1. Based on the results of the audit procedures performed, reassess the risk of material misstatement due to error and due to fraud, and 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.

.060

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 ____ ____ ____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	b. Internal control documentation and test results			
	c. Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors)			
	d. Other planning documents and risk assessments			
	2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.			
[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.			

Obj.		Done By	Date	W/P Ref.
[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, especially 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.			
	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.			
	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.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	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.			
	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.

	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.

[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.			

Obj.		Done By	Date	W/P Ref.
	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			
	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 notes for collateral, 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.			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	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.	____	____	____
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.	____	____	____

Obj.		Done By	Date	W/P Ref.
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 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:			
	Note: Disclosures about the fair value of financial instruments prescribed in FASB Statement No. 107 are optional for nonpublic entities that meet certain criteria (see FASB Statement No. 126). Determine if the client is making FASB Statement No. 107 disclosures.			
	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.

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			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	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.

D. Receivables Sold (Transferred) With Recourse

1. Determine that the proceeds received from the transfer of receivables with recourse have been recognized as a sale, if all of the following conditions are met:
   a. The receivables have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. ____ ____ ____
   b. Each transferee has either obtained the right, free of conditions that constrain it from taking advantage of that right, to pledge or exchange the transferred assets, or the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right, to pledge or exchange those interests. ____ ____ ____
   c. The transferor does not maintain effective control over the transferred assets through either an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable. ____ ____ ____
2. Determine that the proceeds received from the transfer of receivables with recourse that do not meet the aforementioned conditions of a sale have been accounted for as a secured borrowing with a pledge of collateral. ____ ____ ____
3. Upon completion of any transfer of financial assets, determine that the transferor has:
   a. Continued to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets, beneficial interests in assets trans-

Obj.		Done By	Date	W/P Ref.
	ferred to a qualifying special-purpose entity in a securitization, and retained undivided interests.			
	b. Allocated the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer.			
	4. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (see step 1 above), determine that the transferor has:			
	a. Derecognized all assets sold.			
	b. Recognized all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (e.g., guarantee or recourse obligations), forward commitments (e.g., commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (e.g., provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable.			
	c. Initially measured at fair value assets obtained and liabilities incurred in a sale or, if it is not practicable to estimate the fair value of an asset or a liability, applied alternative measures.			
	d. Recognized in earnings any gain or loss on the sale.			

E. Additional Procedures (if any)

_____

_____

_____

_____

_____

_____

_____

_____

_____

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 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			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

.070

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. Internal control documentation and test results	____	____	____
	c. Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors)	____	____	____
	d. Other planning documents and risk assessments	____	____	____
	2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.	____	____	____
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 con-			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	signed and customer's goods, and for controlling the movement of inventory during the count and controlling shipping and receiving during the count.			
	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.

	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			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

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: _____			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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-			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. Additional Procedures (if any)

_____

_____

_____

_____

_____

_____

_____

_____

_____

K. 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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

.080

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.* Internal control documentation and test results
   - *c.* Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors)
   - *d.* Other planning documents and risk assessments
2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.

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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	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.	____	____	____
	(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 crossfootings 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.	____	____	____

Obj.			Done By	Date	W/P Ref.
	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 engineers 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.			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
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.	____	____	____
	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.	____	____	____

Obj.		Done By	Date	W/P Ref.
	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.	____	____	____
	(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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.	____	____	____
	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.	____	____	____

Obj.		Done By	Date	W/P Ref.
	(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.	____	____	____
	(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. Additional Procedures (if any)

_____
_____
_____
_____
_____
_____
_____
_____
_____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	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 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.

.090

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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. Internal control documentation and test results	____	____	____
	c. Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors)	____	____	____
	d. Other planning documents and risk assessments	____	____	____
	2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.	____	____	____
	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.	____	____	____

Obj.			Done By	Date	W/P Ref.
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.			
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.			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
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.	____	____	____
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. Additional Procedures (if any)

_____
_____
_____
_____
_____
_____
_____
_____
_____

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 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.

.100

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.	Internal control documentation and test results	____	____	____
c.	Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors)	____	____	____
d.	Other planning documents and risk assessments	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.			
	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.			

Obj.			Done By	Date	W/P Ref.
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.	____	____	____
		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.

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.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
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.	____	____	____

D. Additional Procedures (if any)

_____

_____

_____

_____

_____

_____

_____

_____

_____

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 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

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.

.110

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:

a.	Preliminary analytical review	____	____	____
b.	Internal control documentation and test results	____	____	____
c.	Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors)	____	____	____
d.	Other planning documents and risk assessments	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.	____	____	____
	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 Tip

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.	____	____	____
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. Evaluate whether management has recorded all accrued liabilities (including those based on significant accounting estimates) that could be material to the financial statements. Consider:			
	a. Information from reading available minutes of meetings of stockholders, directors, and appropriate committees.	____	____	____
	b. Information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies.	____	____	____
	c. Information included on confirmation replies received from financial institutions or other entities.	____	____	____
	d. Information concerning identified litigation, claims, and assessments and other contingencies.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	e. Management replies to inquiries regarding possible accruals.			
A B	10. For those accrued liabilities based on significant accounting estimates, evaluate the reasonableness of the estimate by employing one or a combination of the following approaches:			
	a. Review and test the process used by management to develop the estimate. Consider performing the following procedures:			
	(1) Identify whether there are controls over the preparation of accounting estimates and supporting information that may be useful in the evaluation.			
	(2) Identify the sources of information that management used in forming the assumptions, and consider whether such information is relevant, reliable, and sufficient for the purpose.			
	(3) Consider whether there is additional key information or alternative assumptions about the information.			
	(4) Evaluate whether the assumptions are consistent with each other, the supporting information, relevant historical data, and industry data.			
	(5) Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose.			
	(6) Consider whether changes in the business or industry may cause other information to become more significant to the assumptions.			
	(7) Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the client, as well as consider their relationship to the assumptions.			
	(8) Consider using the work of a specialist regarding certain assumptions.			
	(9) Test the calculations used by management to translate the assumptions and key information into the accrued liability estimate.			
	b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.			
	c. Review subsequent events or transactions occurring prior to completion of fieldwork.			
A B	11. For environmental remediation liabilities identified during planning and other stages of the engagement, perform substantive tests as follows:			

Obj.		Done By	Date	W/P Ref.
	a. Test the accounting estimate recorded by management. (See step 10 above.)	____	____	____

Practice Tip

Read AICPA Statement of Position 96-1, *Environmental Remediation Liabilities* (appendix C), for guidance in applying step 10 above to environmental remediation liabilities. When auditing environmental remediation liabilities, steps 10*a* and 10*b* above, or a combination thereof, usually will be most effective.

	b. Request information about environmental remediation liabilities and loss contingencies in the letter of inquiry sent to the client's counsel.	____	____	____
	c. Obtain, as deemed necessary, written representations from management about estimates and disclosures of environmental remediation liabilities and loss contingencies affecting the financial statements, including specific representations as to the adequacy of such disclosures and the expected outcomes of uncertainties.	____	____	____
	d. If disclosure is required of environmental remediation liabilities and loss contingencies, assess the adequacy of the disclosures, including any conclusions expressed by management regarding the expected outcome of such contingencies.	____	____	____
A B	12. Review revenue accounts and determine whether income recorded in the current period should be deferred to future periods.	____	____	____
A B	13. 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]	14. 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	15. 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	16. Obtain and verify disclosure information for multi-employer plans and vouch expense for the period.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	WIP Ref.
A B	17. 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]	18. 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	19. Consider confirming contents of Trustee report with Trustee.	____	____	____
A B	20. 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	21. 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	22. 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	23. Reconcile plan assets per the trustee's report to amounts shown in the actuarial valuation report.	____	____	____
[A] [B]	24. 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.)	____	____	____

Obj.		Done By	Date	W/P Ref.
[A] [B]	25. Inquire as to any relationships between the actuary and the client that would impair independence.			
A B	26. Review the actuary's most recent certificate on Schedule B, Form 5500, and determine the reasons for qualifications expressed, if any.			
B	27. 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	28. 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	29. 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	30. 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	31. Inquire of the client as to any intent to terminate the plan.			
B	32. Obtain and check disclosure information.			
A B	33. 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	34. Obtain calculation of pension cost for the current period and agree components to actuarial report or trustee's report.			
A B	35. 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	36. 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]	37. 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.			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	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]	38. 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. Additional Procedures (if any)

_____
_____
_____
_____
_____
_____
_____
_____
_____

E. Section Completion

	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.	____	____	____
	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

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.

.120

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 ____ ____ ____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	b. Internal control documentation and test results	____	____	____
	c. Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors)	____	____	____
	d. Other planning documents and risk assessments	____	____	____
	2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.	____	____	____
	B. Detailed Tests			
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.	____	____	____

Obj.		Done By	Date	W/P Ref.
	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.			

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.

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.

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.			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		*Done By*	*Date*	*W/P Ref.*

C. Additional Procedures (if any)

_____
_____
_____
_____
_____
_____
_____
_____
_____

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 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	____	____	____

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.

.130

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 ____ ____ ____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	b. Internal control documentation and test results			
	c. Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors)			
	d. Other planning documents and risk assessments			
	2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.			
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)			

Obj.			Done By	Date	W/P Ref.
		(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)			
[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.

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.			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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:			
	Note: Disclosures about the fair value of financial instruments prescribed in FASB Statement No. 107 are optional for nonpublic entities that meet certain criteria (see FASB Statement No. 126). Determine if the client is making FASB No. 107 disclosures.			
	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. Extinguishments of Liabilities

A D	1. Determine that a liability has been derecognized if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:			
	a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods or services, or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.	____	____	____
	b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.	____	____	____
D	2. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76 prior to the effective date of FASB Statement No. 125, determine that a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding has been disclosed.	____	____	____

Obj.		Done By	Date	W/P Ref.
D	3. If assets are set aside after the effective date of FASB Statement No. 125 solely for satisfying scheduled payments of a specific obligation, determine that a description of the nature of restrictions placed on those assets has been disclosed.	____	____	____

E. Additional Procedures (if any)

_____
_____
_____
_____
_____
_____
_____
_____
_____

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 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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

.140

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. Internal control documentation and test results	____	____	____
	c. Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors)	____	____	____
	d. Other planning documents and risk assessments	____	____	____
	2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.	____	____	____
	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:			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	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 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.	____	____	____

Obj.		Done By	Date	W/P Ref.
	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.			
	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. For disclosure purposes, obtain information concerning the pertinent rights and privileges of the various securities outstanding. Information includes dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking-fund requirements, unusual voting rights, significant terms of contracts to issue additional shares, and redemption requirements. Determine that such information is accurate.			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.	*Done By*	*Date*	*W/P Ref.*

F. Additional Procedures (if any)

_____

_____

_____

_____

_____

_____

_____

_____

_____

G. 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.

.150

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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. Internal control documentation and test results	____	____	____
	c. Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors)	____	____	____
	d. Other planning documents and risk assessments	____	____	____
	2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.	____	____	____
	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).	____	____	____

Obj.			Done By	Date	W/P Ref.
		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.			
[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.			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	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.).			
	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.			
A	14. If earnings-per-share information is presented, determine that the computation and presentation of such amounts are in conformity with the requirements of FASB Statement No. 128, *Earnings per Share.*			

D. Additional Procedures (if any)

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

Obj.		*Done By*	*Date*	*W/P Ref.*
	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			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

.160

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.

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. Internal control documentation and test results	____	____	____
	c. SAS No. 70 report on service center processed transactions (payroll)	____	____	____
	d. Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors)	____	____	____
	e. Other planning documents and risk assessments	____	____	____
	2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.	____	____	____
ABC DEF	**B. Substantive Analytical Procedures**			
	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.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.*			
A B	5. If the client has incurred external or internal costs associated with modifying internal-use software for the year 2000, determine that those costs have been charged to expense as incurred.			

Obj.		Done By	Date	W/P Ref.
	6. 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. Additional Procedures (if any)

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
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 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.	____	____	____
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.

.170

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. 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. Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors) ____ ____ ____

   c. Other planning documents and risk assessments ____ ____ ____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work.	____	____	____
	B. Contingencies			
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.	____	____	____
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	3. Review minutes of directors' meetings and discuss all pertinent items with management. Make excerpts and agree to applicable			
A B	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.	____	____	____

Obj.		Done By	Date	W/P Ref.
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.			
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*

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.			

C. 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.)			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.		Done By	Date	W/P Ref.
	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.	____	____	____
	g. Mergers or acquisitions pending.	____	____	____
	h. Capital stock repurchase agreements.	____	____	____
	i. Futures contracts.	____	____	____
	j. Other.	____	____	____

D. Additional Procedures (if any)

_____
_____
_____
_____
_____
_____
_____
_____
_____

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 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.

.180

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-

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

.190

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. 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. Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors) ____ ____ ____
   c. Other planning documents and risk assessments ____ ____ ____
2. Based on the fraud risk assessment and the presence of fraud risk factors, determine whether additional audit procedures are needed. Consult the "Fraud Risk Factor Memory Jogger" (if utilized), and other planning documents. If additional procedures are necessary, add them to this audit program and perform the specified work. ____ ____ ____

Obj.		Done By	Date	W/P Ref.
	B. Substantive Test Procedures			
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.	____	____	____
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.	____	____	____

C. Additional Procedures (if any)

_____

_____

_____

_____

_____

_____

_____

_____

_____

D. 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			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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

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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 (AICPA)

Audit and Accounting Guides (AICPA)

Financial Statement Preparation Manual (AICPA)

Disclosure Checklist series (AICPA) (individual paperback versions of sections of the *Financial Statement Preparation Manual*)

Considering Fraud in a Financial Statement Audit (AICPA)

Auditing Procedure Studies (AICPA)

Technical Practice Aids (AICPA)

Accounting Trends & Techniques (AICPA)

Derivatives—Current Accounting and Auditing Literature (AICPA)

Standard Confirmation Forms (AICPA)

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 (AICPA)

Accounting Standards—Original Pronouncements (Financial Accounting Standards Board)

Federal Audit Guides (Commerce Clearing House)

[*The next page is 6001.*]

AAM Section 6000
Working Papers

TABLE OF CONTENTS

Section		*Paragraph*
6100	Working Papers—General	.01-.03
	General Discussion	.02-.03
6200	Basic Elements of Format	.01-.04
6300	Content of Working Papers	.01-.06
	General Considerations	.02
	Timesaving Considerations	.03
	Symbols (Tick Marks)	.04-.06
6400	Organization and Filing (Indexing)	.01-.17
	Predetermined Indexing	.02-.09
	Current and Permanent Files	.10-.13
	Work-Paper Retention	.14-.16
	Index Topics	.17
6500	Sample Working Papers	

[*The next page is 6101.*]

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 check-

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

mark 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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- 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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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, Confirmation & 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

Section		*Paragraph*
7100	Control of Confirmations and Correspondence	.01-.09
7200	Requests for Confirmations and Related Materials	.01-.33
	Wording of Confirmation Request Forms	.01-.02
	Request for Bank Cutoff Statement	.03
	Standard Form to Confirm Account Balance Information With Financial Institutions	.04
	Request for Confirmation of Petty Cash Fund and Advances to Employees	.05
	Securities and Cash in Custodian or Trust Accounts	.06
	Securities Held by Brokers	.07
	Sample Receipts for Return of Cash or Securities Counted by Auditor's Representative, and Cutoff Bank Statements Received Directly by the Auditors	.08
	Accounts Receivable—Positive	.09
	Accounts Receivable—Negative	.10
	Notes Receivable	.11
	Inventories Held by Warehouses or Others When Listing Is Not Provided by Client	.12
	Inventories Held by Warehouses or Others When Listing Is Provided by Client	.13
	Standard Confirmation Inquiry for Life Insurance Policies	.14
	Pension Plan Actuarial Information	.15
	Pension Plan Assets Held by Trustee	.16
	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	.17
	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	.18

Section		*Paragraph*
7200	Requests for Confirmations and Related Materials—continued	
	Notes Payable	.19
	Mortgage Debt	.20
	Accounts Payable	.21
	Obligation to Lessor	.22
	Property Out on Lease	.23
	Registrar—Capital Stock	.24
	Transfer Agent—Capital Stock	.25
	Request for Confirmation of Money Market Fund	.26
	Confirmation of Contingent Liabilities	.27
	Confirmation of Compensating Balances	.28
	Confirmation of Lines of Credit	.29
	Related-Party Confirmation	.30
	Safe Deposit Box Access Confirmation	.31
	Insurance In Force Confirmation Request	.32
	Illustrative Letter to Actuary Requesting Employer's Benefit Cost Information	.33
7300	Inquiries to Legal Counsel	.01-.03
	Illustrative Inquiry Letter to Legal Counsel	.01
	Illustrative Inquiry Letter to Legal Counsel If Management Has Not Provided Details About Pending or Threatened Litigation	.02
	Improving Inquiry Techniques	.03
7400	Representation Letters	.01-.05
	Illustrative Representation Letter—Audit of Financial Statements	.01
	Illustrative Representation Letter—Review of Financial Statements	.02
	Illustrative Representation Letter—Personal Financial Statements	.03
	Illustrative Representation Letter to Other Accountants	.04
	Letter to Other Accountants Upon Whose Work We Plan to Rely	.05
7500	Communication With Audit Committees	.01-.03
	Illustrative Communication With Audit Committees	.01
	Report on Reportable Conditions	.02
	Report on Reportable Conditions That Also Identifies a Material Weakness	.03
7600	Reliance Letter	.01
	Illustrative Reliance Letter	.01
7700	Proposal Letter	.01
	Illustrative Proposal Letter	.01

[*The next page is 7101.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 of 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 (*name and address of accountants*) who are performing accounting services for the company.

.02 The samples of correspondence in this section include language that refers to auditors and an audit of the client's financial statements on the assumption that an audit is being performed. This language needs to be modified if services other than an audit are being performed.

.03 Request for Bank Cutoff Statement

[*Prepared on Client's Letterhead*]

[*Date*]

Financial Institution Official
First United Bank
Anytown, USA 00000

In connection with an audit of the financial statements of (*name of client*) as of (*balance-sheet date*) and for the (*period*) then ended, we request that you send the following information directly to our auditors (*name and address of auditors*) as of close of business (*balance-sheet date*):

1. The information requested on the enclosed standard form(s) to confirm account balance information with your financial institution.
2. For the account numbers listed below, statement(s) of our account(s) and the related paid checks for the period from (*balance-sheet date*) to (*two weeks subsequent to the balance-sheet date*) inclusive.

Account Number	*Account Name*
_____	_____
_____	_____
_____	_____
_____	_____

Sincerely,

[*Name of Customer*]

_____

By: _____

_____

Notes: (A) This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the transactions or arrangements. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

(B) The request 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.

(C) 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 assessment of control risk.)

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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 D 451 5951

.05 Request for Confirmation of Petty Cash Fund and Advances to Employees

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]
[*Address*]

Our auditors, (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of the petty cash fund (or amount of advances) in your possession as of December 31, 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 enveloped 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: _____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.06 Securities and Cash in Custodian or Trust Accounts

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Custodian or Trustee*]
[*Address*]

Our auditors, (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the enclosed list of securities owned at (*date*) and the amount of principal and income of cash held by you at that date for each of the following accounts [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: (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*]

[*Broker's Name*]
[*Address*]

In connection with the audit of our financial statements, please send directly to our auditors (*name and address of auditors*), a statement of our account(s) with you as of (*date*), indicating the following information:

1. Securities held by you for our account.
2. Securities out for transfer to our name.
3. Any amounts payable to or due from us.

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,

[*Client's Authorized Signature*]

Notes: (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).

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.08 Sample Receipts for Return of Cash or Securities Counted by Auditor's Representative, and Cutoff Bank Statements Received Directly by the Auditors

Cash Count

The above detailed items were counted in my presence and returned to me intact by (*individual's name*), representative of (*auditor's firm name*).

(*Date and Time*) Custodian: _____
(*Custodian's Signature*)

Securities Count

Received intact from (*individual's name*), representative of (*auditor's firm name*), the securities listed above contained in Box _____ of the (*name of bank or custodian*) which were counted by him or her in my presence (or presented to him or her for count).

Date and Time: _____ Signed: _____

Title: _____

Cutoff Bank Statement(s)

Received intact from (*individual's name*), representative of (*auditor's firm name*), the cutoff bank statements and related paid checks for the period from _____ to _____ (*periods indicated*) for the accounts listed below:

Date and Time: _____ Signed: _____

Title: _____

Notes: (A) Receipt(s) should be written and signed in *ink*.

(B) For counts of petty cash funds, the receipt may be written directly on the bottom of the petty cash-count working paper. For security counts and returns of cutoff bank statements, the receipt may be prepared as a separate working paper.

.09 Accounts Receivable—Positive

[*Prepared on Client's Letterhead*]

[*Customer Name*]
[*Address*]

In connection with the audit of our financial statements, please confirm directly to our auditors (*name and address of auditors*) the amount of your indebtedness to us which according to our records as of (*date*) amounted to $_____.

If the amount shown is in agreement with your records. Please check "A" 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*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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: (A) A negative confirmation may also be requested in letter form using similar wording.

(B) 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.

(C) Negative confirmation requests may be used as substantive procedure to reduce audit risk *only* when three conditions exist: (1) the combined assessed level of inherent and control risk is low, (2) a large number of small balances is involved, and (3) the auditor has no reason to believe that the recipients of the request are unlikely to give them consideration.

.11 Notes Receivable

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]
[*Address*]

Our auditors (*name and address of auditors*) are performing an audit of our financial statements. Accordingly, please confirm directly to our auditors the amount of your indebtedness due us as of (*date*), which our records show as follows:

Type of indebtedness _____
Initial date of indebtedness _____
Original amount of indebtedness _____
Unpaid principal _____
Interest rate _____
Interest paid to _____
Periodic payments required _____
Description of collateral _____

If the above information is in agreement with your records, please so indicate by signing in the 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 (*date*) with the following exceptions (if any): _____

_____

_____

_____

_____

_____

_____

Date: _____ Signed: _____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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 (*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 (*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 (*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 (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about the merchandise held by you for our account as of (*date*):

1. The correctness of the quantities shown on the enclosed listing of such merchandise prepared from our records (a second copy is enclosed for your files). If the enclosed listing differs from the quantities you held for us as of (*date*), please include details of the specific differences in your response to our auditors.

2. Your statement on how you determined the correctness of the quantities you are confirming; please specify whether 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 (*date*).

Please mail your reply directly to (*name and address of auditors*). A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,

[*Client's Authorized Signature*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.14

STANDARD CONFIRMATION INQUIRY FOR LIFE INSURANCE POLICIES

LIFE INSURANCE STANDARD CONFIRMATION INQUIRY

Developed by American Institute of Certified Public Accountants
Life Office Management Association
and Million Dollar Round Table

RETURN TO: [ ]

[ ]

REPORT FROM INSURANCE COMPANY [ ]

[ ]

Date:

Your completion of the following report will be sincerely appreciated. IF THE ANSWER TO ANY ITEM IS "NONE," PLEASE SO STATE. Use the enclosed envelope to return the original directly to our accountant (see name to left).

Yours truly,

(Name of owner as shown on policy contract)

By _____
Authorized Signature

Information requested as of: _____
(Date)

Additional forms available from AICPA-ORDER PO BOX 0946 NYC, NY 10108-0946

		Policy #1	Policy #2	Policy #3
	A. Policy Number			
	B. Insured-Name(s)			
	C. Beneficiaries as Shown on Policies (If Verification Requested in Item 11)			
1 Face Amount of Basic Policy				
2 Values Shown as of (Insert Date If Other Than Date Requested)				
3 Premiums, Including Prepaid Premiums, Are Paid to (Insert Date)				
4 Policy Surrender Value (Excluding Dividends, Additions & Indebtedness Adjustments)				
5 Surrender Value of All Dividend Credits, Including Accumulations & Additions				
6 Termination Dividend Currently Available on Surrender				
7 Other Surrender Values Available to Policy Owner	a. Prepaid Premium Value			
	b. Premium Deposit Funds			
	c. Other			
8 Outstanding Policy Loans, Excluding Accrued Interest				
9 If Any Policy Loans Exist, Complete Either "a" or "b"	a. Interest Accrued on Loans			
	b1. Loan Interest is Paid to (Enter Date)			
	b2. Interest Rate is (Enter Rate)			
NOTE: PLEASE ANSWER ANY ITEM(s) 10–12 INDICATED BY A (✓).				
☐ 10 Is There an Assignee of Record? (Enter Yes or No)				
☐ 11 Is Beneficiary of Record as Shown in Item C. Above? (Enter Yes or No*)		*	*	*
☐ 12 Is the Name of Policy Owner (Subject to Any Assignment) as Shown on Top of Form: ☐ Yes ☐ No If No, Enter Name of Policy Owner of Record:				

* If Answer to Item 11 is "No." Please Give Name of Beneficiary or Date of Last Beneficiary Change:

Yours truly, (Insurance Company)

ORIGINAL
To be mailed to accountant

_____ Date

_____ Authorized Signature - Title

STANDARD CONFIRMATION INQUIRY FOR LIFE INSURANCE POLICIES

LIFE INSURANCE STANDARD CONFIRMATION INQUIRY

Developed by American Institute of Certified Public Accountants Life Office Management Association and Million Dollar Round Table

RETURN TO: [ ]

[ ]

REPORT FROM INSURANCE COMPANY [ ]

[ ]

Date:

Your completion of the following report will be sincerely appreciated. IF THE ANSWER TO ANY ITEM IS "NONE," PLEASE SO STATE. Use the enclosed envelope to return the original directly to our accountant (see name to left).

Yours truly,

(Name of owner as shown on policy contract)

By _____
Authorized Signature

Information requested as of: _____
(Date)

Additional forms available from AICPA-ORDER PO BOX 0946 NYC, NY 10108-0946

		Policy #1	Policy #2	Policy #3
A. Policy Number				
B. Insured-Name(s)				
C. Beneficiaries as Shown on Policies (If Verification Requested in Item 11)				
1 Face Amount of Basic Policy				
2 Values Shown as of (Insert Date If Other Than Date Requested)				
3 Premiums, Including Prepaid Premiums, Are Paid to (Insert Date)				
4 Policy Surrender Value (Excluding Dividends, Additions & Indebtedness Adjustments)				
5 Surrender Value of All Dividend Credits, Including Accumulations & Additions				
6 Termination Dividend Currently Available on Surrender				
7 Other Surrender Values Available to Policy Owner	a. Prepaid Premium Value			
	b. Premium Deposit Funds			
	c. Other			
8 Outstanding Policy Loans, Excluding Accrued Interest				
9 If Any Policy Loans Exist, Complete Either "a" or "b"	a. Interest Accrued on Loans			
	b1. Loan Interest is Paid to (Enter Date)			
	b2. Interest Rate is (Enter Rate)			
NOTE: PLEASE ANSWER ANY ITEM(s) 10–12 INDICATED BY A (✓).				
☐ 10 Is There an Assignee of Record? (Enter Yes or No)				
☐ 11 Is Beneficiary of Record as Shown in Item C. Above? (Enter Yes or No*)		*	*	*

☐ 12 Is the Name of Policy Owner (Subject to Any Assignment) as Shown on Top of Form: ☐ Yes ☐ No
If No, Enter Name of Policy Owner of Record:

* If Answer to Item 11 is "No." Please Give Name of Beneficiary or Date of Last Beneficiary Change:

Yours truly, (Insurance Company)

DUPLICATE

_____ Date

_____ Authorized Signature - Title

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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 (*balance-sheet date*) by our independent auditors (*name and address of auditors*), 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:

Participant's 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/her files to compare with the employer's records.

B. Please provide the following information on the net periodic pension cost for the period ending on _____:

1. Service cost $_____
2. Interest cost
3. Actual return on assets
4. Other components
   a. Net asset gain or (loss) during the period deferred for later recognition
   b. Amortization of net loss or (gain) from earlier periods
   c. Amortization of unrecognized prior service cost
   d. Amortization of the remaining unrecognized net obligation or (asset) existing at the date of the initial application of FASB Statement No. 87—transition obligation or (asset)
   e. Net total of components ($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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

7. The calculations of the items shown in B1 and B5 are based on the following:
   Asset information at _____
   Census data _____
   Measurement date (must not be more than three months before the end of the last fiscal year) _____

   Please describe any adjustments made to project the census data forward to the measurement date or to project the results calculated at an earlier date to those shown in B1 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	
	— nonvested	
	— 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: (1*c* – 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 measure 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 set-tlements, 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,

_____

[*Client's Authorized Signature*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.16 Pension Plan Assets Held by Trustee

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Trustee or Custodian*]
[*Address*]

Our auditors (*name and address of auditor*) are conducting an audit of our financial statements. Accordingly, please provide our auditors directly with a listing of the assets including market values as of (*date*) for our employees' pension trust (*title and trustee's account number*).

Please also provide the auditors with the following information about our employees' pension trust for the period from (*beginning of period*) to (*end of period*) [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 (*balance-sheet 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: 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*]

[*Date*]

[*Name of Actuary of PERS*]
[*Address*]

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 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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:
      (1) Accumulated employee contributions including allocated investment income, if any.
      (2) Employer-financed vested.
      (3) 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:
      (1) Accumulated employee contributions including allocated investment income, if any.
      (2) Employer-financed vested.
      (3) 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 pension benefit obligation applicable to them is transferred to the PERS as a whole.)
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

** 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.

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.

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.

*** 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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*]

[*Date*]

[*Name of Actuary of PERS*]
[*Address*]

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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 (*name and address of auditors*) are conducting an audit of our financial statements.

Accordingly, please confirm directly to them the following information relating to our note(s) payable to you, as of (*date*):

Date of note	_____
Original amount	$_____
Unpaid principal	
Balance	$_____
Periodic payments required	$_____
Payment periods	_____
Maturity date	_____
Interest rate	_____ %
Date to which interest has been paid	_____
Amount and description of collateral	_____
Description of terms, e.g., demand provisions, prepayment penalties, etc.	_____
Any other direct or contingent liabilities to you ("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 (*date*) with the following exceptions (*if any*): _____

_____

Date: _____ Signature: _____

Title: _____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.20 Mortgage Debt

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Creditor or Trustee*]
[*Address*]

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about our mortgage indebtedness to you as of (*date*):

1. Original amount $_____
2. Date of note _____
3. Unpaid principal balance $_____
4. Interest rate _____ %
5. Terms for payment of principal _____
6. Date to which interest has been paid _____
7. Nature of mortgage and description or address of property mortgaged _____
8. Amounts on deposit with you in escrow for:
   a. Insurance $_____
   b. Real estate taxes $_____
9. Amounts paid during the period (*dates from and to*) for:
   a. Insurance $_____
   b. Taxes $_____
10. Amounts on deposit with you for the "reserve for repairs" $_____
11. The nature of defaults, if any _____
12. Description of terms, e.g., prepayment penalties, demand provisions, etc. _____

A return envelope is enclosed for your reply.

Very truly yours,

[*Client's Authorized Signature*]

Note: Many of the items requested will vary with the circumstance of the particular mortgage or other debt involved. The above sample assumes the indenture involves an escrow arrangement for insurance and real estate taxes and a deposit account for repairs.

.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 (*name and address of auditors*), the amount of our liability to you as of (*date*). Please attach a statement of our account due. If no balance is due, please attach a statement of our account showing payments made.

Please mail your reply directly to (*name of auditors*). A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,

[*Client's Authorized Signature*]

Our records indicate that a balance of $_____ was from (*name of client*) at (*date*).

Date: _____ Signature: _____

Title: _____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.22 Obligation to Lessor

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Lessor*]
[*Address*]

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements as of (*balance-sheet date*) and for the (*time period*) then ended. In connection with this audit, please provide directly to our auditors the following information as of (*balance-sheet date*) regarding the lease dated (*date lease was executed*) of (*brief identification of property under lease*) 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: 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 (*name and address of auditors*) are conducting an audit of our financial statements as of (*balance-sheet date*) and for the (*time period*) then ended. In connection with this audit, please confirm directly to our auditors the following information regarding the lease dated (*execution date of lease*) of (*brief identification of property under lease*) which you are leasing from us:

1. Inception and expiration dates of lease period from _____ to _____
2. Amount of monthly rent _____
3. Total rent payments made _____
4. Date of last payment _____

A return envelope is enclosed for your reply.

[*Client's Authorized Signature*]

Notes: (A) If the leased property is of a mobile or portable nature such as a bulldozer or television camera, the confirmation may also include a request for specific serial numbers of significant equipment.

(B) In certain circumstances, the auditor may wish to consider confirming additional information such as renewal options, purchase options, and amendments or supplementary understandings.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.24 Register—Capital Stock

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Registrar*]
[*Address*]

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of the close of business (*balance-sheet date*) about each class of our preferred and common stock:

1. Authorized number of shares _____
2. Issued number of shares _____
3. Outstanding number of shares _____

Please also indicate the amount of any unpaid registrar fees due you as of (*balance-sheet date*).

A return envelope is enclosed for your convenience.

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*]

_____

Notes: (A) It may be helpful to include the registrar's account number for the client's account to receive a timely response.

(B) Some auditors prefer that the confirmation request include identification of each class of stock.

(C) The above illustration assumes the client has a separate transfer agent (see AAM section 7200.25).

.25 Transfer Agent—Capital Stock

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Transfer Agent*]
[*Address*]

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of (*balance-sheet date*) about each class of our preferred and common stock:

1. Authorized number of shares _____
2. Number of shares issued and outstanding _____
3. Number of outstanding shares registered in the name of our Company _____

Please also indicate the amount of any unpaid transfer agent fees due you as of (*balance-sheet date*).

A return envelope is enclosed for your convenience.

Very truly yours,

[*Authorized Signature for Client*]

The above information agrees with our records at (*balance-sheet date*) with the following exceptions: _____

_____

_____

_____

_____

Signed: _____ Date: _____

[*Name and Title*]

_____

Notes: (A) It may be helpful to include the transfer agent's account number for the client's account to receive a timely response.

(B) Some auditors prefer that the confirmation request include identification of each class of stock.

(C) Depending on the auditor's judgment in the circumstances the confirmation request may also include inquiries about such matters as (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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.26 Request for Confirmation of Money Market Fund

[Prepared on Client's Letterhead]

[Date]

[Name]
[Address]

Our auditors, (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of our money market fund account(s) as of (*date*).

Please indicate in the 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

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, from 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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*] [*Date*]

_____
[*Title*]

* 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 arrangements at (*date*) were:

EXAMPLES:

1. The Company has been expected to maintain an average compensating balance of 20 percent of its average loan understanding, as determined from the financial institution's ledger records adjusted for estimated average uncollected funds.

2. The Company has been expected to maintain an average compensating balance of $100,000 during the year, as determined from the financial institution's ledger records without adjustment for uncollected funds.

3. The Company has been expected to maintain a compensating balance, as determined from the financial institution's ledger records without adjustment for uncollected funds, of 15 percent of its outstanding loans plus 10 percent of its unused line of credit.

4. The Company has been expected to maintain as a compensating balance noninterest bearing time deposits of 10 percent of its outstanding loans.

In determining compliance with compensating balance arrangements, the Company uses a factor for uncollected funds of ____ (business) (calendar) days.[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.

There (were the following) (were no) sanctions (applied or imminent) by the financial institution because of noncompliance with compensating balance arrangements.[2]

---

* 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.

[2] Applicable only if the financial institution has applied sanctions during the (*period*) or notified the Company that sanctions may be applied. Indicate details.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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*] [*Date*]

_____
[*Title*]

---

* 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 client*) 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 Client*]

_____

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*] [*Date*]

_____
[*Title*]

---

* 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 (*name and address of auditors*). The questionnaire is designed to provide the auditors with information about the interests of officers, directors, and other related parties in transactions with 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,

_____

[*Client's Authorized Signature*]

_____

[*Title*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

[*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.

_____ _____

[*Signature*] [*Date*]

See definitions which follow.

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 a 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: 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 or herself 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*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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, 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 + 4*e*)		$

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 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.

* This column should be included only in the initial year of application of FASB Statement No. 106.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 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:

(1) The aggregate of service and interest cost components of net periodic postretirement benefit costs.

(2) 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 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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

AAM Section 7300
Inquiries to Legal Counsel[A]

.01 Illustrative Inquiry Letter to Legal Counsel[B]

[*Prepared on Client's Letterhead* (see Note C)]

[*Date* (see Note D)]

[*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.]

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 dis-

closure, 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: (A) 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).

(B) 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 D.]

(C) Auditors should carefully consider the provisions of SAS No. 12 [AU section 337] in drafting this letter.

(D) 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.02 Illustrative Inquiry Letter to Legal Counsel If Management Has Not Provided Details About Pending or Threatened Litigation

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Lawyer*]
[*Address of Lawyer*]

In connection with an audit of our financial statements at (*balance-sheet date*) and for the (*period*) then ended, please furnish to our auditors (*name and address of auditors*), the information requested below for which you have been engaged to provide legal consultation or representation.

Pending or Threatened Litigation, Claims and Assessments

(excluding unasserted claims and assessments)

Please furnish a list of all pending or threatened litigation, claims, and assessments your firm is handling on our behalf including the following:

1. The nature of the litigation (including the amount of monetary or other damages sought).
2. The progress of the case to date.
3. How management is responding or intends to respond to the litigation (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, if you have formed a professional conclusion that we should disclose or consider disclosing concerning such possible claim or assessment, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of 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 there are no unasserted claims which are not specifically identified in this letter that you advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.

(If unasserted claims exist, management's listed information should include the following: (1) the nature of the matter; (2) how management intends to respond if the claim is asserted; and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.)

Please furnish our auditors any explanation you consider necessary to supplement the foregoing information, including an explanation of these matters as to which your views may differ from those stated.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the organization, such as guarantees of indebtedness of others.]

Very truly yours,

[*Authorized Signature for Client*]

Notes: (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.

(C) If a client has not needed to retain legal counsel, an unqualified opinion may be expressed on the financial statements even though a letter from legal counsel has not been obtained. In these circumstances, a written representation should be obtained from the Company that legal counsel has not been retained for matters concerning its operations that involve current or prospective litigation (see AICPA *Technical Practice Aids*, section 8340.10).

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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/her audit, he/she may wish to consider the following matters in an inquiry to legal counsel:

a. A request that the attorney specify the effective date of his/her response if it is other than the date of the reply.

b. A request that the attorney mail the response so that it will be received by a certain date.

c. A request that the nature of any litigation specifically identify (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/her reasons for that position.

f. A request that the attorney specify to what extent potential damages are covered by insurance. (It may be possible to obtain the opinion of the insurer's counsel regarding the applicability of insurance coverage.)

g. A request that the attorney provide a summary of material litigation, claims, and assessments settled during the period.

h. A statement that confirmation of the understanding regarding disclosure of unasserted claims and assessments is an integral part of the audit inquiry and that failure to so confirm will require a follow-up contact.

i. A statement that the attorney's response will not be quoted or referred to in the financial statements without first consulting with him/her.

[*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 engagement 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 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 316A]) and related parties (SFAS 57, *Related Party Disclosures*, paragraph 24f [AC R36.406], and SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Related Parties" [AU section 334.01, footnote 1]). 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

[*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 state-

ments 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). We are also responsible for adopting sound accounting policies, establishing and maintaining internal control, and preventing and detecting fraud.
2. We have made available to you all—
   a. Financial records and related data.
   b. Minutes of meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
   c. Information relating to all statutes, laws, or regulations that have a direct effect on our financial statements.
   d. All reports from other accountants who have been engaged to make a review of interim financial information of significant components of the reporting entity, its subsidiaries, or its other investees.
   e. All information relating to contracts with and results of work by specialists.
3. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
4. 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.
   e. Security agreements under the Uniform Commercial Code.
   f. Contractual obligations for purchases of assets.
   g. Liens, encumbrances, or subordination of assets pledged as collateral in any way.
   h. Subordination of any liabilities.
   i. All lease or rental obligation under long-term leases.
   j. Information relating to risks and uncertainties existing as of the date of those statements regarding nature of operations, use of estimates in the preparation of financial statements, certain significant estimates, and current vulnerability due to certain concentrations in accordance with Statement of Position 94-6.
   k. Environmental liabilities, which must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59] (criteria as interpreted by Statement of Position 96-1, paragraph 5.6).
5. 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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].

c. 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].

d. Material transactions that have not been properly recorded in the accounting records underlying the financial statements.

e. Communications from regulatory agencies concerning noncompliance with or deficiencies in, financial reporting practices that could have a material effect on the financial statements.

6. Provision, when material, has been made to:

   a. Reduce excess or obsolete inventories to their estimated net realized value.

   b. Reduce all investments for permanent declines in value.

   c. Adjust long-lived assets, certain identifiable intangibles, and related goodwill in accordance with Statement of Financial Accounting Standards No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* [AC I08].

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

8. Provision has been made for any material loss to be sustained in the fulfillment of, or from inability to fulfill, any sales commitments.

9. 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.

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

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

12. We have apprised you of all (There are no) instances of fraud perpetrated on or within the Company of which we are aware.

_____

[*Name of Chief Executive Officer and Title*]

_____

[*Name of Chief Financial Officer and Title*]

Note: 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 (*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 (or other comprehensive basis of accounting), 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*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

[Source: SSARS 1, Appendix D (AR section 100.55).]

Note: This representation letter should be modified when the financial statements are prepared in accordance with an other comprehensive basis of accounting.

.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 (*identification of financial statements*) of (*client's name*) as of (*date*) 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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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 accountant's 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 accountant's 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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. This 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 internal control (i.e., a proposed adjustment may have resulted from errors detected during the audit that result from weaknesses in internal control);
4. Other information presented by management that is included with the entity's audited financial statements. The auditor should discuss the nature of his/her 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)]

Note: 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.

* Audit Committee, or other formally designated oversight group which is equivalent to the audit committee such as a finance committee or budget committee.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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 in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. However, we noted the following matters involving internal control 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 and operation of internal control 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 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 the use of the Board of Directors, management, and others within the entity.

Very truly yours,

_____

[*Engagement Partner*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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 in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. However, we noted the following matters involving internal control 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 and operation of internal control 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 19XX, 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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

TABLE OF CONTENTS

Section		*Paragraph*
8010	Audit Risk Alert—1996/1997	.01-.94
	Introduction	.01-.03
	New Auditing and Attestation Pronouncements	.04-.30
	SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*	.04-.10
	SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements	.11-.13
	SAS No. 80, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter	.14-.15
	SAS No. 81, *Auditing Investments*	.16-.20
	SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*	.21-.26
	Auditing and Attestation Interpretations Issued in 1996	.27-.30
	Developments in Quality Control and Peer Review	.31-.39
	New Statements on Quality Control Standards	.31-.35
	Standards for Performing and Reporting on Peer Reviews	.36-.37
	Responding to Peer Review Letters of Comments	.38-.39
	Audit Issues and Audit Problems to Watch For	.40-.57
	Revenue Recognition	.40-.42
	Updating Legal Letters	.43
	Undisclosed Related Parties and Related-Party Transactions	.44-.46
	Discontinued Operations	.47-.48
	Management Reports on Internal Control Over Financial Reporting	.49-.50
	Predecessor/Successor Auditor—Access to Working Papers	.51-.53
	The Wrong "Tone at the Top" Can Lead to Fraudulent Financial Reporting	.54-.57
	Audit Communication and Reporting Issues	.58-.60
	Going Concern	.58-.60
	Lessons From Litigation	.61-.64
	Analysis of International Standards on Auditing	.65
	Recent GAAP Requirements	.66-.81
	Authoritative Pronouncements Becoming Effective in 1996	.66-.77
	Authoritative Accounting Pronouncements Issued in 1996	.78

Section		*Paragraph*
8010	Audit Risk Alert—1996/97—continued	
	SOP 96-1, *Environmental Remediation Liabilities*	.79-.81
	Standards Overload Report	.82-.83
	Guides and Risk Alerts	.84-.86
	AICPA Audit and Accounting Guides	.84-.85
	AICPA Annual Industry Audit Risk Alerts	.86
	Publications From the Audit and Attest Standards Group	.87
	Recently Published Practice Alerts	.88-.89
	AICPA Services	.90-.93
	Order Department	.90
	Accounting and Auditing Technical Hotline	.91
	Ethics Hotline	.92
	World Wide Web Site	.93
8015	Compilation and Review Alert—1996/97	.01-.76
	Introduction	.01
	Practice Problems Identified in Comment Letters on the Assembly Exposure Draft	.02-.05
	When Has a CPA Submitted Financial Statements?	.06-.07
	Using Staff in a Compilation or Review Engagement	.08-.09
	Legends on Compiled or Reviewed Financial Statements	.10
	Compiling Pro Forma Financial Information	.11-.13
	Use of Emphasis and Going-Concern Paragraphs in Compilation and Review Reports	.14-.17
	Incomplete Information	.18-.22
	Deciding When to Use OCBOA Financial Statements	.23-.25
	Obtaining a Representation Letter for All Periods Covered by a Review Report	.26-.28
	How an On-Site Peer Review Differs From an Off-Site Peer Review	.29-.30
	Responding to Peer Review Letters of Comments	.31-.32
	Recurring Deficiencies Noted in Compilation and Review Engagements	.33-.37
	Common Reporting Deficiencies	.34
	Common Financial-Statement Deficiencies	.35
	Common Financial-Statement Disclosure Deficiencies	.36
	Other Deficiencies	.37
	Performance Measurement Engagements—An Engagement Expansion Opportunity	.38-.41
	Standards Overload	.42
	Modifying Engagements for SOP 94-6	.43-.47
	New Statements on Quality Control Standards	.48-.51
	GAAP for Compiled and Reviewed Financial Statements	.52-.64
	FASB Original Pronouncements—Accounting Standards	.56
	AICPA Technical Practice Aids (Including Statements of Position)	.57
	FASB Emerging Issues Task Force Abstracts	.58
	FASB Implementation Guides (Qs and As)	.59
	Codification of Governmental Accounting and Financial Reporting Standards	.60
	AICPA Audit and Accounting Guides	.61-.62
	Ordering Information	.63-.64
	Recent GAAP Pronouncements	.65-.68
	Authoritative Accounting Pronouncements Becoming Effective in 1996	.65
	Authoritative Accounting Pronouncements Issued in 1996	.66
	SOP 96-1, *Environmental Remediation Liabilities*	.67-.68

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Section		*Paragraph*
8015	Compilation and Review Alert—1996/97—continued	
	Other AICPA Publications Relevant to SSARS Engagements	.69-.71
	Codification of Statements on Standards for Accounting and Review Services	.69
	Codification of Statements on Auditing Standards	.70
	AICPA Annual Audit Industry Risk Alerts	.71
	AICPA Services	.72-.75
	Order Department	.72
	Technical Hotline	.73
	Ethics Hotline	.74-.75
	Appendix—Compilation and Review Quiz	.76
8020	Credit Union Industry Developments—1996/97	.01-.86
	Industry and Economic Developments	.01-.05
	Financial Trends	.01-.03
	Consolidation and Restructuring	.04-.05
	Regulatory Developments	.06-.32
	New and Proposed Regulations	.09-.27
	Other Regulatory Matters	.28-.32
	Audit Issues and Developments	.33-.53
	Supervisory Committee Audits	.33-.41
	Secondary Capital Accounts	.42
	Noncompliance With Regulatory Requirements	.43-.44
	Warning Flags and Fraud Indicators	.45-.46
	Auditing Pronouncements	.47-.52
	SAS No. 70 Auditing Procedure Study	.53
	Accounting Issues and Developments	.54-.78
	Mortgage Servicing Rights	.54-.57
	Transfers and Servicing of Financial Assets	.58-.59
	Impairment of Long-Lived Assets	.60-.65
	Disclosures About Derivatives	.66-.69
	Consensus Decisions of the FASB's Emerging Issues Task Force	.70-.72
	Risks and Uncertainties	.73-.77
	Foreclosed Assets	.78
	Information Sources	.79-.86
8030	Health Care Industry Developments—1996/97	.01-.71
	Industry and Economic Developments	.01-.04
	Regulatory, Legislative, and Other Developments	.05-.21
	Revisions to the Single Audit Act and OMB Single Audit Circulars	.05-.08
	Internal Revenue Service Developments	.09-.12
	Governmental Investigations Relating to Fraud and Abuse Violations	.13-.21
	Audit Issues and Developments	.22-.27
	Risk-Related Issues in a Managed Care Environment	.22-.24
	Obligated Group Financial Statements	.25
	Auditing Pronouncements	.26-.27
	Accounting Issues and Developments	.28-.57
	Health Care Audit Guide Project	.28-.30
	Securities and Exchange Commission Issues and Developments	.31-.37
	Classification of Net Appreciation on Investments of Donor-Restricted Endowment Funds	.38-.41
	Agency Transactions	.42-.44

Section		*Paragraph*
8030	Health Care Industry Developments—1996/97—continued	
	Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities	.45-.49
	Developments Related to Governmental/Nongovernmental Issues Affecting Health Care Entities	.50-.54
	Governmental Not-for-Profit Accounting Developments	.55
	Accounting for Transfers Among Health Care Organizations	.56
	Accounting for Exchange Transactions in Health Care Organizations	.57
	AICPA Audit and Accounting Literature	.58-.61
	Audit and Accounting Guide	.58
	Health Care Financial Reporting Checklist	.59
	Technical Practice Aids Publication	.60
	National Health Care Conference	.61
	Information Sources	.62-.71
8040	Insurance Industry Developments—1996/97	.01-.111
	Industry and Economic Developments	.01-.13
	Competitive Market	.04
	Mergers and Acquisitions	.05
	Property and Casualty Insurers	.06-.09
	Life and Health Insurers	.10-.13
	Regulatory Developments	.14-.23
	Reinsurance Accounting on a Statutory Basis	.15-.18
	Significant Changes to the NAIC Annual Statement Instructions	.19-.20
	Codification of Statutory Accounting Principles	.21-.22
	Change in Florida Department of Insurance Requirements	.23
	Audit Issues	.24-.54
	Mergers, Acquisitions, and Consolidations	.24-.26
	Investments in Derivatives	.27-.28
	Liabilities for Unpaid Claims	.29-.42
	Reinsurance Arrangements	.43-.51
	Asset Quality and Valuation Issues	.52-.54
	Audit Developments	.55-.71
	Elimination of Uncertainty Reporting	.55-.59
	Internal Control	.60
	Planning, Supervision, and Going Concern	.61
	Letters for Underwriters	.62
	Agreed-Upon Procedures	.63-.68
	Auditor's Reports on Statutory Financial Statements	.69
	Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule	.70
	Risk-Based Capital	.71
	Accounting Developments	.72-.103
	Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities	.72-.80
	Stock-Based Compensation	.81
	Long-Lived Assets	.82-.85
	Mutual Life Insurance Enterprises	.86-.95
	AcSEC Conforming Changes	.96
	Exposure Draft—Accounting by Insurance and Other Enterprises for Guaranty-Fund and Certain Other Insurance-Related Assessments	.97

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Section		*Paragraph*
8040	Insurance Industry Developments—1996/97—continued	
	Accounting by the Issuer of Surplus Notes	.98
	Certain FASB Statement No. 115 Implementation Issues	.99-.100
	Special Report on FASB Statement No. 115	.101
	Consensus Decisions of the FASB's Emerging Issues Task Force	.102-.103
	Information Sources	.104-.111
8050	Banks and Savings Institutions Industry Developments—1996/97	.01-.54
	Industry and Economic Developments	.01-.02
	Audit and Accounting Guide	.03-.04
	Legislative and Regulatory Developments	.05-.27
	Legislative Matters	.07-.11
	Regulatory Capital Matters	.12-.17
	Other Regulatory Matters	.18-.27
	Audit Issues and Developments	.28-.36
	Agreed-Upon Procedures Engagements	.28-.33
	SAS No. 70 Auditing Procedure Study	.34
	Elimination of Uncertainty Reporting	.35
	Other Newly Effective Auditing Pronouncements	.36
	Accounting Developments	.37-.45
	Transfers and Servicing of Financial Assets	.37-.38
	Debt and Equity Securities	.39-.40
	Other Newly Effective Accounting Pronouncements	.41-.42
	Discussions of the FASB's EITF	.43-.45
	Ethics Developments	.46
	Information Sources	.47-.54
8060	Employee Benefit Plans Industry Developments—1997	.01-.62
	Industry and Economic Developments	.01
	Regulatory and Legislative Developments	.02-.25
	Regulatory Developments	.02-.23
	Legislative Developments	.24-.25
	Audit and Accounting Developments	.26-.57
	Audit Issues and Developments	.26-.45
	New Pronouncements	.46-.48
	Accounting Issues and Developments	.49-.57
	New Pronouncements	.58-.60
	Information Sources	.61
	Appendix—Fraud Risk Factors for Employee Benefit Plans	.62
8070	State and Local Governmental Developments—1997	.01-.104
	Industry and Economic Developments	.01-.06
	Industry Conferences	.06
	Regulatory, Legislative, and Other Developments	.07-.38
	Major Changes to Single Audits of Federal Awards	.07-.17
	Status of Interim Compliance Supplements for Housing Agencies and Authorities and Certain Department of Education Programs	.18-.20
	OMB Circular A-21	.21
	U.S. Department of Education Issues New Drawdown Procedures for Grant Payments	.22
	SEC Municipal Bond Disclosure Requirements	.23-.25
	Recent IRS Activities	.26-.33

Section		*Paragraph*
8070	State and Local Governmental Developments—1997—continued	
	IRC Section 457 Deferred Compensation Plans	.34-.35
	Financial Assurance Mechanisms for Local Government Landfills	.36
	Airport Revenue Diversion	.37-.38
	Audit Issues and Developments	.39-.58
	Investment Policy Compliance	.39-.40
	Going Concern	.41-.42
	Recent Auditing Pronouncements Issued	.43-.49
	Audit Quality	.50
	Financial Statements on the Internet	.51-.53
	Modifying Computer Systems for the Year 2000	.54-.55
	Lawyers' Letters	.56-.57
	Pre-Award Surveys	.58
	Accounting Issues and Developments	.59-.80
	GASB Statements Effective During 1997	.60-.67
	GASB Statements Effective After 1997, With Early Application Encouraged	.68-.70
	GASB Interpretations Effective in 1997	.71-.74
	GASB Exposure Drafts Outstanding	.75-.78
	Other Accounting Matters	.79-.80
	References for Additional Guidance	.81-.103
	AICPA	.81-.87
	Governmental Accounting Standards Board	.88
	Federal Agencies—Administrative Regulations	.89-.91
	General Accounting Office	.92
	Office of Management and Budget	.93-.97
	PCIE Audit Committee Guidance	.98-.100
	Government Finance Officers Association	.101-.103
	References to Useful Web Sites	.104
8080	Agribusiness Industry Developments—1995/96	.01-.63
	Industry and Economic Developments	.01-.06
	Legislative and Regulatory Developments	.07-.08
	Audit Issues and Developments	.09-.35
	Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance	.09-.12
	Illegal Acts by Clients	.13
	Going-Concern Issues	.14-.16
	Inventory	.17-.19
	Research and Development Costs	.20
	Derivatives	.21-.24
	Environmental Issues	.25-.27
	Service-Center Produced Records	.28-.32
	Computerized Accounting Systems	.33
	Agricultural Producers' Financial Statements	.34-.35
	Accounting Issues and Developments	.36-.52
	Impairment of Long-Lived Assets	.36-.40
	Hedging Activities	.41-.42
	Disclosures About Derivatives	.43-.47
	Risks and Uncertainties	.48-.50
	AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities	.51-.52

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Section		*Paragraph*
8080	Agribusiness Industry Developments—1995/96—continued	
	AICPA Audit and Accounting Literature	.53-.55
	Audit and Accounting Guide	.53
	Agricultural Cooperatives' Financial Reporting Checklist	.54
	Technical Practice Aids	.55
	Information Sources	.56-.63
8090	Airline Industry Developments—1995/96	.01-.49
	Industry and Economic Developments	.01-.06
	Competitive Environment	.05-.06
	Regulatory Developments	.07-.11
	Passenger Facility Charges	.07-.09
	Illustrative Report on Audit of PFC Schedules	.08
	Illustrative Report on Internal Control Structure Used in Administering PFC's	.09
	Passenger Facility Charges—Internal Control Examination Guide	.10
	Stage II Aircraft	.11
	Audit Issues	.12-.20
	Ticketless Travel	.12
	Code Sharing Agreements	.13
	Restructurings	.14-.17
	Environmental Issues	.18-.20
	Accounting Issues and Developments	.21-.40
	Stock-Based Compensation	.21-.25
	Impairment of Long-Lived Assets	.26-.30
	Risks and Uncertainties	.31-.33
	AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities	.34-.35
	Frequent Travel Award Programs	.36-.37
	SEC Accounting Guidance	.38-.40
	AICPA Audit and Accounting Literature	.41
	Industry Audit Guide	.41
	Information Sources	.42-.49
8100	Common Interest Realty Associations Industry Developments—1995/96	.01-.47
	Industry and Economic Developments	.01-.04
	Legislative Issues	.05-.06
	Audit Issues and Developments	.07-.26
	Internal Control Structure	.07
	Related Parties	.08-.09
	Interfund Receivable/Payable or Transfer?	.10
	Information Accompanying a CIRA's Basic Financial Statements	.11
	Independence	.12
	Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance	.13-.16
	Elimination of Uncertainty Reporting	.17-.20
	Environmental Issues	.21-.22
	Service-Center Produced Records	.23-.26
	Accounting Issues and Developments	.27-.38
	Impairment of Long-Lived Assets	.27-.30
	Risks and Uncertainties	.31-.33
	CIRA Investments in Debt and Equity Securities	.34-.37

Section		Paragraph
8100	Common Interest Realty Associations Industry Developments—1995/96—continued	
	AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities	.38
	AICPA Audit and Accounting Literature	.39
	Audit and Accounting Guide	.39
	Information Sources	.40-.47
8110	Casino Industry Developments—1995/96	.01-.63
	Industry and Economic Developments	.01-.12
	Competitive Environment	.07-.09
	Casino Specialization	.10-.12
	Regulatory Issues and Developments	.13-.19
	Bank Secrecy Act	.14-.17
	Casino Taxation	.18-.19
	Audit Issues	.20-.38
	Audit Planning Considerations	.20
	Internal Control Structure	.21-.22
	Casino Revenues—Analytical Procedures	.23-.25
	Illegal Acts by Clients	.26-.27
	Loan Covenants	.28-.32
	Casino Receivables	.33-.35
	Chip and Token Liability	.36-.38
	Accounting Developments	.39-.54
	Impairment of Long-Lived Assets	.39-.43
	Risks and Uncertainties	.44-.46
	Restructuring Charges	.47-.49
	Promotional Allowances or Complimentary Expenses	.50-.54
	AICPA Audit and Accounting Literature	.55
	Audit and Accounting Guide	.55
	Information Sources	.56-.63
8120	Construction Contractors Industry Developments—1996/97	.01-.75
	Industry and Economic Developments	.01-.08
	Audit Issues and Developments	.09-.41
	Impairment of Long-Lived Assets	.09-.10
	Auditing Estimates	.11-.18
	Change Orders and Claims	.19-.20
	Control Environment	.21-.23
	Job Site Visits	.24
	Other Auditing Considerations	.25-.26
	New Pronouncements	.27-.37
	Ethics Ruling—Indemnification of a Client	.38
	AICPA Exposure Drafts: Proposed SASs	.39-.41
	Accounting Issues and Developments	.42-.62
	Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities	.42-.50
	Delayed Effective Dates—Accounting Pronouncements	.51-.55
	Revenue Recognition	.56-.57
	Joint Ventures	.58-.62
	Exhibits	.63-.64
	Information Sources	.65-.75

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Section		*Paragraph*
8130	Federal Government Contractors Industry Developments—1995/96	.01-.95
	Industry and Economic Developments	.01-.06
	Mergers, Consolidations, and Downsizing	.02
	Unexpected Losses and Claims Activity	.03-.06
	Regulatory and Legislative Developments	.07-.55
	Regulatory Developments	.07-.29
	Cost Allowability and Allocability Issues	.30-.40
	Legislative Developments	.41-.55
	Audit Issues	.56-.61
	Claims, Change Orders, and Requests for Equitable Adjustment	.56
	High-Risk Contracts	.57
	Costs in Excess of Contractual Funding	.58
	Recoverability of Environmental Liability Costs	.59-.61
	Accounting Issues and Developments	.62-.87
	Postretirement Benefits Other Than Pensions (OPEB)	.62-.63
	Commercial Nonrecurring Costs	.64
	Discontinued Operations	.65
	Impairment of Long-Lived Assets	.66-.71
	Consensus Decisions of the FASB's EITF	.72-.81
	Risks and Uncertainties	.82-.84
	AICPA Exposure Draft: Proposed SOP on Environmental Remediation Liabilities	.85-.86
	SEC Staff Accounting Bulletin	.87
	Information Sources	.88-.95
8140	Finance Companies Industry Developments—1995/96	.01-.78
	Industry and Economic Developments	.01-.18
	Credit Card Services	.05-.06
	Mortgage Related Services	.07-.09
	Industry Diversification	.10-.14
	Competitive Environment	.15-.18
	Audit Issues and Developments	.19-.36
	Asset Quality and Valuation Issues	.19-.23
	Noncompliance With Regulatory Requirements	.24-.25
	Elimination of Uncertainty Reporting	.26-.30
	Mortgage Banking Engagements	.31-.34
	SAS No. 70 Auditing Procedure Study	.35
	Agreed-Upon Procedures Engagements	.36
	Accounting Issues and Developments	.37-.69
	Mortgage Servicing Rights	.37-.40
	Impairment of Long-Lived Assets	.41-.46
	Disclosures About Derivatives	.47-.50
	Income Recognition on Impaired Loans	.51-.54
	Impairment of a Loan	.55-.58
	Offsetting	.59
	Consensus Decisions of FASB's EITF	.60-.63
	Risks and Uncertainties	.64-.66
	Restructuring Charges	.67-.69
	AICPA Audit and Accounting Literature	.70
	Audit and Accounting Guide	.70
	Information Sources	.71-.78

Section		*Paragraph*
8150	Investment Companies Industry Developments—1996/97	.01-.70
	Industry and Economic Developments	.01-.07
	Regulatory and Legislative Developments	.08-.23
	Securities Regulation Bill	.08
	IRS Audits of Investment Companies	.09-.11
	SEC—Proposed Mutual Fund Disclosure Practice	.12-.13
	1996 SEC Generic Comment Letter	.14
	Private Securities Litigation Reform Act	.15-.16
	SEC Proposal to Implement Private Securities Litigation Reform Act	.17-.23
	Audit Issues and Developments	.24-.49
	Related-Party Transactions	.24-.26
	Valuation of Securities	.27
	Tax Qualification	.28-.30
	Service Auditor's Reports	.31-.35
	New Pronouncements	.36-.46
	New Independence Standards	.47
	AICPA Exposure Drafts: Proposed SASs	.48-.49
	Accounting Issues and Developments	.50-.61
	Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities	.50-.58
	Disclosures About Derivative Financial Instruments	.59-.61
	Exhibits	.62
	Information Sources	.63-.70
8160	Oil and Gas Producers Industry Developments—1995/96	.01-.66
	Industry and Economic Developments	.01-.08
	Legislative and Regulatory Issues	.09-.15
	Continuing Impact of FERC Order 636	.09-.11
	Proposed Environmental Legislation	.12-.13
	Reformulated Gasoline Program	.14-.15
	Audit Issues	.16-.35
	Price Volatility	.16-.17
	Environmental Issues	.18-.22
	Investments in Derivatives	.23-.26
	Related-Party Transactions	.27-.29
	Estimated Reserves	.30-.34
	Adequacy of Disclosure	.35
	Accounting Issues and Developments	.36-.57
	Impairment of Long-Lived Assets	.36-.44
	Risks and Uncertainties	.45-.47
	Restructuring Charges	.48-.50
	Disclosures About Derivatives	.51-.55
	AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities	.56
	Disclosures—Publicly Held Companies	.57
	AICPA Audit and Accounting Literature	.58
	Audit and Accounting Guide	.58
	Information Sources	.59-.66
8170	Securities Industry Developments—1996/97	.01-.66
	Industry and Economic Developments	.01-.02
	Regulatory and Legislative Developments	.03-.17

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Section		*Paragraph*
8170	Securities Industry Developments—1996/97—continued	
	Justice Department Action	.03
	Commodities Futures Trading Commission—Issuance of Final Rules	.04
	Private Securities Litigation Reform Act	.05-.07
	Securities and Exchange Commission Proposal to Implement Private Securities Litigation Reform Act	.08-.14
	Securities and Exchange Commission Amendments	.15
	FOCUS Reports	.16-.17
	Audit Issues and Developments	.18-.39
	Illegal Acts by Clients	.18
	Underwriting Activities	.19
	Valuation of Securities	.20
	On-Line trading	.21
	Service Auditor's Reports	.22-.25
	New Pronouncements	.26-.36
	New Independence Standards	.37
	AICPA Exposure Drafts: Proposed SASs	.38-.39
	Accounting Issues and Developments	.40-.57
	Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities	.40-.48
	Delayed Effective Dates—Accounting Pronouncements	.49-.53
	Restructurings	.54-.56
	FASB Exposure Draft	.57
	Exhibits	.58
	Information Sources	.59-.66
8180	Not-for-Profit Organizations Industry Developments—1997	.01-.120
	Industry and Economic Developments	.01-.05
	Regulatory and Legislative Developments	.06-.46
	Major Changes to Single Audits of Federal Awards	.06-.16
	OMB Circulars A-21 and A-122	.17-.18
	U.S. Department of Education Issues New Drawdown Procedures for Grant Payments	.19
	Audit Quality	.20
	Other Federal Issues	.21-.28
	State and Local Issues	.29
	IRS Activities	.30-.46
	Audit Issues and Developments	.47-.69
	Internal Control	.47-.49
	Auditing Pronouncements	.50-.61
	Financial Statements on the Internet	.62-.64
	Modifying Computer Systems for the Year 2000	.65-.66
	Lawyers' Letters	.67-.68
	Pre-Award Surveys	.69
	Accounting Issues and Developments	.70-.97
	Joint Costs	.70-.73
	Religious Organizations	.74-.75
	Restructuring and Reengineering	.76
	Accounting Pronouncements and Projects	.77-.97
	Nonauthoritative AICPA Audit and Accounting Literature	.98-.104
	Continuing Professional Education Courses	.98-.101
	Not-for-Profit Organizations Checklists	.102

Section		*Paragraph*
8180	Not-for-Profit Organizations Industry Developments—1997—continued	
	Technical Practice Aids	.103
	Industry Conference	.104
	References for Additional Guidance	.105-.120
	Federal Agencies—Administrative Regulations	.105-.106
	General Accounting Office	.107
	Office of Management and Budget	.108-.112
	Information Sources	.113-.120
8190	FDIC Improvement Act Implementation Issues	.01-.54
	Introduction	.01-.03
	The Law	.04-.07
	The Implementing Regulations	.08-.45
	Reporting Requirements—Section 36	.08-.21
	Accounting Reforms—Section 37	.22-.23
	Prompt Corrective Action—Section 38	.24-.37
	Internal Control Standards—Section 39	.38-.42
	Effects on Institutions' Liquidity	.43
	Qualified-Thrift-Lender Test—Subtitle G	.44-.45
	Information Sources	.46-.51
	Appendix A—Audit and Reporting Requirements	.52
	Appendix B—Agreed-Upon Procedures	.53
	Appendix C—Guidance for Independent Auditors When Required to Provide Access to or Photocopies of Workpapers to Regulators	.54
8200	High-Technology Industry Developments—1996/97	.01-.79
	Industry and Economic Developments	.01-.05
	Legislative Developments	.06-.09
	Telecommunications Act	.06
	Litigation Reform	.07-.09
	Audit Issues and Developments	.10-.56
	Inventory Valuation	.10
	Loan Covenants	.11-.13
	Impairment of Long-Lived Assets	.14-.16
	Control Environment	.17
	Going Concern	.18-.22
	Revenue Recognition	.23-.31
	New Pronouncements	.32-.42
	Ethics Ruling—Indemnification of a Client	.43
	AICPA Exposure Drafts: Proposed SASs	.44-.46
	Allocation of Purchase Price in "Purchase" Business Combinations	.47-.51
	Research and Development Arrangements	.52-.56
	Accounting Issues and Developments	.57-.70
	Costs of Internally Developed and Purchased Software	.57-.59
	AICPA Exposure Draft: Proposed SOP, *Software Revenue Recognition*	.60
	Delayed Effective Dates—Accounting Pronouncements	.61-.65
	Restructurings	.66-.69
	Management's Discussion and Analysis Public Companies	.70
	Exhibits	.71
	Information Sources	.72-.79
8210	Real Estate Industry Developments—1996/97	.01-.132
	Industry and Economic Developments	.01-.10
	Regulatory Matters	.11-.34

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Section		Paragraph
8210	Real Estate Industry Developments—1996/97—continued	
	Private Securities Litigation Reform Act of 1995	.13-.19
	U.S. Department of Housing and Urban Development Regulations	.20-.21
	Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance	.22-.24
	Interstate Land Sales and Full Disclosure Act	.25
	Regulation Z of the Consumer Credit Protection Act	.26
	Tax Matters	.27-.34
	Audit Issues and Developments	.35-.90
	General Risk Factors	.35-.38
	Asset Impairment	.39-.49
	Foreclosed Real Estate	.50-.52
	Revenue Recognition	.53-.54
	Availability of Funding	.55-.56
	Deferred Rents	.57
	Environmental Issues	.58-.61
	Real Estate Investment Trusts	.62-.74
	Liquidity and Cash Flow Information	.75
	Non-GAAP Measures of Performance	.76-.77
	Investments in Derivatives	.78
	Auditing Pronouncements	.79-.90
	Accounting Developments	.91-.123
	FASB Statement on Impairment	.91-.94
	FASB Statement on Transfers and Servicing of Financial Assets and Extinguishment of Liabilities	.95-.103
	Stock-Based Compensation	.104
	FASB Statement on Derivatives	.105-.107
	FASB Statement on Disclosures About Fair Value of Financial Instruments	.108-.111
	Emerging Issues Task Force Issues	.112-.116
	AICPA Statement of Position 94-6 on Disclosure of Certain Significant Risks and Uncertainties	.117-.120
	AICPA Statement of Position 96-1 on Environmental Remediation Liabilities	.121-.122
	Accounting Standards Executive Committee Conforming Changes	.123
	Information Sources	.124-.132
8220	Public Utilities Industry Developments—1995/96	.01-.71
	Industry and Economic Developments	.01-.07
	Electric Utilities	.02
	Gas Utilities	.03
	Telecommunications	.04
	Water Utilities	.05
	The Impact of Competition on Accounting Decisions	.06-.07
	Regulatory and Legislative Development	.08
	Rural Utilities Service Approval of AICPA Peer Review Program	.08
	Audit Issues and Developments	.09-.49
	The Interrelationship of Rate Making and Accounting	.09-.11
	Continued Applicability of FASB Statement No. 71	.12-.15
	Regulatory Assets	.16-.22
	Stranded Costs	.23
	Depreciation	.24-.25
	Nuclear Decommissioning	.26-.29
	Environmental Matters	.30-.33

Section *Paragraph*

8220 Public Utilities Industry Developments—1995/96—continued
Derivatives 34-.37
Order 636 Transition Costs 38
Purchased-Power Contracts 39-.45
Elimination of Uncertainty Reporting 46-.49
Accounting Issues and Developments 50-.67
Restructuring Charges 50
Revenue Recognition of Long-Term Power Sales Contracts 51-.52
Impairment of Long-Lived Assets 53-.57
Disclosures About Derivatives 58-.62
Risks and Uncertainties 63-.65
AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities 66-.67
AICPA Accounting and Auditing Literature 68
Technical Practice Aids 68

8230 Retail Industry Developments—1996/97 . . . .01-.83
Industry and Economic Developments 01-.15
Industry Profile 01-.07
Economic Developments 08-.15
Audit Issues and Developments 16-.48
Going-Concern Issues 16-.20
Merchandise Inventory 21-.23
Revenue and Purchasing Cycles 24-.30
Impairment of Long-Lived Assets 31-.32
Control Environment 33
New Pronouncements 34-.44
Ethics Ruling—Indemnification of a Client 45
AICPA Exposure Drafts: Proposed SASs 46-.48
Accounting Issues and Developments 49-.75
Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities 49-.57
Revenue Recognition When Right of Return Exists 58-.61
Product Warranties, Extended Warranties, and Product Maintenance Contracts 62-.66
Advertising Costs 67-.69
Preopening Expenses 70
Delayed Effective Dates—Accounting Pronouncements 71-.75
Exhibits 76
Information Sources 77-.83

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

AAM Section 8010
Audit Risk Alert—1996/97

Introduction

.01 This Alert is intended to help auditors plan their 1996 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 the 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 the effect on the auditor's reputation resulting from association with the client

.03 Although this Audit Risk Alert does not provide a complete list of the 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 paramount responsibilities are to boards of directors, shareholders, creditors, and the public. This requires traits that are the hallmarks of auditors: independence, objectivity, and integrity.

New Auditing and Attestation Pronouncements

SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*

.04 In December 1995, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AU section 319). SAS No. 78 (AU section 319) is effective for audits of financial statements for periods beginning on or after January 1, 1997.

.05 This amendment revises the definition and description of internal control contained in SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319A), to recognize the definition and description contained in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO Report).

.06 Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

1. Reliability of financial reporting
2. Effectiveness and efficiency of operations
3. Compliance with applicable laws and regulations

.07 Internal control consists of the following five interrelated components:

1. Control environment
2. Risk assessment (the entity's, not the auditor's)
3. Control activities
4. Information and communication (including the accounting system)
5. Monitoring

.08 There is a direct relationship between objectives (what an entity strives to achieve), and components (what is needed to achieve the objectives). Not all of the objectives and components listed above are relevant to an audit of financial statements. Internal control, no matter how well designed and operated, can provide only reasonable assurance regarding the achievement of an entity's objectives.

.09 Changes in terminology introduced by the amendment to SAS No. 55 (AU section 319A) are presented in the following table.

Old Terminology	*New Terminology*
Elements (In SAS No. 55 (AU section 319A), the elements of internal control were the control environment, accounting system, and control procedures.)	Components (The five components are listed above.)
Control procedures	Control activities
Internal control structure	Internal control
Policies and procedures	Controls (other than those for control activities)

.10 At the same time that SAS No. 78 (AU section 319) was published, the ASB also issued Statement on Standards for Attestation Engagements (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). Like SAS No. 78 (AU section 319), the amendment conforms the description of the elements of an entity's internal control to the components of internal control contained in COSO. SSAE No. 6 (AT section 400) is effective for examinations of management's assertion if the assertion is as of or for the period ending on December 15, 1996, or thereafter. Earlier application is encouraged.

SAS No. 79, *Amendment to Statement on Auditing Standards No. 58*, Reports on Audited Financial Statements

.11 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 eliminated the requirement that, if certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report. The Statement (AU section 508) is effective for reports issued or reissued on or after February 29, 1996.

.12 Before the issuance of this Statement (AU section 508), if the chance of a material loss resulting from the resolution of an uncertainty was at least reasonably possible, the auditor was required to consider adding an explanatory paragraph to an unqualified report describing the matter giving rise to the uncertainty and indicating that the outcome of the uncertainty could not be determined at the time. Now, if such a matter is presented and disclosed in the financial statements in accordance with generally accepted accounting principles (GAAP), the auditor should issue a standard report.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.13 In addition to eliminating uncertainties paragraphs, SAS No. 79 (AU section 508)—

- Clarifies the guidance concerning emphasis paragraphs to indicate that such paragraphs are never required and are always optional. Emphasis paragraphs may be added to an auditor's report to emphasize a matter disclosed in the financial statements. They point to information already disclosed in the financial statements rather than introducing new information.
- Continues to allow an auditor to disclaim an opinion on financial statements because of a matter involving an uncertainty.
- Indicates that an unresolved uncertainty in the current year that gave rise to an uncertainties paragraph in the prior year does not require the addition of such a paragraph in the current year's report or retention of the paragraph in a reissued report on the prior year's financial statements.
- 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 an auditor add an explanatory paragraph to the auditor's report if there is substantial doubt about an entity's ability to continue as a going concern.

SAS No. 80, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter

.14 In December 1996, the ASB issued SAS No. 80 entitled *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter (AU section 326). The Statement (AU section 326) provides guidance to auditors engaged to audit the financial statements of entities for which significant information is transmitted, processed, maintained, or accessed electronically. The Statement (AU section 326) includes examples of evidential matter in electronic form and provides that an auditor should consider the period during which electronic evidential matter will be in existence or be available in determining the nature, timing, and extent of substantive tests. In addition, the Statement (AU section 326) indicates that an auditor may determine that in certain engagements for which evidential matter is in electronic form, it would not be practical or possible to reduce detection risk to an acceptable level by performing only substantive tests. The Statement (AU section 326) provides that, in such circumstances, the auditor should consider performing tests of controls to support an assessed level of control risk below the maximum for affected assertions. SAS No. 80 (AU section 326) is effective for engagements beginning on or after January 1, 1997.

.15 In the first quarter of 1997, an Auditing Procedure Study (APS) entitled *The Information Technology Age: Evidential Matter in the Electronic Environment* will be issued. The APS provides guidance to auditors in applying SAS No. 80 (AU section 326) by describing electronic evidence and illustrating the implications of electronic evidence on the audit and possible audit approaches. The APS includes two case studies that present approaches an auditor might use to audit the financial statements of entities for which the electronic environment and the use of information technology significantly affect information and transactions.

SAS No. 81, *Auditing Investments*

.16 In December 1996, the ASB issued SAS No. 81, *Auditing Investments* (AU section 332), which revises the guidance on auditing investments to make that guidance consistent with recently issued accounting standards, particularly Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80). SAS No. 81 (AU section 332) supersedes SAS No. 1, section 332, *Long-Term Investments,* which required updating because it is based on FASB Statement No. 12, *Accounting for Certain Marketable Securities,* an accounting standard that was superseded by FASB Statement No. 115 (AC I80). The new Statement (AU section 332) also deletes Interpretation No. 1 of SAS No. 1, section 332, entitled "Evidential Matter for the Carrying Amount of Marketable Securities."

.17 SAS No. 81 (AU section 332) is applicable to audits of financial statements that contain assertions about investments in debt securities and equity securities (as those terms are defined in FASB Statement No. 115 [AC I08]) and investments accounted for under Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (AC I82). It also is applicable to audits of presentations covered by SAS No. 62, *Special Reports* (AU section 623), that contain such assertions.

.18 The new Statement (AU section 332) provides guidance to auditors on evaluating management's intent related to an investment and an entity's ability to hold a debt security to maturity. Such guidance is important because the intent and ability to hold a security to maturity affect the accounting for investments under FASB Statement No. 115 (AC I08). The Statement (AU section 332) also contains guidance on auditing assertions about the valuation of investments, including guidance on auditing investments carried at cost and fair value.

.19 Finally, the Statement (AU section 332) contains guidance on evaluating other-than-temporary impairment conditions related to an investment. The auditor considers whether evidence related to factors about other-than-temporary impairment conditions corroborates or conflicts with management's conclusions. The guidance in SAS No. 81 (AU section 332) regarding investments accounted for using the equity method of accounting is generally unchanged from the guidance contained in the previous standard.

.20 SAS No. 81 (AU section 332) is effective for audits of financial statements for periods ending on or after December 15, 1997, with early application permitted.

SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*

.21 In November 1996, the AICPA's ASB voted to ballot the proposed Statement on Auditing Standards, *Consideration of Fraud in a Financial Statement Audit,* for issuance as a final Statement (AU section 316). The new standard (AU section 316) will supersede SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU section 316A). The standard (AU section 316) will provide auditors with expanded guidance on the consideration of fraud in conducting a financial statement audit. It will strengthen the auditor's ability to fulfill his or her responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.

.22 The standard (AU section 316) describes the types of fraud and requires the auditor to specifically assess the risk of material fraud in every audit. It also provides separate categories of risk factors for fraudulent financial reporting (management fraud) and misappropriation of assets (theft) that require auditor consideration.

.23 In addition, the new standard (AU section 316) provides procedural guidance and examples of how the auditor can respond to the presence of fraud risk factors. The standard (AU section 316) reaffirms the requirement that the auditor communicate known instances of fraud to appropriate levels of management and the audit committee and, under certain circumstances, appropriate regulators.

.24 The AICPA's current effort regarding the detection of fraud in financial statements began in 1993. The standard (AU section 316) is responsive to both the AICPA Board of Directors' 1993 policy statement, *Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession,* and the Public Oversight Board's recommendations in its 1993 report, *In the Public Interest.*

.25 The ASB expects to issue the standard (AU section 316) in the first quarter of 1997. The Statement (AU section 316) is effective for audits of financial statements for periods ending on or after December 15, 1997. The following are some questions and answers that will assist in explaining the need for the new standard (AU section 316), and highlighting some of the significant changes.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

1. *Q* Why is the ASB issuing a new standard (AU section 316) on fraud?

   A The ASB is issuing the new standard (AU section 316) to enhance auditor performance. The standard (AU section 316) will provide auditors with expanded operational guidance on the consideration of material fraud in conducting a financial statement audit. It will aid the auditor in fulfilling his or her responsibility to plan and perform the audit to obtain reasonable assurance about whether financial statements are free of material misstatement, whether caused by error or fraud. The standard (AU section 316) is thus expected to drive auditor performance.

2. *Q* What does the standard (AU section 316) require?

   A The standard (AU section 316) requires the auditor to—

   - Specifically assess the risk of material misstatement due to fraud. (The standard (AU section 316) provides categories of fraud risk factors that the auditor should consider.)
   - Respond to the results of the assessment.
   - Document the fraud risk factors identified and the responses to those risk factors.

   The standard (AU section 316) also reaffirms the auditor's responsibility to communicate fraud to management, the audit committee, and, under some circumstances, appropriate regulators.

3. *Q* How will the independent auditor's responsibility for the detection of material fraud (fraud that would result in a material misstatement in an entity's financial statements) change with the new standard (AU section 316)?

   A The auditor's responsibility will not change. The standard (AU section 316) reaffirms the independent auditor's current responsibility, that is, to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. However, the ASB concluded that performance standards are needed to support the auditor in executing that responsibility.

4. *Q* How will the new standard (AU section 316) affect audit fees?

   A The effect will vary. Some organizations have very strong internal control. In these organizations, management is concerned about fraud and its effects on the entity, and there are controls that are designed to prevent and detect fraud. For these organizations, the effect on audit fees will not be significant. For organizations with fraud risk factors that are not effectively addressed by management, the costs will be greater. The profession believes that the public interest benefits will outweigh the additional cost. Also, organizations concerned about such costs can take active measures to reduce them by, for example, implementing controls designed to prevent and detect fraud.

5. *Q* In what other ways will the new standard (AU section 316) affect entities under audit?

   A The new standard (AU section 316) will require the auditor to ask management about the risk of fraud and whether management has knowledge of fraud that has been perpetrated on or within the entity. The auditor also will be expected to communicate to management any risk factors that the auditor identifies. This is expected to have the salutary effect of encouraging management to improve fraud prevention and detection techniques.

6. *Q* How will the new standard (AU section 316) help the auditor?

   A The new standard (AU section 316) describes fraud and its characteristics. It also provides examples of fraud risk factors that, when present, might indicate the existence of fraud. The standard (AU section 316) also explains how the auditor should respond to the risk of material misstatement due to fraud.

7. *Q* How does the standard (AU section 316) serve the public interest?

   A This new procedural guidance on fraud detection will help auditors better serve the public interest by increasing their ability to detect material misstatements in financial statements caused by fraud. The public interest is served by adding independent assurance to the credibility of financial statements upon which our capital and credit markets depend.

8. *Q* Is there a connection between this standard (AU section 316) and the securities litigation reform legislation passed in 1995?

   A Although the new standard (AU section 316) is not directly related to the 1995 legislation, it reminds auditors of the legislative requirements. Title III of the Private Securities Litigation Reform Act of 1995 (P.L.104-67) incorporates the auditor's present responsibility for the detection of material fraud, and shortens the time frame for reporting findings to the Securities and Exchange Commission (SEC), if such reporting is required.

.26 The AICPA recognizes its responsibility to help auditors understand and implement this standard (AU section 316) and is undertaking a major initiative to assist auditors in attaining that objective. This initiative will include the following.

- *Communication*—These initiatives will include a coordinated effort to inform the public and the business community about the new Statement (AU section 316) on fraud and a series of presentations, given by members of the ASB and the Fraud Task Force, discussing the new Statement (AU section 316) (to be held in several major United States cities in May 1997). The AICPA is also developing a video presentation of a panel of representatives from both large and small firms discussing implementation issues.
- *Implementation Guidance*—A nonauthoritative guide, to be available upon issuance of the final Statement (AU section 316) or shortly thereafter, will provide practical guidance on implementing the new Statement (AU section 316). A case study and sample nonauthoritative documentation, such as audit engagement letters and client representation letters, will be included. The guide will also identify risk factors that may be considered in assessing the risk of fraud for specific industries.
- *Training and Education*—Group and self-study courses on the auditor's consideration of fraud in a financial statement audit will be developed.
- *Additional Interpretative Guidance*—Questions and answers on issues that practitioners may face in implementing the new Statement (AU section 316) will be developed.

A complete list of AICPA implementation efforts will be published when the new Statement (AU section 316) is issued in the first quarter of 1997.

Auditing and Attestation Interpretations Issued in 1996

.27 In 1996, the AITF of the ASB issued two Interpretations and an additional Interpretation will be issued in January 1997, and all three are discussed below. 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; however, practitioners should be aware that they may have to justify departures from an Interpretation if the quality of their work is questioned.

.28 *Financial Statements for General Use Only Outside of the United States in Accordance With International Accounting Standards and International Standards on Auditing.* In May 1996, the AITF issued an auditing Interpretation of SAS No. 51, *Reporting on Financial Statements Prepared for Use in Other Countries* (AU section 534), entitled "Financial Statements for General Use Only Outside of the United States in Accordance With International Accounting Standards and International Standards on Auditing" (AU section 9534.01–.04). The

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Interpretation (AU section 9534.01–.04) indicates that an auditor practicing in the United States may report on the financial statements of a United States entity in conformity with the International Accounting Standards (IAS) for general use only outside of the United States. In addition, the Interpretation (AU section 9534.01–.04) states that an auditor may perform an audit in accordance with the International Standards on Auditing (ISA) if the financial statements are presented in conformity with the IAS provided that the general and fieldwork standards of United States generally accepted auditing standards (GAAS) and any additional requirements of the ISA are followed.

.29 *Providing Regulators Access to or Photocopies of Working Papers.* In May 1996, the AITF issued an attestation Interpretation of SSAE No. 1, *Attestation Engagements* (AT section 100), entitled "Providing Access to or Photocopies of Working Papers to a Regulator" (AT section 9100.56–.59). The Interpretation (AT section 9100.56–.59) states that Interpretation No. 1 of SAS No. 41, *Working Papers* (AU section 339), entitled "Providing Access to or Photocopies of Working Papers to a Regulator" (AU section 9339.01–.15), applies to attestation engagements if a regulator requests access to or photocopies of working papers. Illustrative letters to a regulator for an examination and agreed-upon procedures engagements are included in the Interpretation (AT section 9100.56–.59).

.30 *Lawyers' Responses to Audit Inquiry Letters.* The AITF will issue an auditing Interpretation of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU section 337), in January 1997, entitled "Use of Explanatory Language Concerning Unasserted Possible Claims or Assessments in Lawyers' Responses to Audit Inquiry Letters" (AU section 9337.31–.32). The Interpretation (AU section 9337.31–.32) indicates that the inclusion of certain explanatory comments to emphasize the preservation of the attorney-client privilege, in responses by lawyers to audit inquiry letters, does not result in an audit scope limitation. The Interpretation (AU section 9337.31–.32) also reminds auditors of the requirement in SAS No. 12 (AU section 337) to obtain the lawyer's acknowledgment of his or her responsibility to advise and consult with the client concerning financial statement disclosure obligations for unasserted possible claims or assessments.

Developments in Quality Control and Peer Review

New Statements on Quality Control Standards

.31 In May 1996, the ASB issued two new Statements on Quality Control Standards (SQCS), Nos. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (QC section 20), and 3, *Monitoring a CPA Firm's Accounting and Auditing Practice* (QC section 30). The new Statements (QC sections 20 and 30) supersede SQCS No. 1, *System of Quality Control for a CPA Firm* (QC section 10), and provide guidance for developing a system of quality control for a firm's accounting and auditing practice.

.32 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 (ARSC) under Rules 201, *General Standards* (ET section 201.01), and 202, *Compliance With Standards* (ET section 202.01), of the AICPA *Code of Professional Conduct*, and any other professional standards that may be issued by the aforementioned standard setters in the future. Before the issuance of SQCS No. 2 (QC section 20), attestation services were not specifically addressed in the quality control standards because the SSAEs had not been issued when SQCS No. 1 (QC section 10) was promulgated. The revised definition now makes it clear that attestation services must be included in a firm's quality control system.

.33 SQCS No. 2 (QC section 20) replaces the nine elements of quality control presented in SQCS No. 1 (QC section 10) with five broad elements of quality control. It does not establish any new elements but instead combines and renames the previous elements as shown in the following table.

Old *Nine Elements of SQCS No. 1*	*Change*	*New* *Five Elements of SQCS No. 2*
Independence	The independence element is expanded to include integrity and objectivity. Firms are now required to establish policies and procedures assuring that personnel perform all professional responsibilities with integrity and maintain objectivity while performing those responsibilities.	Independence, integrity, and objectivity
• Hiring • Advancement • Assigning personnel to engagements • Professional development	Four elements are combined into a single element. This element also adds a requirement that firms establish policies and procedures to meet the continuing professional education requirements of the AICPA and regulatory agencies.	Personnel management
Acceptance and continuance of clients	The name of this element is modified because SQCS No. 2 (QC section 20) requires that firms consider the acceptance of client engagements in addition to considering client relationships. SQCS No. 2 (QC section 20) also requires a firm to establish policies and procedures that provide reasonable assurance that a firm will accept only those engagements it can complete with due professional competence. Firms also must have policies and procedures in place requiring them to obtain an understanding with their client of the nature, scope, and limitations of the services they will perform.	Acceptance and continuance of clients and engagements
• Supervision • Consultation	These two elements are combined and referred to as activities within the new element of engagement performance.	Engagement performance
Inspection	*Monitoring* is defined as an ongoing consideration and evaluation relating to the design and application of each of the other elements of quality control. Inspection becomes subsumed under the new element of monitoring. SQCS No. 3 (QC section 30) provides guidance on how a CPA firm can monitor its accounting and auditing practice.	Monitoring

.34 SQCS Nos. 2 (QC section 20) and 3 (QC section 30) are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 1997. Firms with well-established quality control systems should not have to make significant modifications to their policies and procedures as a result of the issuance of these new standards.

.35 To help firms implement the new standards, a booklet entitled *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* has been issued. The guide includes illustrative examples of four hypothetical firms and the suggested policies and procedures for the design and maintenance of a quality control system that is appropriate for each firm's accounting and auditing practice. A firm's policies and procedures should be sufficient for it to obtain reasonable assurance of complying with the requirements of SQCS Nos. 2 (QC section 20) and 3 (QC section 30), and the illustrative examples depict various types of policies and procedures that a firm may consider for each of the elements of quality control.

Standards for Performing and Reporting on Peer Reviews

.36 The AICPA Peer Review Board (the Board) has voted to ballot for final issuance a proposed standard that updates the *Standards for Performing and Reporting on Peer Reviews* (PR section 100) to reflect the recently issued SQCS Nos. 2 (QC section 20) and 3 (QC section 30) discussed in paragraphs .31 through .35 of this Audit Risk Alert. In addition, the Board believes there was a need to reevaluate the overall guidance provided in the standards.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.37 The following are some of the significant provisions of the new standard.

- The new standard expands the definition of an accounting and auditing practice for the purposes of performing and reporting on a peer review to include attest services on financial information if the firm audits, reviews, or compiles the historical financial statements of the client.
- A firm that performs any engagement covered by the Statement on Auditing Standards must have an on-site peer review. This means that if the only engagements performed by a firm are engagements to apply agreed-upon procedures under SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622), the firm would be required to have an on-site peer review. 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, such as accounts receivable aged over thirty days, average monthly sales, or the amounts included in the property and equipment account.
- The restriction prohibiting a team captain from serving in that capacity for more than two successive reviews of the same firm is eliminated. The responsibility for determining when and whether it is appropriate to rotate reviewers is placed in the hands of the reviewed firm. As a result, the new standard does not restrict the number of successive reviews a firm or individual may perform.
- The peer review is to be planned and performed using a risk-based approach in the same way that an audit is planned and performed using a risk-based approach. Examples of factors to consider in a risk-based approach include the size of the entity, the industry in which the entity operates, the level of service being performed, entity personnel, litigation in the industry in which the entity operates, and whether the engagement is an initial engagement.

The effective date of the proposed standard is for peer reviews with year ends of December 31, 1997, or later.[1]

Responding to Peer Review Letters of Comments

.38 During fieldwork in a peer review, the reviewer will inform the reviewed firm of any deficiencies noted during the peer review, and generally will note those deficiencies on a form entitled "Matter for Further Consideration" (MFC). The reviewed firm will have the opportunity to discuss the identified deficiencies during the peer review and to respond in writing concerning the deficiencies on the response section of the MFC form. Because peer review is a subjective process, there may be differences of opinion between the reviewer and the reviewed firm as to whether a deficiency exists that is not resolved to the reviewed firm's satisfaction. In such circumstances, the reviewed firm should ask the reviewer to cite the applicable section of the professional standards or the reviewed firm's policies that support the reviewer's conclusion that a deficiency exists. Ordinarily, such matters are resolved before the exit conference. If the reviewed firm is still dissatisfied with the reviewer's conclusions, the reviewer or reviewed firm should consult with the entity administering the peer review or the AICPA Peer Review Program at (201) 938-3030. If the matter is not resolved through consultation, the reviewed firm should respond to the reviewer's letter of comments by addressing each deficiency noted and citing the section of the professional standards that supports the reviewed firm's view. The state CPA society peer review committee, or the SEC Practice Section Peer Review Committee, if applicable, will then attempt to resolve the disagreement.

.39 Many professional standards require the use of professional judgment; accordingly, a reviewed firm should not assume that the reviewer's interpretation is always the correct one. If a reviewer identifies deficiencies in an engagement, it is in the reviewed firm's best interest to read the applicable section of the standards to broaden his or her knowledge of the subject and to verify that the comment is applicable to that particular situation.

[1] This is a revised effective date. The effective date in the exposure draft of the proposed standard was for peer reviews beginning on or after January 1, 1997.

Audit Issues and Audit Problems to Watch For

Revenue Recognition

.40 Improper revenue recognition continues to be a primary cause of misstated financial statements, and sometimes these misstatements are intentional. This problem continues to arise in litigation involving high technology clients. The use of side agreements that relieve the customer of some of the customary risks and rewards of ownership is frequently associated with improper revenue recognition. Examples of such practices are shipping merchandise to customers without proper authorization from the customer, shipping merchandise to company-owned warehouses and billing fictitious customers, and making sales arrangements that obligate the customer to pay only upon resale.

.41 Because very few individuals within the client organization may be aware of side agreements, it is often difficult to discover their existence. If accounting and financial personnel are not aware of side agreements, management representations and standard audit procedures in the revenue and accounts receivable areas will not be an adequate audit response to this problem.

.42 If there is a significant risk of undisclosed side agreements, in addition to confirming account balances and material revenue transactions, the auditor should confirm relevant contract terms with customers to obtain assurance that side agreements do not exist. Such confirmations should be addressed to the contract signer and not to the accounts payable department.

Updating Legal Letters

.43 SAS No. 12 (AU section 337) requires the auditor to ask his or her client to send a letter of audit inquiry to the client's lawyer to corroborate information furnished by management concerning litigation, claims, and assessments. The latest date of the period covered by legal counsel's response should be as close to the completion of fieldwork as is practicable in the circumstances. The timing of the auditor's request should be carefully planned to assure that this is accomplished. However, if completion of the fieldwork has been delayed, or for other reasons the attorney's response date is significantly earlier than the date of the completion of fieldwork, the auditor should request that the attorney update his or her response. An oral update, documented in the audit working papers, may be acceptable if there have been no changes from the previously received letter, or if any changes that have occurred are relatively simple and straightforward (the lawsuit was dismissed or settled at no cost to the client). However, for important matters discovered in oral updates, including new litigation or significant additional matters relating to prior litigation, it is good practice to confirm these in writing.

Undisclosed Related Parties and Related-Party Transactions

.44 Auditors should be alert to indicators of undisclosed related-party transactions that may be a source for fraudulent financial reporting. Indicators of possible undisclosed related parties include the following:

- A complex corporate structure with restrictions on the disclosure of ownership or the identity of shareholders
- Entities that conduct material intercompany transactions with each other and that are audited by different firms
- Highly complex business practices that facilitate management's ability to mask their economic substance
- The existence of unique, highly complex, and material transactions that pose difficult questions relating to their business purpose

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.45 Examples of transactions that might indicate previously undisclosed related parties include the following:

- Significant and unusual transactions at or near year end, particularly those for which significant income is recognized, even if the full sales proceeds have been remitted
- Significant purchases from new suppliers or sales to new customers during the course of the year that seem unusual as to location, quantity, price, or terms
- Borrowings from unusual sources at below-market interest rates
- Sales or nonmonetary exchanges of recently acquired noncurrent assets such as wine or works of art at significant gains (Such assets, if they appreciate in value at all, tend to do so over a long period.)

.46 The AICPA's Division for CPA Firms—Professional Issues Task Force has issued Practice Alert No. 95-3 entitled *Auditing Related Parties and Related-Party Transactions*. This Practice Alert describes how related parties may be used to commit and conceal fraud, provides guidance on identifying related parties and related-party transactions that are not voluntarily disclosed by management, and provides guidance on how to respond to a heightened risk of the use of related parties to commit fraud. The Practice Alert appears in the November 1995 issue of *The CPA Letter*.

Discontinued Operations

.47 Accounting for discontinued operations with a measurement date after the balance-sheet date but before the issuance of the financial statements is controversial. Emerging Issues Task Force (EITF) Consensus Position No. 95-18 describes the appropriate GAAP accounting. In summary, the EITF concluded that the following presumptions exist if a loss is expected from the planned disposal of a segment.

1. The estimated loss, as determined in accordance with 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), should be recognized in the not-yet-issued financial statements for the period prior to the measurement date.
2. The segment should be presented as a discontinued operation in the income statement of the not-yet-issued financial statements.

.48 If a gain is expected, or if the loss presumption is overcome, the segment's operating results should be shown as discontinued operations.

Management Reports on Internal Control Over Financial Reporting

.49 As in the past, annual reports to shareholders this year may include comments by management about its responsibility for the financial statements and internal control over financial reporting. Interpretation No. 3 of SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550), entitled "Other References by Management to the Internal Control Structure Over Financial Reporting, Including References to the Independent Auditor" (AU section 9550.12–.15), generally prohibits management from stating in its management report or elsewhere in the document that the auditor has not identified any material weaknesses in internal control in connection with the audit unless a separate, full examination of internal control has been performed and a report has been issued in accordance with SSAE No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting* (AT section 400).

.50 If the annual report contains an assertion by management about the effectiveness of the entity's internal control over financial reporting that implies the auditor's endorsement of the assertion, and the auditor has not been engaged to examine that assertion, the auditor should request that management revise the wording of the assertion. In the rare instances in which the client does not agree to revise the wording,

the auditor should follow the guidance in paragraph 6 of SAS No. 8 (AU section 550.06), which indicates that the auditor should notify the client in writing about his or her concerns, and consult with legal counsel about additional actions.

Predecessor/Successor Auditor—Access to Working Papers

.51 SAS No. 7, *Communications Between Predecessor and Successor Auditors* (AU section 315), indicates that a predecessor auditor ordinarily should permit a successor auditor to review working papers relating to matters of continuing accounting significance. Frequently, predecessor auditors request that the successor auditor agree, in writing, to certain conditions concerning the use of the predecessor's working papers. Such agreements are designed to protect the predecessor auditor from litigation that may result from information obtained from the predecessor's working papers.

.52 Although the ASB has not reached a conclusion on this matter, several public accounting firms believe that the use of this type of written agreement better serves the public interest and the profession. The use of a written agreement in practice has provided successor auditors with greater access to the predecessor auditor's working papers. Greater access can assist a successor auditor in identifying and evaluating audit risk when planning a first-time audit. Also, broader access to working papers could have a favorable effect on the profession's litigation experience, particularly in light of the fact that many claims are related to audits performed in the first or second year of a client relationship.

.53 Following are examples of items that a predecessor auditor might request a successor auditor to agree to in writing concerning the use of the predecessor's working papers.

- The review of the predecessor's working papers is undertaken solely for the purpose of obtaining an understanding about the client and certain information about the predecessor's audit.
- Due to the successor's limited access to the predecessor's working papers, the successor will not comment orally or in writing to anyone as a result of the review as to whether the engagement was performed in accordance with GAAS.
- The successor will not provide expert testimony or litigation support services, or accept an engagement to comment on issues relating to the quality of the predecessor's audit, and will not use the audit procedures or results thereof documented in the predecessor's working papers as evidential matter in rendering his or her opinion except as contemplated in SAS No. 7 (AU section 315).
- The successor understands the purpose for which the working papers were prepared, and does not intend to rely upon the audit results documented therein as part of the audit evidence in rendering an opinion on the current-year financial statements.
- The successor agrees to subject any copies of the working papers obtained from the predecessor to his or her working paper retention policy.
- The successor will obtain permission before voluntarily allowing any third-party access to the working papers and information otherwise derived from them and will obtain on behalf of the predecessor any releases that the successor may have obtained by such third parties.
- The successor will provide the predecessor with copies of any subpoena, summons, or other court order for access to the working papers that include copies of the working papers provided by the predecessor auditor or information otherwise derived therefrom.

The Wrong "Tone at the Top" Can Lead to Fraudulent Financial Reporting

.54 Here is an example of how one company's pursuit of double-digit sales and earnings growth got out of hand.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.55 The company, a manufacturer and distributor, enjoyed over a decade of double-digit growth in sales and earnings. However, insistence by top management on maintaining that growth rate resulted in practices by certain divisions that appeared to have led to falsified financial statements.

.56 Apparently, the message from the top was to achieve the numbers at all costs. The pressure to achieve management's sales forecasts was fueled by unrelenting criticism of those who failed to achieve the targets, and a bonus plan that punished those who fell even slightly below budget while generously rewarding those who exceeded the budget. Bonus computations gave little weight to controlling assets such as receivables and inventories. Further, in some instances, the failure to meet the targeted goals may have resulted in dismissal. Top management and its auditors ultimately were alerted to these activities by the soaring receivables in the various divisions. Some of the alleged practices that led to inflated sales are highlighted in the following.

- In December 1993, a meeting was held with a number of the company's wholesale distributors at which they were allegedly instructed to take huge stocks of old inventory (up to two years' worth) or lose their exclusive distributorships. However, at the same time many of the distributors were told verbally that they would not have to pay for the merchandise until they in turn had sold it (a form of *side agreement*). The result—millions of dollars of sales booked in the final days of 1993, with much of the merchandise returned in 1994.
- In addition to offering extended payment terms and rebates for large orders, one division would ship merchandise that was not even ordered (there were no purchase orders) and book the shipments as sales.
- In one of the foreign locations, to achieve sales targets, the manager prepared invoices showing false sales to distributors and shipped millions of dollars of merchandise to a warehouse. This scheme unraveled when the accounts receivable jumped so significantly that the company had to investigate. The company's auditors later discovered that the goods were still on hand.

.57 A careful assessment of the control environment, particularly the emphasis that top management places on the bottom line and how management motivates lower level executives and employees to meet targeted results, coupled with a careful analysis of the financial statements, may identify a heightened risk of fraud.

Audit Communication and Reporting Issues

Going Concern

.58 As required by GAAS, auditors should assess in every audit, the entity's ability to continue as a going concern for one year from the date of the audited balance sheet. Examples of conditions or events that might raise doubts about an entity's ability to continue as a going concern include the following:

- Negative cash flow from either current operations or forecasted results for the coming year
- Declining revenues accompanied by losses from continuing operations
- Adverse key financial rations such as negative net worth or negative working capital
- Loss of or significant declines in orders from major customers
- Noncompliance with statutory capital requirements
- Lawsuits or other significant loss contingencies such as those related to environmental or uninsured catastrophic events
- Loan defaults
- Preferred dividend arrearages

- Denial of the usual trade credit from suppliers
- Departures of key personnel, for example, the departure of a top research scientist from a biotech firm.

.59 If the auditor believes that the presence of one or more conditions or events raises a question as to the validity of the going-concern assumption, ordinarily the key audit issue is whether management's plans, if any, for addressing the problem are appropriate and achievable. If management's plans relate primarily to the success of future normal operations for the coming year, the auditor should review the assumptions underlying management's forecast and become satisfied that the forecasted results are reasonable in light of past experience and that any significant differences are suitably supported. If management's plans relate primarily to the disposition of assets, or another single event (for example, signing up a major new customer), the auditor should consider whether sufficient evidence currently exists (for example, the existence of an identified financially capable and committed buyer or customer) to enable the auditor to conclude that it is more likely than not that management will be successful.

.60 If the auditor still has substantial doubt about the entity's ability to continue as a going concern, the report language should be unequivocal. Auditors should not use conditional language in expressing substantial doubt about an entity's ability to continue as a going concern. Examples of inappropriate conditional language include, "If the company continues to incur operating losses, there may be substantial doubt..." or "The company has been unable to renegotiate its expiring credit agreements; unless the company is able to obtain financial support there is substantial doubt..." Guidance on the appropriate language for a going-concern explanatory paragraph is provided in paragraphs 13 and 14 of SAS No. 59 (AU section 341.13 and .14).

Lessons From Litigation

.61 Not every financial disaster befalling a client is the result of an audit failure, even though all too frequently the auditor is sued because the audit firm is perceived to have failed to properly perform its work diligently and because the investors or creditors want to "bail out" of a bad decision. On the other hand, there are audit failures.

.62 Audit failures continue to be uncovered with startling regularity. In many cases, the presumed audit failure relates to situations in which management has decided to account for certain transactions incorrectly and to withhold that decision from the auditors. In other cases, management initiates and perpetrates a fraud for its own benefit. Auditors need to increase their diligence to uncover situations in which management is deliberately misstating the books and records.

.63 The following are some of the more common audit issues identified in litigation and audit failures:

- Willingness to accept management's representations without corroboration
- Allowing the client to unduly influence the scope of the auditing procedures
- Accepting the accounting for transactions, especially revenue recognition, without thoroughly understanding relevant GAAP or all the facts surrounding the transactions
- Failure to obtain and read contracts
- Failure to identify risky situations, or ignoring identified audit risks, by not applying professional skepticism and revising auditing procedures appropriately
- Not examining year-end transactions critically
- Ignoring or failing to understand the client's business, including its distribution channels and the environment in which it operates

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- Misusing the summary of unadjusted differences to justify accounting that is wrong and should be corrected
- Not using specialists in such fields as insurance, pensions, and derivatives
- Accepting accounting estimates at the low (but acceptable) end of a range without extending auditing procedures or communicating the matter to the audit committee

.64 A number of these cases involve either management fraud or deliberate deceit by management in working with auditors. Nevertheless, there may be signs of material errors or fraud that under GAAS should lead the auditors to perform additional procedures. Perhaps, if the auditor extends the auditing procedures or takes a firmer stance earlier, many of the failures would be avoided.

Analysis of International Standards on Auditing

.65 An auditor practicing in the United States may be engaged to audit financial statements in accordance with International Standards on Auditing (ISAs) (AU sections 8100–10,090). In such circumstances, the U.S. auditor should comply with both the ISAs and the SASs. An engagement of this nature is ordinarily conducted by performing an audit in accordance with U.S. auditing standards and then performing any additional procedures required by the ISAs. To help auditors perform such engagements, an analysis has been prepared that identifies the sections and paragraphs of the ISAs that contain procedural or documentation requirements that go beyond the requirements of U.S. auditing standards or that conflict with U.S. standards. A brief description of how the international standard differs from the U.S. standard is also provided. The analysis is entitled *Analysis of International Standards on Auditing* and is AU appendix B of the "Statements on Auditing Standards" (AU appendix B).

Recent GAAP Requirements

Authoritative Pronouncements Becoming Effective in 1996

.66 A number of authoritative accounting pronouncements, issued before 1996, have delayed effective dates for certain reporting entities and will be implemented for the first time in 1996 by those entities. Following is a brief overview of a number of the pronouncements becoming effective in 1996 that auditors should be aware of. When applying these pronouncements, auditors should refer to the complete professional standard.

.67 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 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 the 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. FASB Statement No. 107 (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1992, except for entities with less than $150 million in total assets. For those entities, the effective date is for fiscal years ending after December 15, 1995.

.68 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 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. FASB Statement No. 116 (AC C67) establishes accounting standards for contributions and applies to all entities that receive or make contributions. Generally, contri-

butions 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.

.69 FASB Statement No. 117 (AC 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 the 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 No5), refer to the article entitled "Implementing FASB 116 and 117," that recently appeared in the *Journal of Accountancy*.[2]

.70 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 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. It also amends FASB Statement Nos. 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.

.71 FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC 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 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 (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 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

[2] Benson, Martha L, Alan S. Glazer, Henry R. Jaenicke, and Kenneth D. Williams, "Implementing FASB 116 and 117," *Journal of Accountancy* (New York: AICPA, September 1995).

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

permitted. Impairment losses resulting from the application of the Statement (AC I08) should be reported in the period in which the recognition criteria are first applied and 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.

.72 FASB Statement No. 122, *Accounting for Mortgage Servicing Rights* (AC Mo4), was issued in May 1995 and amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (AC Mo4), to require that mortgage banking enterprises capitalize the cost of purchased and originated mortgage servicing rights as part of the cost of a mortgage loan and, for mortgage loans sold with servicing rights retained, allocate the cost of the loan between the servicing rights and the loan without the servicing rights based on the relative fair values of each of the components. The gain or loss on the sale of the loan is equal to the sales proceeds less the allocated cost of the mortgage loan; any cost allocated to the mortgage servicing rights is recognized as a separate asset. The Statement (AC Mo4) also includes guidance on estimating the fair values of the components and accounting for the impairment of the capitalized mortgage serving rights and expands the disclosure requirements of FASB Statement No. 65 (AC Mo4). The provisions of the Statement (AC Mo4) are to be applied prospectively in fiscal years beginning after December 15, 1995; special transition provisions apply.

.73 FASB Statement No. 123, *Accounting for Stock-Based Compensation* (AC C36), applies to all transactions in which an entity acquires goods or services by issuing equity instruments or by incurring liabilities to a supplier (an employee or nonemployee) in amounts based on the price of the entity's common stock or other equity instruments. The Statement (AC C36) provides a choice of accounting methods for transactions with employees that are within the scope of APB Opinion No. 25, *Accounting for Stock Issued to Employees* (AC C47). It presents a fair-value based method of accounting for employee stock options or similar equity instruments and encourages all entities to adopt that accounting method for all their employee stock compensation plans. Under the fair-value method, compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. Entities having transactions with employees that are within the scope of APB Opinion No. 25 (AC C47) may continue to measure compensation cost under that standard. However, if they choose that measurement option, they must make pro forma disclosures of net income and, if presented, earnings per share, as if the fair-value based method of accounting presented in FASB Statement No. 123 (AC C36) had been applied. The fair-value method is preferable to the method presented in APB Opinion No. 25 (AC C47) for purposes of justifying a change in accounting principle under APB Opinion No. 20, *Accounting Changes* (AC A06). Equity instruments issued to acquire goods and services from nonemployees should be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. The Statement (AC C36) is generally effective for fiscal years beginning after December 15, 1995; special transition provisions apply.

.74 FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations* (AC No5), establishes standards for accounting for certain investments held by not-for-profit organizations. It requires that investments in equity securities with readily determinable fair values and all investments in debt securities be reported at fair value with gains and losses included in a statement of activities. The Statement (AC No5) requires disclosures about investments held by not-for-profit organizations and the return on those investments. The Statement (AC No5) also establishes standards for reporting losses on investments held because of a donor's stipulation to invest a gift in perpetuity or for a specified term. The Statement (AC No5) is effective for annual financial statements issued for fiscal years beginning after December 15, 1995. Earlier application is encouraged. The Statement (AC No5) is applied either by restating the financial statements of all prior years presented or by recognizing the cumulative effect of the change in the year of the change. The expiration of restrictions on previously unrecognized net gains may be recognized prospectively.

.75 FASB Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power* (AC C67), interprets paragraph 4 of FASB Statement No. 116 (AC C67.103). Paragraph

4 of FASB Statement No. 116 (AC C67.103) states, "This Statement does not apply to transfers of assets in which the reporting entity acts as an agent, trustee, or intermediary, rather than as a donor or donee." FASB Interpretation No. 42 (AC C67) clarifies that an organization that receives assets acts as a donee and a donor, rather than as an agent, trustee, or intermediary, if a resource provider specifies a third-party beneficiary or beneficiaries and explicitly grants the recipient organization the unilateral power to redirect the use of the assets away from the specified beneficiary or beneficiaries (variance power). The Interpretation (AC C67) is effective for financial statements issued for fiscal years ending after September 15, 1996. Earlier application is encouraged. The Interpretation (AC C67) may be applied either retroactively or by reporting the cumulative effect of the change in the year of the change.

.76 Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, 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 as to 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 No5) before its effective date, earlier application of the SOP is encouraged.

.77 Practice Bulletin No. 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships*, provides guidance on applying existing accounting literature to limited liability companies (LLCs) and limited liability partnerships (hereinafter referred to as limited liabilities companies or LLCs).[3] 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.
- 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 No. 14 is effective for financial statements issued after May 31, 1995.

Authoritative Accounting Pronouncements Issued in 1996

.78 The following tables list various authoritative accounting pronouncements issued from January 1, 1996, to November 1, 1996, and their effective dates.[4] To order copies, call the FASB at (203) 847-0700, ext. 10.

---

[3] SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AU section 411), identifies AICPA practice bulletins as authoritative ("must know") accounting principles.

[4] See the Audit Risk Alert *State and Local Governmental Industry Developments—1996* [AAM section 8070] for recently issued Statements of the Governmental Accounting Standards Board.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

FASB Statements of Financial Accounting Standards and Interpretations

	Description	*Effective Date*
FASB Statement No. 125 (AC F38)	*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*	For transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996; should be applied prospectively
FASB Interpretation No. 42 (AC C67)	*Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power*	For financial statements issued for fiscal years ending after September 15, 1996; earlier application is encouraged

EITF Consensus Positions

EITF Issue No.	*Description*	*Date of Consensus*
96-1	*Sale of Put Options on Issuer's Stock That Require or Permit Cash Settlement*	January 18, 1996
96-3	*Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services under FASB Statement No. 123*	March 21, 1996
96-4	*Accounting for Reorganizations Involving Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners*	May 23, 1996
96-5	*Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination*	March 21, 1996
96-7	*Accounting for Deferred Taxes on In-Process Research and Development Activities Acquired in a Purchase Business Combination*	May 23, 1996
96-8	*Accounting for a Business Combination When the Issuing Company Has Targeted Stock*	May 23, 1996
96-10	*Impact of Certain Transactions on the Held-to-Maturity Classification under FASB Statement No. 115*	May 23, 1996
96-11	*Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115*	May 23, 1996
96-14	*Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*	July 18, 1996
96-17	*Revenue Recognition under Long-Term Power Sales Contracts That Contain both Fixed and Variable Pricing Terms*	September 18–19, 1996

EITF Issue No.	Description	Date of Consensus
96-21	*Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities*	September 18–19, 1996
96-22	*Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan is Restructured in a Troubled Debt Restructuring into Two (or More) Loans*	September 18–19, 1996

SOP 96-1, *Environmental Remediation Liabilities*

.79 In October 1996, the AcSEC issued SOP 96-1, *Environmental Remediation Liabilities*, which provides accounting guidance for the recognition, measurement, display, and disclosure of environmental remediation liabilities. The SOP requires that environmental remediation liabilities be accrued when the criteria in FASB Statement No. 5, *Accounting for Contingencies* (AC C59), are met. The SOP includes benchmarks to aid in the determination of when environmental remediation liabilities should be recognized in accordance with FASB Statement No. 5 (AC C59). Examples of such benchmarks are when an entity is identified as a potentially responsible party (PRP) and when a feasibility study is completed. The SOP also requires that the accrual for environmental remediation liabilities include the incremental direct costs of the remediation effort and the costs of compensation and benefits for employees who are expected to devote a significant amount of time directly to the remediation effort, to the extent of the time expected to be spent directly on the remediation effort. The measurement of the liability should—

- Include the entity's allocable share of the liability for a specific site, and the entity's share of amounts that will not be paid by other PRPs or the government.
- Be based on enacted laws and existing regulations and policies, and on the remediation technology that is expected to be approved to complete the remediation effort.
- Be based on the entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed. The measurement may be discounted to reflect the time value of money if the aggregate amount of the liability or component of the liability and the amount and timing of the cash payments for the liability or component are fixed or reliably determinable.

.80 The SOP also provides guidance on the display of environmental remediation liabilities in financial statements and on the disclosures about environmental-cost-related accounting principles, environmental loss contingencies, and other loss contingency considerations. In addition to the accounting guidance, the document also contains a nonauthoritative section describing major federal legislation dealing with pollution control (responsibility) laws and environmental remediation (cleanup) laws and the need to consider various state and non-U.S. government requirements. The provisions of the SOP are effective for fiscal years beginning after December 15, 1996. Earlier application is encouraged. The effect of initially applying the SOP should be reported as a change in accounting estimate. Restatement of previously issued financial statements is not permitted.

.81 The Environmental Issues Task Force of the ASB has drafted auditing guidance on planning, performing, and reporting on an audit of financial statements as it relates to auditing environmental remediation liabilities. The guidance is included in an appendix of the SOP 96-1 that is entitled "Auditing Environmental Remediation Liabilities." The following are some of the topics included in that appendix.

- Environmental-related matters the auditor should obtain knowledge of when planning an audit, including knowledge about the industry the entity operates in, the types of products or services the entity provides, the number and characteristics of the entity's locations, applicable governmental regulations, and the entity's production and distribution processes.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- Questions an auditor might ask of entity personnel to obtain an understanding of potential environmental remediation liabilities to which an entity might be exposed. Examples follow. What controls are in place to identify potential environmental remediation liabilities or related contingencies affecting the entity? Are landfills or underground storage tanks used to store or dispose of environmentally hazardous waste?
- Substantive audit procedures the auditor might perform to audit management's estimate of environmental remediation liabilities, such as, reviewing and testing the process used by management to develop the estimate, developing an independent expectation, using the work of a specialist, making inquiries of a client's lawyer, and obtaining client representations.
- The effects of various audit findings on the auditor's report.

Standards Overload Report

.82 Managing the information overload that results from the large number of standards in existence, the continuous development of new standards, and the amendment of existing standards makes the work of a CPA extremely difficult. In August 1996, the AICPA's Private Companies Practice Section Special Task Force on Standards Overload completed its report containing recommendations as to the actions that should be taken to address the problem of standards overload. The task force was composed of CPAs from small firms who provide financial-statement services primarily to small nonpublic entities. The following are some of the recommendations that were made by the task force.

1. *Increase small-firm input in the standard-setting process.* Standard-setters should be made aware of the unique problems certain standards pose for small entities, such as the high cost of capturing and generating certain financial information, and the irrelevancy of certain required financial-statement disclosures to the users of the financial statements of small entities. Small CPA firms are less likely than large firms to be able to allocate resources to the formal consideration of proposed standards and may require assistance in expressing their views on proposed standards. One way to assist small firms in expressing their views is to increase the effectiveness and visibility of the AICPA's Technical Issues Committee (TIC), which has primary responsibility for communicating the views of small CPA firms and their clients to standard setters. The task force recommends that the TIC be assigned an additional staff person to serve as a liaison between the TIC and the standard-setting bodies and to assist the TIC in expressing its views on the potential effects of specified standards on small businesses.

.83 The Financial Accounting Foundation should make a concerted effort to recruit and select trustees, FASB members, and FASB staff persons who have experience with and understanding of the needs of small nonpublic entities.

2. *Facilitate access to the professional literature and improve the understandability of that literature.* To help CPAs keep abreast of new standards as they are issued, and understand and apply those standards, the AICPA should—
   - Provide members with all of the relevant codified professional and accounting standards and other important literature, such as Emerging Issues Task Force (EITF) consensuses, and Audit and Accounting Guides, in a single CD-ROM format. The product should be reasonably priced, easy to learn, well-indexed, and contain an effective search capability so that it serves as an effective research tool.[5]

[5] Practitioners Publishing Company (PPC) and the AICPA are currently offering on one CD-ROM disk, entitled *The Practitioner's Library—Accounting and Auditing*, publications issued by PPC, the AICPA, and the FASB. The disk contains the following publications issued by the FASB: *Original Pronouncements, Current Text, Emerging Issues Task Force Abstracts,* and *FASB Implementation Guides;* and the following publications issued by the AICPA: *Professional Standards, Technical Practice Aids, Audit and Accounting Guides* (available January 1997), and *Peer Review Program Manual* (available April 1997). The disk also contains eighteen PPC engagement manuals. The disk may be customized so that purchasers pay for and receive only selected segments of the material. For more information about this product call (800) 323-8724.

- Provide members with the option of ordering a minimum library package of professional standards, in soft cover, at the time they renew their annual AICPA memberships. This could be implemented by providing a checkoff option on the annual dues statement.
- Expand the staff and hours of the AICPA Technical Information Hotline, which provides answers to accounting, auditing, and attestation questions, as well as to questions related to compilation and review engagements. The Technical Information Hotline provides important technical consultation services to CPAs in small firms, and, for many CPAs, serves as the only contact with the AICPA.
- Publish articles in the *Journal of Accountancy* that present new accounting standards in a succinct and understandable format and that contain examples and journal entries elucidating the application of the standard to situations that are relevant to small entities. Each article should be followed by a self-study examination on the new standard that may be submitted to the AICPA for CPE credit at a nominal cost.
- Enable CPAs to obtain copies of professional standards and other technical pronouncements for a fee through the AICPA 24-Hour Fax Hotline or via the computer.
- Draft standards using language that is unambiguous and easy to understand, and when accounting matters require a high degree of subjectivity, provide examples of appropriate options. Pivotal terms should always be defined and terminology should be used consistently in all standards.

3. *Sensitize peer reviewers and reviewed firms to standards-overload concerns.* The implementation of peer review has significantly improved the quality of practice. However, in some cases, peer reviewers are more demanding than the standards require and thereby become de facto standard setters. The task force believes that representatives of the AICPA's Practice Monitoring Division (Peer Review) should continue to be involved in the examination of the standards-overload problem by ensuring that peer reviewers are well qualified and do not expect firms to exceed professional standards. In addition, reviewed firms should be encouraged to request that peer reviewers cite the applicable section of the professional standards or firm policy that supports peer-reviewer recommendations for changes to the financial statements or accountant's report, or recommendations that additional procedures be performed or provided for in the firm's quality control procedures.

4. *Provide guidance on disclosure in OCBOA presentations.* Because of the complexities of GAAP, many entities elect to present their financial statements using an other comprehensive bases of accounting (OCBOA). Paragraph 9 of SAS No. 62 (AU section 623.09) indicates that OCBOA financial statements should include "all informative disclosures that are appropriate for the basis of accounting used." However, the guidance in SAS No. 62 (AU section 623) is extremely broad and practitioners find they need more specific guidance concerning disclosures in OCBOA presentations. The task force recommends that standard setters issue such guidance.

5. *Provide guidance concerning materiality and financial-statement disclosures.* A problematic area of practice is the consideration of materiality in determining whether specified financial-statement disclosures are required. Many CPAs believe that the materiality threshold is relatively low for small nonpublic entities. The task force believes that CPAs who make this assumption are overlooking the fact that materiality has a qualitative aspect in addition to a quantitative aspect. Both aspects should be considered in making decisions about the disclosures that should be included in financial statements. The AICPA should provide implementation guidance on the consideration of materiality in applying accounting standards and in making judgments about financial-statement disclosures for small nonpublic entities.

6. *Provide practice guidance concerning compilation engagements.* There is a need to provide CPAs with high-quality, practical CPE in modules that address problematic areas of practice. For example, comments from focus groups and responses to questionnaires indicate that CPAs need additional information about how to perform cost-effective compilation engagements tailored to their clients' financial-information needs. Statement on Standards for Accounting and Review Services (SSARS) 1,

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Compilation and Review of Financial Statements (AR section 100), provides for alternatives to full-disclosure GAAP financial statements, such as financial statements that omit substantially all disclosures, and financial statements prepared in accordance with an OCBOA. These engagements should enable CPAs to provide clients with a timely and cost-effective service; however, many practitioners are unaware of effective ways to use these alternatives. The task force recommends that the AICPA develop a four-hour CPE course to alert CPAs to these options and that the course be designed, coordinated, and staffed by the AICPA to ensure that the course content is technically correct, that there is consistency in the information presented, and that instructors are knowledgeable and effective communicators. This course should be offered in locations nationwide and should be reasonably priced to encourage attendance by as many practitioners as possible. It should also be available in video and, perhaps, CD-ROM format to maximize exposure.

7. *Continue to evaluate the effectiveness and relevance of financial-statement disclosures.* The task force reviewed the FASB Prospectus, *Disclosure Effectiveness*, and is aware that the FASB is currently considering modification of the disclosure requirements in certain specified standards. The task force strongly supports the FASB's project to reevaluate the information needs of financial statement users.[6]

Guides and Risk Alerts

AICPA Audit and Accounting Guides

.84 Audit and Accounting 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. Guides are available from the AICPA for the following industries:

- Agricultural Producers and Cooperatives
- Airlines
- Banks and Savings Institutions
- Brokers and Dealers in Securities
- Casinos
- Certain Nonprofit Organizations
- Colleges and Universities
- Common Interest Realty Associations
- Construction Contractors
- Credit Unions
- Employee Benefit Plans
- Entities With Oil and Gas Producing Activities
- Federal Government Contractors
- Finance Companies

[6] On September 20, 1996, the FASB issued an exposure draft of a proposed Statement entitled *Elimination of Certain Disclosures about Financial Instruments by Small Nonpublic Entities*. The proposed Statement would amend FASB Statement No. 107 (AC F25) to make the disclosures about the fair value of financial instruments prescribed in FASB Statement No. 107 (AC F25) optional for nonpublic entities that (1) have total assets of less than $10 million on the date of the financial statements, and (2) have not held or issued any derivative financial instruments, as defined in FASB Statement No. 119 (AC F25) during the reporting period.

- Health Care Organizations
- Investment Companies
- Not-for-Profit Organizations
- Property and Liability Insurance Companies
- State and Local Governmental Units
- Stock Life Insurance Companies
- Voluntary Health and Welfare Organizations

.85 The following general Audit and Accounting Guides also may be of interest to CPAs performing audit and attest engagements:

- *Consideration of Internal Control in a Financial Statement Audit*
- *Personal Financial Statements*
- *Prospective Financial Information*
- *Use of Real Estate Appraisal Information*

AICPA Annual Industry Audit Risk Alerts

.86 AICPA annual Industry Audit Risk Alerts provide information about current economic, regulatory, and professional developments in specified industries. They assist CPAs in planning and performing engagements by highlighting reporting issues, recurring peer review problems, and lessons learned from litigation. 1996/97 Audit Risk Alerts are available from the AICPA for the following industries:

- Banks and Savings Institutions [AAM section 8050]
- Construction Contractors [AAM section 8120]
- Credit Unions [AAM section 8020]
- Employee Benefit Plans [AAM section 8060]
- Health Care [AAM section 8030]
- High-Technology [AAM section 8200]
- Insurance [AAM section 8040]
- Investment Companies [AAM section 8150]
- Not-for-Profit Organizations [AAM section 8180]
- Real Estate [AAM section 8210]
- Retail Enterprises [AAM section 8230]
- Securities [AAM section 8170]
- State and Local Governments [AAM section 8070]

Publications From the Audit and Attest Standards Group

.87 The following publications are available from the AICPA. Product numbers and prices are shown in parentheses.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- *Codification of Statements on Auditing Standards* includes SAS Nos. 1 to 79 as well as SSAEs (059026, $52.00 members, $57.25 nonmembers)
- Recently published Auditing Procedures Studies are the following:
  - — *Implementing SAS No. 70,* Reports on the Processing of Transactions by Service Organizations (0210566A, $28.50 members, $31.50 nonmembers)
  - — *Audit Implications of Electronic Data Intercharge (0210606A, $19.50 members, $21.50 nonmembers)*
  - — *Auditing in a Client/Server Environment* (available end of first quarter of 1997)
  - — *Audit Implications of Electronic Document Management* (available end of first quarter of 1997)
  - — *Revised Confirmation of Accounts Receivable* (0210646A, $28.50 members, $31.50 nonmembers)
- *Codification of Statements for Accounting and Review Services* includes SSARSs 1 to 7 (0571676A, $13.00 members, $14.25 nonmembers)

Recently Published Practice Alerts

.88 The Professional Issues Task Force of the AICPA's Division for CPA Firms issued Practice Alert 95-2 entitled *Complex Derivatives.* The Practice Alert explores factors auditors should be aware of that might indicate the presence of a complex derivative structure and the risks associated with such a structure through a discussion of complex swap derivatives. This Practice Alert appears in the October 1995 issue of *The CPA Letter.*

.89 In addition, the Division for CPA Firms—Professional Issues Task Force of the AICPA recently issued Practice Alert 96-1 entitled *The Private Securities Litigation Reform Act of 1995* (the Act). The Practice Alert addresses two sections of the Act—fraud detection and disclosure and the safe harbor for forward-looking statements—and how they affect auditors in performing audits and other services. This Practice Alert appears in the May 1996 issue of *The CPA Letter.*

AICPA Services

Order Department

.90 To order AICPA products, call (800) 862-4272 (menu selection #1); write AICPA Order Department, CLA10, P.O. Box 2209, Jersey City, NJ 07303-2209; fax (800) 362-5066. Prices do not include shipping and handling. The best times to call are 8:30 to 11:30 A.M. and 2:00 to 7:30 P.M., EST.

Accounting and Auditing Technical Hotline

.91 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (800) 862-4272 (menu selection #2).

Ethics Hotline

.92 Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (800) 862-4272 (menu selection #4).

World Wide Web Site

.93 The AICPA recently established a home page on the World Wide Web. "AICPA Online," the Web site (URL or uniform resource locator: http://www.aicpa.org), offers CPAs the unique opportunity to stay abreast of developments in accounting and auditing, including exposure drafts. The home page is updated daily.

* * * *

.94 This Audit Risk Alert replaces *Audit Risk Alert—1995/96.*

[*The next page is 8055.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

AAM Section 8015
Compilation and Review Alert—1996/97

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 upon by a senior technical committee of the AICPA.

Introduction

.01 The *Compilation and Review Alert—1996/97* is a nonauthoritative practice aid designed to help accountants plan and perform their 1996 and 1997 compilation and review engagements. It clarifies certain existing professional standards, suggests ways of implementing 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.

Practice Problems Identified in Comment Letters on the Assembly Exposure Draft

.02 In September 1995, the Accounting and Review Services Committee (ARSC) issued an exposure draft of a proposed SSARS entitled *Assembly of Financial Statements for Internal-Use Only*. The proposed SSARS would allow CPAs to prepare financial statements for their clients without having to comply with the requirements of SSARS 1, *Compilation and Review of Financial Statements* (AR section 100), if distribution of the financial statements were restricted to internal personnel. The proposed Statement would introduce a new financial-statement service for nonpublic entities because under existing standards, an accountant is required to at least compile financial statements that he or she submits to a client or others, and report on them accordingly.

.03 The AICPA received over 500 comment letters on this highly controversial proposal, and when the ARSC met in February 1996 to discuss the comment letters, they concluded that they needed additional information about the kinds of problems CPAs encounter when performing compilation engagements under SSARSs. To obtain this information, the ARSC sent a questionnaire to all the commenters who had written letters in support of the exposure draft, called some of those commenters, and invited members of the AICPA Small Firm Advocacy Committee to the May 1996 ARSC meeting to talk about the problems practitioners are experiencing.

.04 The primary complaint expressed by supporters of the exposure draft was that performing compilation engagements is too time-consuming and too costly and that clients are reluctant to pay for these services. A careful analysis of these practitioners' comments revealed that the following factors appear to increase the time and cost entailed in performing compilation engagements.

- *Making Cosmetic Improvements to Financial Statements*—Many CPAs generate financial statements at their clients' offices using their clients' software. In some cases, limitations of the software prevent the CPA from being able to modify the statements as needed. For example, the software might not

allow the CPA to change the title of a financial statement from "Income Statement" to a title that would be appropriate for a cash-basis statement, such as "Statement of Revenue Collected and Expenses Paid." Also, the software might provide a limited amount of space for captions in the statements so that certain captions would have to be abbreviated. These limitations require that the CPA cross out inappropriate information and write in corrected information or expand on abbreviated information. CPAs find that the resulting financial statements are unprofessional-looking and are concerned that the statements do not meet professional standards. Many of these CPAs go back to their offices to reenter the financial-statement data using more sophisticated word-processing software that produces a more polished statement. These practitioners contend that the statements produced in their clients' offices are "good enough" for their clients, and when the ARSC inspected some of these computer-produced financial statements (with appropriate modifications as needed), they concurred. The additional work performed at the CPA's office delays submission of the financial statements to the client and makes the engagement more time-consuming and costly than it need be. SSARSs does not require this additional effort, and if a CPA has complied with the requirements of SSARSs and believes the financial statements are presented in accordance with the stated basis of accounting, there is no need for cosmetic improvements, especially if the financial statements are for a client's use only.

An option available to a CPA in this situation is to mark the rough financial statements with words such as, "Draft—Subject to Change" and to leave the statements with the client. The accountant may submit revised financial statements to the client with an appropriate compilation report after any additional work is completed, as provided for in Interpretation No. 17 of SSARS 1, "Submitting Draft Financial Statements" (AR section 9100.61 and .62).

- *Stationery and Signature for Compilation and Review Reports*—Many of the CPAs who wrote letters in support of the assembly exposure draft indicated that an assembly service would be helpful to them because it would enable them to submit financial statements to their clients at their clients' offices without having to go back to their own offices to print the compilation report on firm letterhead and have the compilation report manually signed by a specified individual. SSARS 1 (AR section 100) requires neither that a compilation or review report be printed on firm letterhead, nor that the report be manually signed. A compilation or review report may be printed on plain stationery, without any letterhead, and the signature on the report may be manually signed, typed, computer printed, or stamped with a signature facsimile.

- *Overlooking Simpler Options Available Under Existing Standards*—Many CPAs are unaware of the wide range of financial statement services they may provide to their clients under existing standards, such as compiling cash or tax-basis financial statements or statements that omit substantially all disclosures. They mistakenly believe that all financial statements must be full-disclosure generally accepted accounting principles (GAAP) financial statements. If a CPA compiles cash-basis interim financial statements that omit substantially all disclosures, the compilation report generally will not change from period to period because only items representing departures from the cash basis must be identified in the compilation report, and such departures are extremely rare. If a client requests that a CPA prepare monthly GAAP-basis financial statements, but does not require that the financial statements be adjusted for certain accruals and deferrals until year end, a CPA may forgo making those adjustments and may prepare standardized interim compilation reports, in advance, identifying the anticipated GAAP departures. Doing this will enable the CPA to save time in drafting the compilation report and perform a service that meets client needs.

  Another option is for the CPA to compile only one financial statement, such as the balance sheet, and not the other related financial statements, as provided for in paragraph 18 of SSARS 1 (AR section 100.18). A CPA also may provide his or her client with monthly presentations containing only selected information requested by the client. This information might consist of 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 1, "Reports on Specified Elements, Accounts, or Items of a Financial Statement" (AR section 9100.27

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

and .28), excludes the presentations of elements, accounts, or items of a financial statement from the applicability of SSARS 1 (AR section 100). Thus, an accountant is not required to report on such presentations. Finally, another option is to provide a client or other users with a copy of the client's tax return, if that meets users' needs. Interpretation No. 10 of SSARS 1, "Reporting on Tax Returns" (AR section 9100.31 and .32), states that SSARS 1 (AR section 100) imposes no requirement on an accountant to report on financial information contained in a tax return. The fact that a tax return is subsequently used for purposes other than submission to taxing authorities does not affect that exception.

- *Performing More Work Than Is Required Because of Concerns About Peer Review*—CPAs are distressed about the time and cost entailed in peer review, especially if they only perform compilation engagements for one or very few clients. Some practitioners perform more work than is required in a compilation engagement in anticipation of peer review. The ARSC has been meeting with representatives of the AICPA Peer Review Program in an effort to reconcile some of the differences that might exist between the expectations of some peer reviewers and the requirements of SSARSs for compilation engagements. Although many CPAs use procedural and disclosure checklists to assist them in performing compilation engagements, SSARSs does not require the use of checklists or any other working paper documentation in a compilation engagement.

.05 In addition to factors that increase the time and cost of performing compilation engagements, supporters of the exposure draft also indicated that they are concerned about the following matters.

- *CPAs Providing Controllership Services to Clients*—Many CPAs are engaged to provide part-time or full-time controllership services to their clients. They maintain the accounting books and records, prepare financial statements, and perform significant management functions for their clients, such as hiring employees, authorizing purchases, investing idle cash, and signing checks. They contend that the services they perform are the same as those performed by management and that they are well beyond being *nonindependent*. They believe that SSARSs should not be applicable to the financial statements they prepare because a compilation report is used by an outside accountant to report on financial statements that are the representations of another party. The ARSC agrees that SSARSs probably should not be applicable to such financial statements; however, the ARSC is struggling with the problem of differentiating between services that impair an accountant's independence and those that are equivalent to management. Under existing standards, an accountant whose independence is impaired may compile financial statements for a client as long as the accountant indicates his or her lack of independence in the compilation report. If a CPA were deemed to be performing significant management functions for a client, the CPA would no longer be able to compile financial statements for that client.

- *Submission of Financial Statements*—The definition of the term *submission of financial statements* is very important in SSARS 1 (AR section 100) because if an accountant submits financial statements to a client or others, he or she is required to at least compile those statements. Paragraph 7 of SSARS 1 (AR section 100.07) defines the submission of financial statements and specifies which acts trigger the requirement to compile financial statements. Submission of financial statements is currently defined as presenting to a client or others financial statements that the accountant has—

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

  2. Modified by materially changing account classification, amounts, or disclosures directly on client-prepared financial statements

  Some CPAs are uncertain about whether they have "generated" financial statements when they perform certain services for a client, especially in the context of computer-generated financial statements. For example, consider a situation in which a CPA prepares adjusting journal entries for a client and enters them into a client's computerized financial-statement database using software that automatically updates the existing data to produce revised financial statements. The CPA may not have intended to generate financial statements, but the computer automatically performs this func-

tion. Has the CPA generated financial statements if the statements exist in the computer's memory or on the screen of the computer's monitor, or does generation require that the statements be printed? (Additional examples of submission-related scenarios are presented in the article, "When Has a CPA Submitted Financial Statements," in this Alert.) The ARSC is wrestling with this issue and may have to amend SSARS 1 (AR section 100) to clarify the guidance on this topic. In addition, an AICPA task force is studying the impact of electronic transmission on financial statements and accountants' reports, and is addressing issues related to reporting on compiled financial statements that are produced and transmitted electronically.

- *Status of the Exposure Draft*—The ARSC is grappling with the aforementioned issues with the expectation that a substantial number of the problems encountered by practitioners in performing compilation engagements will disappear once the ARSC has provided solutions to these problems. The ARSC is examining the pros and cons of various options before deciding whether to develop a modified version of the exposure draft or whether to abandon the concept of an assembly service. If the ARSC decides not to issue the exposure draft as a final standard, it will need to amend or interpret SSARSs to address the problems identified in the comment letters. A conclusion that most parties agree on is that there is a need to make the guidance on how to perform cost-effective compilation engagements readily available to all CPAs, and especially to individual practitioners and others practicing in small firms. It has been suggested that this guidance be provided in the form of low-cost or free continuing professional education (CPE) programs or presented in brief installments in *The CPA Letter.*

When Has a CPA Submitted Financial Statements?

.06 The article, "Practice Problems Identified in Comment Letters on the Assembly Exposure Draft," in this Alert, notes that many CPAs are uncertain about whether the services they perform for their clients constitute a submission of financial statements. The term *submission of financial statements* is pivotal in SSARS 1 (AR section 100) because if an accountant submits financial statements to a client or others, he or she is required to at least compile the financial statements. If a CPA has not submitted financial statements, SSARSs is not applicable to the engagement. As noted in paragraph .05 of this Alert, paragraph 7 of SSARS 1 (AR section 100.07) defines the submission of financial statements as presenting financial statements to a client or others that the accountant has—

1. Generated, either manually or through the use of computer software, or
2. Modified by materially changing account classification, amounts, or disclosures directly on client-prepared financial statements

.07 In most situations, the applicability of SSARSs is fairly clear; however, the applicability may become blurry in certain situations, especially those involving computer-generated financial statements. At its September 1996 meeting, the members of the ARSC focused on this problem by describing various scenarios they have encountered involving the submission of financial statements and offering conclusions as to whether each situation is subject to the requirements of SSARSs. The following are some of the scenarios that were described and the conclusions reached by the members of the ARSC, based on existing standards.

1. The CPA prepares financial statements for a client and attaches them to a tax return. The financial-statement information correlates with the information requested on the tax return. The CPA gives the returns and the statements to the client who submits them to the taxing authority.

   Conclusion: This engagement is excluded from the applicability of SSARSs based on Interpretation No. 10 of SSARS 1 (AR section 9100.31 and .32) which states that SSARS 1 (AR section 100) imposes no requirement on an accountant to report on financial information contained in a tax return.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

2. The CPA performs the services described in the preceding situation. The client informs the CPA that he or she intends to submit the tax return packet to parties other than the taxing authority.

   Conclusion: This engagement is excluded from the applicability of SSARSs based on Interpretation No. 10 of SSARS 1 (AR section 9100.31 and .32), which states that the fact that a tax return is subsequently used for purposes other than submission to taxing authorities does not affect that exception.

3. The CPA attaches interim financial statements to an annual tax return. Since the financial statements are for only an interim period, they will not be submitted to the taxing authority.

   Conclusion: SSARSs is applicable to this engagement. Although not specifically stated, Interpretation No. 10 of SSARS 1 (AR section 9100.31 and .32) is predicated on the assumption that the financial information entered on a tax return or attached to a tax return correlates with the financial information requested on the tax return, and that the return will be filed with a taxing authority. Attaching a financial statement to a tax return that does not dovetail with the information requested on the tax return, and that will not be filed with the taxing authority, violates Interpretation No. 10 (AR section 9100.31 and .32).

4. A client gives client-prepared financial statements to a CPA. The CPA posts adjustments to the client's financial statements in a worksheet format (either manually or via computer) to reflect the tax closing, and carries the adjusted balances forward. The CPA gives the client the financial-statement worksheet so that the client can enter the adjustments into the client's accounting system to reflect the tax closing.

   Conclusion: SSARSs is applicable to this engagement for the following reasons.

   a. The worksheet that the CPA gives to the client includes adjusted financial statements; therefore, the accountant has generated financial statements.

   b. The accountant has materially modified the client's financial statements. This would be covered under paragraphs 7a and 7b of SSARS 1 (AR section 100.07).

5. On a separate sheet of paper, the CPA prepares adjustments to client-prepared financial statements and gives the adjustments to the client. The client posts the adjustments to the financial statements and sends the adjusted financial statements to the CPA for his or her consideration.

   Conclusion: SSARSs is not applicable to this engagement. Paragraph 7 of SSARS 1 (AR section 100.07) identifies the following service as one that does not constitute a submission of financial statements.

   > Proposing correcting journal entries or disclosures to the financial statements, either orally or in written form, that materially change client-prepared financial statements, *as long as the accountant does not directly modify the client-prepared financial statements*

6. The CPA enters adjustments to the client's financial-statement database using the client's computer, prints the adjusted financial statements, and takes the financial statements with him or her. The CPA does not give the statements to the client. The client has the ability to access the adjusted financial statements by viewing them on the computer monitor or printing them.

   Conclusion: SSARSs is applicable to this engagement because by causing the computer to create adjusted financial statements, the accountant has generated financial statements. Although the CPA did not "present" them to the client, the accountant made them available to the client.

7. The CPA is engaged to compile the client's financial statements. The CPA prepares the financial statements and shows them to the client for his or her review. The client or CPA notes a problem in the statements and the CPA adjusts the statements and shows a revised draft of the statements to the client. Several additional versions of the financial statements are prepared for the client's review.

   Conclusion: Interpretation No. 17 of SSARS 1 (AR section 9100.61 and .62), provides guidance for this situation. It states that an accountant should not submit draft financial statements without intending

to submit those financial statements in final form, accompanied by an appropriate compilation or review report. As long as the accountant intends to submit the financial statements in final form and labels each page of the draft financial statements with words such as "Draft," "Preliminary Draft," "Draft—Subject to Changes," or "Working Draft," the accountant is not required to comply with the reporting provisions of SSARS 1 (AR section 100) for the draft financial statements. Based on this Interpretation (AR section 9100.61 and .62), the accountant would not be required to report on the draft financial statements and would only be required to report on the final financial statements.

8. The CPA meets with the client's bookkeeper to discuss client-prepared financial statements. The CPA notes a problem in the statements and communicates the required adjusting entries to the bookkeeper, either orally or in writing, but not directly on the client-prepared financial statements. The bookkeeper enters the adjusting entries into the computer, prints the revised financial statements, and shows them to the CPA. The CPA reads the financial statements and informs the bookkeeper that no further adjustments are required. The bookkeeper gives the CPA and the client a copy of the financial statements, which the CPA discusses with the client.

   Conclusion: SSARSs is not applicable to this engagement. Based on paragraph 7 of SSARS 1 (AR section 100.07), none of the procedures performed by the CPA constitutes a submission of financial statements.

9. The client sends the CPA a computer disk that contains client-prepared financial statements. The CPA adjusts the financial statements on the disk resulting in revised financial statements. The CPA returns the disk to the client.

   Conclusion: SSARS is applicable to this engagement because the CPA has materially modified client-prepared financial statements and generated revised financial statements.

Using Staff in a Compilation or Review Engagement

.08 Many practitioners are uncertain about whether they may delegate to a staff person, including a paraprofessional, the performance of a compilation or review engagement. Interpretation No. 5 of SSARS 1, "Planning and Supervision" (AR section 9100.16 and .17), notes that SSARSs is silent on this topic and that Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), provides guidance on the use of staff in an audit engagement and on the auditor's responsibility for supervising staff. The Interpretation (AR section 9100.16 and .17) states that an accountant is not required to follow the guidance in SAS No. 22 (AU section 311) when performing a compilation or review engagement. However, the Interpretation (AR section 9100.16 and .17) also states that an accountant may wish to consider SAS No. 22 (AU section 311) or other reference sources, such as textbooks and articles, as sources of information about planning and supervising a compilation or review engagement.

.09 The Interpretation's (AR section 9100.16 and .17) reference to SAS No. 22 (AU section 311) as a source of information about planning and supervising a compilation or review engagement, and the fact that SSARSs does not preclude a CPA from delegating the performance of such engagements to a staff person causes the authors of this Alert to conclude that a CPA may delegate the performance of a compilation or review engagement to staff persons, including paraprofessionals, as long as the staff person is qualified to perform the work. In all cases, the owners, partners, or shareholders of the accounting firm retain responsibility for the engagement and the representations in the compilation or review report.

Legends on Compiled or Reviewed Financial Statements

.10 Paragraphs 16 and 34 of SSARS 1 (AR section 100.16 and .34) require that each page of compiled (reviewed) financial statements bear the legend, "See Accountant's Compilation (Review) Report." The following are questions that are frequently asked about the use of legends in compiled and reviewed financial statements and suggestions for implementing this requirement.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

1. *Question.* Must the legend, "See Accountant's Compilation (Review) Report" be placed on pages of the financial statements that contain footnote disclosures?

   Answer. Paragraph 4 of SSARS 1 (AR section 100.04) defines a financial statement as a presentation of financial data, including accompanying notes. Since the accompanying notes are part of the financial statements, the legend should be placed on those pages as well. However, if each page of the financial statements contains a statement indicating that the footnotes to the financial statements are an integral part of the statements, it may not be necessary to include the reference to the accountant's report on the footnote pages.

2. *Question.* Should the legend, "See Accountant's Compilation (Review) Report" be placed on pages of the financial-statement package that contain supplementary information?

   Answer. Yes. Although the paragraph 4 (AR section 100.04) definition of a financial statement referred to above does not include supplementary information as a component of a financial statement, the authors of this Alert believe that the pages containing supplementary information should bear the legend as well. Paragraph 43 of SSARS 1 (AR section 100.43) states that if the basic financial statements are accompanied by supplementary information, the accountant should clearly indicate the degree of responsibility he or she is taking for that information. Since the accountant's compilation or review report must identify the level of service that has been performed on the supplementary information, the most effective way of communicating that information to the user is to refer the user to the accountant's report.

3. *Question.* How should the legend on the financial statements be worded in the event of either of the following?

   a. The financial statements have been reviewed and the supplementary information has been compiled.

   b. Comparative financial statements are being presented and one year has been reviewed and the other year has been compiled.

   Answer. The legend on the pages of such financial statements may read, "See Accountant's Report." Although this approach is less precise because it does not identify the level of service in the legend, it does refer the reader to the report that will clearly state the level of service performed on each component of the financial statements and each year presented.

Compiling Pro Forma Financial Information

.11 A client who is considering entering into an important transaction, such as acquiring another entity, may find it helpful to have a CPA compile pro forma financial information related to that transaction. The objective of pro forma financial information is to present historical financial information as if a proposed or consummated transaction had occurred at the date of the historical financial information. The pro forma financial information may consist of financial statements or selected elements of a financial statement. Pro forma financial information is prepared by making pro forma adjustments to the historical financial information. The adjustments are based on management's assumptions and should reflect all of the significant effects that would be directly attributable to the proposed transaction or event. For example, in 1996, Company A may be considering acquiring Company B and would like to determine what the December 31, 1995, financial statements would have looked like had that acquisition occurred during 1995. The client, with the assistance of the CPA, would prepare pro forma financial statements that reflect all of the significant factors that would have affected the historical financial statements, such as increased labor costs if the acquisition involves the use of employees covered by a collective bargaining agreement, or the tax effects of operating in a new locality. Other situations for which pro forma financial information may be useful are to show the effects of transactions such as the following:

- The disposition of a significant portion of a business, such as the sale of a division
- A change in the form of a business organization, such as the incorporation of a sole proprietorship

- The sale of securities and the application of the proceeds, such as the issuance of debt or equity securities and the use of the proceeds to purchase additional manufacturing equipment

.12 Statement on Standards for Attestation Engagements (SSAE) No. 1, *Attestation Standards*, "Reporting on Pro Forma Financial Information" (AT section 300), establishes standards for examining or reviewing pro forma financial information. However, that standard does not apply to the compilation of pro forma financial information. In Technical Practice Aids (TPA) *Other Reporting Problems*, No. 9, "Compilation of Pro Forma Information" (TIS section 9900.09), an inquiry is made as to whether an accountant may compile pro forma financial information if the related historical financial statements have been compiled. The TPA (TIS section 9900.09) states that an accountant may compile pro forma financial information because the SSAE (AT section 300) does not proscribe such a service. Although there is no authoritative guidance for compiling such information, the authors of this Alert recommend that CPAs who compile such information

- Obtain a general understanding of the underlying transaction or event that created the need for the pro forma financial information.
- Consider whether management's assumptions underlying the pro forma adjustments are disclosed in the notes to the pro forma financial information and whether the pro forma adjustments appear to be consistent with each other and with the data used to develop them.

.13 If the historical financial statements have been compiled, the pro forma financial information may be presented as supplementary information accompanying the historical financial statements and the accountant may report on the pro forma financial information in accordance with the guidance on supplementary information presented in paragraph 43 of SSARS 1 (AR section 100.43).

Use of Emphasis and Going-Concern Paragraphs in Compilation and Review Reports

.14 Practitioners frequently ask whether they may add a paragraph to a compilation or review report to emphasize a matter regarding the financial statements, especially if they are concerned about an entity's ability to continue as a going concern. The second line in footnote 18 of SSARS 1 (AR section 100.40) states, "Nothing in this statement is intended to preclude an accountant from emphasizing in a separate paragraph of his or her report a matter regarding the financial statements." Although SSARS 1 (AR section 100) does not discuss the use of emphasis paragraphs, the important rule to remember about such paragraphs is that they should not introduce new information to the reader of the financial statements. They should only highlight or emphasize a matter disclosed in the financial statements. If a CPA believes that certain information should be disclosed in the financial statements to conform with the basis of accounting used, and the client refuses to disclose that information, the accountant is required to state, in a separate paragraph of the report, that the disclosure has been omitted and that the omission represents a departure from the basis of accounting used. This kind of paragraph is different from an emphasis paragraph because its purpose is to make the reader aware of a deficiency in the financial statements—it lets the reader know there is something wrong with the statements. Whereas, the tone and purpose of an emphasis paragraph is nonjudgmental; the paragraph simply points to information that is already disclosed in the financial statements. The financial statements are management's statements, not the accountant's, and it is management's responsibility to disclose the appropriate information in the statements. It is the accountant's responsibility to function as a referee and to report problems noted in the financial statements.

.15 Emphasis paragraphs should never contain information about procedures the accountant has or has not performed or about the CPA's conclusions or opinions concerning the entity's status as a going concern. Footnote 18 of SSARS 1 (AR section 100.40) points out that paragraphs 10 and 11 of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341.10 and .11), provide guidance on evaluating the adequacy of going-concern disclosures in financial statements. The disclosure guidance in

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

those paragraphs (AU section 341.10 and .11) applies to compiled, reviewed, and audited financial statements. The following are examples of information related to going concern that might need to be disclosed in the financial statements:

- Pertinent conditions and events giving rise to the going-concern matter
- The possible effects of such condition
- Management's evaluation of the significance of those conditions and events and any mitigating factors
- Possible discontinuance of operations
- Management's plans (including relevant prospective financial information)
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities

.16 If full-disclosure financial statements need the going-concern disclosure required by SAS No. 59 (AU section 341) and the disclosure has been omitted, the accountant should add a paragraph to the report describing the departure from GAAP, as required by paragraphs 39 and 40 of SSARS 1 (AR section 100.39 and .40). If financial statements include appropriate disclosure about a going-concern matter, the accountant is *not* required to modify the standard compilation or review report. However, the accountant may add an emphasis paragraph highlighting the disclosures in the financial statements. Interpretation No. 11 of SSARS 1, "Reporting on Uncertainties" (AR section 9100.33–.40), suggests the following sample paragraph as one that might be used to emphasize going-concern disclosure included in compiled or reviewed financial statements.

> 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.

.17 SAS No. 59 (AU section 341) requires that the terms *substantial doubt* and *going concern* be used in the explanatory paragraph if the auditor concludes that substantial doubt exists. The auditor determines that there is substantial doubt on the basis of evidence obtained from procedures performed in an audit, not from compilation or review procedures. Accordingly, the phrase "substantial doubt about the entity's ability to continue as a going concern" is reserved for audit reports and should not be used in an emphasis paragraph of a compilation or review report.

Incomplete Information

.18 Paragraphs 39 and 40 of SSARS 1 (AR section 100.39 and .40) note that an accountant who is engaged to compile or review financial statements may become aware of a departure from GAAP, or an other comprehensive basis of accounting (OCBOA), that is material to the financial statements. Paragraph 12 of SSARS 1 (AR section 100.12) indicates some of the ways in which potential financial-statement misstatements may come to the accountant's attention, such as through inquiries the accountant may have made, procedures the accountant may have performed, knowledge gained from prior engagements, and the appearance of the financial statements on their face. Paragraph 12 (AR section 100.12) states that an accountant is not required to make inquiries or perform other procedures in a compilation engagement to verify, corroborate, or review information supplied by the entity. However, it also states that if information comes to the accountant's attention that causes him or her to conclude that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory, the accountant is required to obtain additional or revised information. Practitioners have asked about the extent of their responsibility in a compilation engagement for determining the

existence of potential suspected financial statement misstatements if not all of the information needed to make such a determination is available. How much work must a CPA perform in a compilation engagement to discharge his or her responsibility for identifying financial statement misstatements?

.19 Consider the following situation. A CPA who is compiling financial statements for a client notes that the client's cash disbursements journal shows monthly disbursements for several pieces of leased equipment. When the CPA asks the client whether the equipment is rented or whether the client is making payments on purchased equipment, the client indicates that he is uncertain. The client does not have documentation concerning the leased equipment, and telephone calls to the lessor do not readily elucidate the matter. This is the first year of the engagement and the CPA does not have information from prior years. Paragraph 12 of SSARS 1 (AR section 100.12) directs the accountant to obtain additional information if the accountant concludes that information supplied by the entity is incomplete.

.20 In this situation, the CPA should explain to the client why the information is needed and request that the client contact the lessor to obtain copies of the lease agreements. Making the client aware of the reason why the information is needed is important because a compilation is defined as presenting in the form of financial statements information that is the representation of management, and management must take responsibility for the representations in the financial statements.

.21 As a practical solution, for the current financial statements that the CPA is compiling, the CPA has several options. Interpretation No. 17 of SSARS 1 (AR section 9100.61 and .62) permits the accountant to prepare the financial statements with the existing information and not to report on them as long as the CPA marks the statements with words such as "Draft—Subject to Change," and intends to submit final financial statements, with an appropriate compilation report, when the information needed to complete the compilation becomes available. Another alternative is to prepare the financial statements using the cash basis of accounting, if that meets the client's temporary needs, until the required information is obtained.

.22 A CPA should *not* issue a compilation report indicating that management has not determined the appropriateness of the accounting treatment used in the financial statements and that any potential departures from GAAP have not been determined. The use of such language is inappropriate because it permits the accountant to evade his or her responsibility for identifying material departures from the basis of accounting used.

Deciding When to Use OCBOA Financial Statements

.23 The article, "Practice Problems Identified in Comment Letters on the Assembly Exposure Draft," in this Alert, recommends that practitioners consider preparing OCBOA financial statements for their clients as a cost-effective alternative when GAAP financial statements are not needed or required. SAS No. 62, *Special Reports* (AU section 623), 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[1]
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

[1] An accountant's report on financial statements prepared using a basis of accounting that complies with the requirements of a governmental regulatory agency should include a paragraph restricting distribution of the report to those within the entity and to the regulatory agency.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

.24 Preparing OCBOA financial statements is generally less costly than preparing GAAP financial statements because OCBOA financial statements generally do not require the extensive disclosures required by GAAP. It should be noted that the use of an OCBOA does not necessarily eliminate the need for disclosures in financial statements,[2] unless the CPA prepares financial statements that omit substantially all disclosures, as provided for in paragraphs 19 through 21 of SSARS 1 (AR section 100.19–.21).

.25 In determining whether OCBOA financial statements are appropriate for a client, a CPA should consider who the users of the financial statements will be and whether the client is bound by contractual agreement or regulatory provisions to prepare GAAP financial statements. Characteristics of entities that generally are good candidates for cash or tax-basis financial statements are the following.

- The entity has no third-party users of the financial statements, for example, the entity is a small closely held business with no third-party debt.
- The entity only has secured debt rather than unsecured debt.
- Creditors of the entity do not require GAAP financial statements.
- The entity's cost of complying with GAAP would exceed the benefits, for example, a small construction contractor who would be required to account for long-term contracts using the percentage-of-completion method and would be required to compute deferred taxes.
- The business is owned by a manager who is closely involved in the day-to-day operations of the business and carries in his or her mind a fairly accurate picture of the entity's financial position.
- The owners of the entity are primarily interested in cash flows, for example, a professional corporation of physicians that distributes its cash-basis earnings through salaries, bonuses, and retirement plan contributions.
- The owners of the entity are primarily interested in the tax implications of transactions, for example, partners in a partnership who are concerned about the tax effects of transactions that will be reflected on their personal tax returns.
- Capital expenditures and long-term financing are not significant to the entity.
- The entity is not subject to Internal Revenue Code rules that would require the entity to prepare its tax return on the accrual basis of accounting, for example, the entity does not have inventory that is material to the business or does not have average annual gross receipts that exceed $5 million for the prior three tax years.

Obtaining a Representation Letter for All Periods Covered by a Review Report

.26 Paragraph 28 of SSARS 1 (AR section 100.28) requires that a client provide a CPA with a representation letter in a review engagement. According to Interpretation No. 2 of SAS No. 19, *Client Representations* (AU section 333), entitled "Management Representations When Current Management Was Not Present During the Period Under Audit" (AU section 9333.05 and .06), representation letters should cover all periods covered by the auditor's report and should be signed by the current owner/manager. Although the Interpretation (AU section 9333.05 and .06) only addresses audit engagements, the authors of this Alert

[2] Footnote 4 of SSARS 1 (AR section 100.04) indicates that the source of guidance for evaluating the adequacy of disclosure in OCBOA financial statements is paragraphs 9 and 10 of SAS No. 62 (AU section 623.09 and .10).

believe that this requirement also is applicable to review engagements. If a CPA is reviewing comparative financial statements (financial statements covering two or more periods), the CPA should obtain a representation letter that covers all periods covered by the review report.

.27 Paragraph 28 of SSARS 1 (AR section 100.28) requires that the representation letter in a review engagement be obtained 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." Because a representation letter must cover all periods covered by the review report, a problem may arise if ownership/management of the entity has changed during the period covered by the report. For example, there may have been a different owner/manager in the first year of the two-year period for which comparative financial statements are presented or a new owner/manager may have joined the entity in the latter part of a single year under review. In these circumstances, the new owner/manager may be reluctant to sign the representation letter because he or she is not sufficiently familiar with the events that occurred during the period prior to his or her tenancy.

.28 In such circumstances, it may be possible to obtain a representation letter from the previous owner/manager; however, this is highly unlikely. The accountant may point out to the client that the sample representation letter for a review engagement, presented in appendix D of SSARS 1 (AR section 100.55), limits the confirmant's response to his or her "best knowledge or belief" concerning the representations in the representation letter. If the current owner/manager refuses to sign a representation letter, the review will be considered incomplete and is not an adequate basis for issuing a review report. Paragraph 47 of SSARS 1 (AR section 100.47) states that if, in an audit or review engagement, a client does not provide the accountant with a signed representation letter, the accountant is precluded from issuing a review report on the financial statements and would ordinarily be precluded from issuing a compilation report on the financial statements. Thus, the client would not be able to step down to a compilation engagement.

How an On-Site Peer Review Differs From an Off-Site Peer Review

.29 Firms that perform even one compilation, review, or audit of historical financial statements, or compilation or examination of prospective financial statements are required to undergo peer review; however, the type of peer review the firm receives depends on the types of engagements the firm performs. Firms that perform audit engagements or examinations of prospective financial statements (even one such engagement) are required to have an *on-site* peer review.[3] In an on-site peer review, a cross section of the firm's accounting and auditing engagements are reviewed to evaluate the adequacy of the firm's quality control system. Procedures performed during an on-site peer review include reviewing the reports, financial statements, and working papers for specified engagements; interviewing firm personnel, and testing the administrative files. The objective of an on-site peer review is to report on whether the firm's system of quality control for its accounting and auditing practice met the objectives of the quality control standards established by the AICPA and was complied with during the period under review to provide the firm with reasonable assurance of conforming with professional standards.

.30 If a firm performs no audit engagements or examinations of prospective financial statements, and only performs compilations or reviews, the firm may have an *off-site* peer review.[4] Prior to an off-site peer review, the reviewed firm completes a form that requests information about the types of engagements the firm performs, such as the number and nature of the compilation and review clients served, and the industries in which those clients operate. Based on that information, the administering entity or the assigned reviewer advises the reviewed firm as to the types of engagements that will be selected for review. For each engage-

[3] In certain circumstances, sole practitioners who perform audit engagements are permitted to have their on-site review at a location other than their office.

[4] The SEC Practice Section Peer Review Program has certain requirements that are different from those of the AICPA Peer Review Program and does not offer off-site peer reviews. For additional information about peer review, call (201) 938-3030.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

ment selected, the reviewed firm submits a copy of the financial statements and accountant's report as well as a completed engagement questionnaire. The engagement questionnaire requests information about the client as well as information about accounting matters that may have arisen during the engagement. During the off-site peer review, the reviewer reads the accountant's compilation or review report, the related financial statements, and the engagement questionnaire for the engagements selected for review. The objective of an off-site peer review is to provide the reviewer with a reasonable basis for expressing limited assurance that the engagements submitted for review do not materially depart from the requirements of professional standards. An off-site peer review does *not* include a review of working papers, tests of the firm's administrative and personnel files, or interviews with firm personnel. In certain circumstances, if a firm has relinquished its audit clients, the firm may be able to change from an on-site peer review to an off-site peer review. In such situations, the firm should call or write to the entity administering its peer review to determine whether it qualifies for such a change.

Responding to Peer Review Letters of Comments

.31 During fieldwork in an on-site peer review, the reviewer will inform the reviewed firm of any deficiencies noted during the peer review, and generally will note those deficiencies on a form entitled, "Matter for Further Consideration" (MFC). The reviewed firm will have the opportunity to discuss the identified deficiencies during the peer review and to respond in writing concerning the deficiencies on the response section of the MFC form. In an off-site peer review, any identified deficiencies are communicated to the reviewed firm either by telephone or in writing on the MFC form. Because peer review is a subjective process, there may be differences of opinion between the reviewer and the reviewed firm as to whether a deficiency exists that are not resolved to the reviewed firm's satisfaction. In such circumstances, the reviewed firm should ask the reviewer to cite the applicable section of the professional standards (or the reviewed firm's policy for on-site reviews) that supports the reviewer's conclusion that a deficiency exists. Ordinarily, such matters are resolved by the exit conference in an on-site peer review and before the peer review report and letter of comments are issued in an off-site peer review. If the reviewed firm is still dissatisfied with the reviewer's conclusions, the reviewer or reviewed firm should consult with the entity administering the peer review. [5] If the matter is not resolved through consultation, the reviewed firm should respond to the reviewer's letter of comments by addressing each deficiency noted and citing the section of the professional standards that supports the reviewed firm's view. The state CPA society peer review committee will then attempt to resolve the disagreement.

.32 Many professional standards require the use of professional judgment; accordingly, a reviewed firm should not assume that the reviewer's interpretation is always the correct one. If a reviewer identifies deficiencies in an engagement, it is in the reviewed firm's best interest to read the applicable section of the standards to broaden his or her knowledge of the subject and to verify that the comment is applicable to that particular situation.

Recurring Deficiencies Noted in Compilation and Review Engagements

.33 Certain deficiencies in compilation and review engagements recur frequently and are noted by peer reviewers in letters of comments on those engagements. The following is a list of some of those deficiencies and, where applicable, a reference to the appropriate professional standard.

Common Reporting Deficiencies

.34 The accountant's report—

[5] This guidance is applicable to firms enrolled in the AICPA Peer Review Program. If a firm is a member of the SEC Practice Section, it should contact the staff of the SEC Peer Review Committee at the AICPA by calling (201) 938-3030.

- Departs from the revised report wording established in SSARS 7, *Omnibus Statement on Standards for Accounting and Review Services*. SSARS 7 revised the wording of the SSARSs compilation and review reports to indicate that the standards referred to in these reports are the SSARSs. Guidance on the appropriate wording for compilation and review reports is presented in paragraphs 14 and 32 of SSARS 1 (AR section 100.14 and .32), respectively.

- Does not disclose the accountant's lack of independence in a compilation engagement when the prior year's accounting fees were not paid. Ethics Ruling No. 52, *Unpaid Fees* (ET section 191.103 and .104), states that a firm's independence is impaired if, when the report on the client's current year is issued, fees remain unpaid, whether billed or unbilled, for any professional services provided more than one year prior to the date of the report.

- Does not disclose the basis of accounting used when the financial statements are prepared using a comprehensive basis of accounting other than GAAP and the financial statements do not disclose the basis, as required by paragraph 20 of SSARS 1 (AR section 100.20).

- Does not refer to all periods presented in the financial statements. Paragraph 2 of SSARS 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.

- Does not indicate that substantially all disclosures have been omitted from the financial statements. Paragraph 21 of SSARS 1 (AR section 100.21) provides an example of a paragraph that should be added to the accountant's report if management has elected to omit substantially all of the disclosures required by GAAP.

- For GAAP-basis financial statements, does not indicate that a statement of cash flows has been omitted. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards 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.

- Does not refer to the accompanying supplementary information. Paragraph 43 of SSARS 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.

- Contains financial-statement titles that are not the same as the titles in the financial statements presented.

- Is not dated. Paragraph 15 of SSARS 1 (AR section 100.15) states that the date of completion of the compilation should be used as the date of the accountant's compilation report, and paragraph 33 of SSARS 1 (AR section 100.33) indicates that the date of the completion of the accountant's inquiry and analytical procedures should be used as the date of the accountant's review report.

Common Financial-Statement Deficiencies

.35

- OCBOA financial statements contain unmodified GAAP-basis titles such as "Balance Sheet" and "Income Statement." Footnote 6 of SSARS 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 does not include a reference to the accountant's report. Paragraphs 16 and 43, respectively, of SSARS 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."

- Interim GAAP-basis financial statements omit a provision for income taxes and the accountant's compilation or review report does not identify the omission.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- The notes to financial statements containing only selected disclosures are not appropriately labeled. Paragraph 19 of SSARS 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

.36 Financial-statement disclosures concerning the following matters are missing or incomplete:

- Leases
- Concentrations of credit risk
- Off-balance-sheet risk
- Long-term debt commitments for the five years following the date of the latest balance sheet
- Related-party transactions
- Disclosures for each of the periods presented, if comparative financial statements are presented
- Accounting policies

Other Deficiencies

.37

- The accountant fails to report on financial statements that he or she has submitted to a client, as required by paragraph 7 of SSARS 1 (AR section 100.07).
- In a review engagement, the accountant's working papers do not include information about matters covered in the accountant's inquiry and analytical procedures or about unusual matters that the accountant considered during the performance of the review, including their disposition, as required by paragraph 31 of SSARS 1 (AR section 100.31).
- The accountant fails to obtain a representation letter from the client in a review engagement, as required by paragraph 28 of SSARS 1 (AR section 100.28).
- The accountant submits draft financial statements to a client without submitting final financial statements and reporting on them accordingly, as required by Interpretation No. 17 of SSARS 1 (AR section 9100.61 and .62).

Performance Measurement Engagements—An Engagement Expansion Opportunity

.38 A CPA who compiles or reviews financial statements for a client on a monthly or quarterly basis is in a strategic position to provide other services to that client as well. The CPA's regular visits to a client's office and discussions with management enable the CPA to develop a thorough knowledge of the client's business and its personnel. Also, by performing financial-statement services for many clients, a CPA develops a broad knowledge of business practices, including the use of technology, financial services, and outsourcing organizations, such as payroll services. The CPA's wide network of clients enables him or her to observe, firsthand, what works for businesses and what does not.

.39 The AICPA's Special Committee on Assurance Services, which was created in 1994, reports that the market for traditional accounting and auditing services is flat, and that the future will hold even greater

challenges to the profession if it is unwilling to embrace new services. The Special Committee on Assurance Services has been focusing on developing new engagement opportunities for CPAs, such as CPA association with information that may be useful to clients and unavailable or unreliable without that association. One such engagement that may be especially suited to CPAs performing compilation and review engagements is providing clients with information about their businesses in the form of performance measures that tell management whether it is achieving its objectives and enable it to monitor its progress toward achieving those objectives. Performance measures are specific quantifiable operational or financial measures that individuals can control and work to improve. For example, an objective that a company might establish is to reduce accounts receivable collection time from an average of 90 days to 60 days by selling only to customers who meet certain specified criteria. The performance measure would be the number of days required to collect accounts receivable.

.40 In a performance measurement engagement, the client must determine what its current performance measures are and whether they are consistent with its overall business strategy and primary objectives. The CPA may have to help the client to articulate its business strategy and primary objectives. For example, management must decide whether its primary objective is to maximize cash flows and current earnings or to build the value of the entity through the reinvestment of profits. Management may be uncertain about its business strategy and may need help in developing it.

.41 To develop performance measures, the CPA will need to analyze the client's business by identifying all of its processes and focusing on key indicators for that business such as revenue (volume and price), collections, cash flow, quality of the product, customer satisfaction, relationships with suppliers, product promotion, and financing. The CPA also will have to develop an understanding of the entity's strengths, weaknesses, opportunities, and threats. After a thorough analysis of the business, the CPA assists management in developing an action plan for achieving its objectives that includes the required actions needed, the individuals responsible for those actions, the timing of those actions, and the required resources (including outside specialists or advisers). Finally, the CPA helps the client to develop performance measures that are best suited for monitoring the success of the action plan. The data used for the performance measures must be reliable and relevant to the achievement of the entity's goals. CPAs should be particularly alert for measures that are counterproductive in that they encourage actions that actually hinder the achievement of the entity's overall goals and objectives. For example, consider a situation in which salespeople sell by telephone. It would be counterproductive to measure performance by measuring the number of hours salespeople spend on the telephone if the entity's objective is high sales, not high telephone bills. In addition, sales alone would not be a good performance measure if another entity objective is to avoid sales returns because the goods being sold have a high cost and are fragile and subject to breakage when returned through the mail. In those circumstances, management should focus on net sales (sales less returns) as a performance measure, rather than on sales alone. The CPA will also have to determine whether the current accounting system captures the information needed for the performance measure. For example, the accounting system would have to segregate sales returns from gross sales and sales allowances to capture the information needed for the performance measure in the previous example. Finally, the performance measure must reflect actions that the specified individual can control. If management's primary objective is to increase net sales per hour spent on the telephone, management needs to develop information, in the form of customer profiles, about the customers who are best suited to the product being sold. Providing salespeople with relevant data about customers enables salespeople to select customers who are more likely to purchase a product and to decrease the number of unproductive hours spent on the telephone.

Standards Overload

.42 Managing the information overload that results from the large number of standards in existence, the continuous development of new standards, and the amendment of existing standards makes the work of a CPA extremely difficult. In August 1996, the AICPA's Private Companies Practice Section Special Task Force on Standards Overload issued its report containing recommendations as to the actions that should be taken

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

to address the problem of standards overload. The task force was composed of CPAs from small firms who provide financial-statement services primarily to small nonpublic entities. The following are some of the recommendations that were made by the task force.

1. *Increase small-firm input in the standard-setting process.* Standard setters should be made aware of the unique problems certain standards pose for small entities, such as the high cost of capturing and generating certain financial information, and the irrelevancy of certain required financial-statement disclosures to the users of the financial statements of small entities. Small CPA firms are less likely than large firms to be able to allocate resources to the formal consideration of proposed standards and may require assistance in expressing their views on proposed standards. One way to assist small firms in expressing their views is to increase the effectiveness and visibility of the AICPA's Technical Issues Committee (TIC), which has primary responsibility for communicating the views of small CPA firms and their clients to standard setters. The task force recommends that the TIC be assigned an additional staff person to serve as a liaison between the TIC and the standard-setting bodies and to assist the TIC in expressing its views on the potential effects of specified standards on small businesses.

   The Financial Accounting Foundation should make a concerted effort to recruit and select trustees, FASB members, and FASB staff persons who have experience with and understanding of the needs of small nonpublic entities.

2. *Facilitate access to the professional literature and improve the understandability of that literature.* To help CPAs keep abreast of new standards as they are issued, and understand and apply those standards, the AICPA should—

   a. Provide members with all of the relevant codified professional and accounting standards and other important literature, such as Emerging Issues Task Force (EITF) consensuses, and Audit and Accounting Guides, in a single CD-ROM format. The product should be reasonably priced, easy to learn, well-indexed, and contain an effective search capability so that it serves as an effective research tool. [6]

   b. Provide members with the option of ordering a minimum library package of professional standards, in soft cover, at the time they renew their annual AICPA memberships. This could be implemented by providing a checkoff option on the annual dues statement.

   c. Expand the staff and hours of the AICPA Technical Information Hotline, which provides answers to accounting, auditing, and attestation questions, as well as questions related to compilation and review engagements. The Technical Information Hotline provides important technical consultation services to CPAs in small firms, and for many CPAs serves as their only contact with the AICPA.

   d. Publish articles in the *Journal of Accountancy* that present new accounting standards in a succinct and understandable format and that contain examples and journal entries elucidating the application of the standard to situations that are relevant to small entities. Each article should be followed by a self-study examination on the new standard that may be submitted to the AICPA for CPE credit at a nominal cost.

   e. Enable CPAs to obtain copies of professional standards and other technical pronouncements for a fee through the AICPA 24-Hour Fax Hotline or via the computer.

   f. Draft standards using language that is unambiguous and easy to understand, and when accounting matters require a high degree of subjectivity, provide examples of appropriate options. Pivotal terms should always be defined and terminology should be used consistently in all standards.

---

[6] Practitioners Publishing Company (PPC) and the AICPA are currently offering on one CD-ROM disk, titled *The Practitioner's Library—Accounting and Auditing*, publications issued by PPC, the AICPA, and the FASB. The disk contains the following publications issued by the FASB: *Original Pronouncements, Current Text, Emerging Issues Task Force Abstracts*, and *FASB Implementation Guides*; and the following publications issued by the AICPA: *Professional Standards, Technical Practice Aids, Audit and Accounting Guides* (available January 1997), and *Peer Review Program Manual* (available April 1997). The disk also contains 18 PPC engagement manuals. The disk may be customized so that purchasers pay for and receive only selected segments of the material. For more information about this product call (800) 323-8724.

3. *Sensitize peer reviewers and reviewed firms to standards-overload concerns.* The implementation of peer review has significantly improved the quality of practice. However, in some cases, peer reviewers are more demanding than the standards require and thereby become *de facto* standard setters. The task force believes that representatives of the AICPA's Practice Monitoring Division (Peer Review) should continue to be involved in the examination of the standards-overload problem by ensuring that peer reviewers are well qualified and do not expect firms to exceed professional standards. In addition, reviewed firms should be encouraged to request that peer reviewers cite the applicable section of the professional standards or firm policy that supports peer-reviewer recommendations for changes to the financial statements or accountant's report, or recommendations that additional procedures be performed or provided for in the firm's quality control procedures.

4. *Provide guidance on disclosure in OCBOA presentations.* Because of the complexities of GAAP, many entities elect to present their financial statements using an OCBOA. Paragraph 9 of SAS No. 62 (AU section 623.09) indicates that OCBOA financial statements should include "all informative disclosures that are appropriate for the basis of accounting used." However, the guidance in SAS No. 62 (AU section 623) is extremely broad and practitioners find they need more specific guidance concerning disclosures in OCBOA presentations. The task force recommends that standard setters issue such guidance.

5. *Provide guidance concerning materiality and financial-statement disclosures.* A problematic area of practice is the consideration of materiality in determining whether specified financial-statement disclosures are required. Many CPAs believe that the materiality threshold is relatively low for small nonpublic entities. The task force believes that CPAs who make this assumption are overlooking the fact that materiality has a qualitative aspect in addition to a quantitative aspect. Both aspects should be considered in making decisions about the disclosures that should be included in financial statements. The AICPA should provide implementation guidance on the consideration of materiality in applying accounting standards and in making judgments about financial-statement disclosures for small nonpublic entities.

6. *Provide practice guidance concerning compilation engagements.* There is a need to provide CPAs with high-quality, practical, CPE in modules that address problematic areas of practice. For example, comments from focus groups and responses to questionnaires indicate that CPAs need additional information about how to perform cost-effective compilation engagements tailored to their clients' financial-information needs. SSARS 1 (AR section 100) provides for alternatives to full-disclosure GAAP financial statements, such as financial statements that omit substantially all disclosures, and financial statements prepared in accordance with an OCBOA. These engagements should enable CPAs to provide clients with a timely and cost-effective service; however, many practitioners are unaware of effective ways to use these alternatives. The task force recommends that the AICPA develop a four-hour CPE course to alert CPAs to these options and that the course be designed, coordinated, and staffed by the AICPA to ensure that the course content is technically correct, that there is consistency in the information presented, and that instructors are knowledgeable and effective communicators. This course should be offered in locations nationwide and should be reasonably priced to encourage attendance by as many practitioners as possible. It should also be available in video and, perhaps, CD-ROM format to maximize exposure.

7. *Continue to evaluate the effectiveness and relevance of financial-statement disclosures.* The task force reviewed the FASB Prospectus, *Disclosure Effectiveness*, and is aware that the FASB is currently considering modification of the disclosure requirements in certain specified standards. The task force strongly supports the FASB's project to reevaluate the information needs of financial statement users.[7]

---

[7] On September 20, 1996, the FASB issued an exposure draft of a proposed Statement entitled *Elimination of Certain Disclosures about Financial Instruments by Small Nonpublic Entities.* The proposed Statement would amend FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 (AC F25) optional for nonpublic entities that (1) have total assets of less than $10 million on the date of the financial statements, and (2) have not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, *Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), during the reporting period.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Modifying Engagements for SOP 94-6

.43 Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, was issued by the Accounting Standards Executive Committee (AcSEC) in December 1994 and is 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. Pronouncements issued by the AcSEC are in the GAAP hierarchy and are applicable to audited, reviewed, and compiled financial statements. Accordingly, SOP 94-6 must be considered when compiling or reviewing financial statements. The SOP is applicable to all nongovernmental entities that prepare financial statements in conformity with GAAP. [8] The SOP requires disclosure of the following information:

- The nature of an entity's operations
- Its major products or services
- Its principal markets and the locations of those markets
- The relative importance of its operations in each business, and the basis for that determination, if the entity operates in more than one business
- An explanation that the preparation of financial statements in conformity with GAAP requires the use of management's estimates

.44 The SOP also requires disclosure of information about sensitive estimates in the financial statements if 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. Examples of such items are recorded amounts or disclosures that are based on estimates particularly sensitive to change in the near term, such as 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 postemployment 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.

.45 The final disclosure requirement of the SOP concerns risks and uncertainties that arise from an entity's current vulnerability due to certain concentrations. An example of a concentration is a manufacturer who depends on a single 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, the following conditions exist.

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)
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, the disclosure 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.

[8] 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.

.46 The following are some additional inquiries that may be added to the list of illustrative inquiries for a review of financial statements, presented in appendix A of SSARS 1 (AR section 100.52), to provide for the consideration of SOP 94-6 in a SSARSs review engagement.

- Do the financial statements include estimates that may be subject to a material change within the next year? If such estimates exist, what is the probability that the change will occur within the next year?
- Do individual or group concentrations exist for any of the following?
  - — Customers
  - — Suppliers
  - — Lenders
  - — Products or services
  - — Sources of labor
  - — Sources of material
  - — Licenses or other rights
  - — Operating areas or markets
  - — Grantors, contributors, or fund-raising events (for not-for-profit organizations)
- Do concentrations exist at the date of the financial statements that will make the company vulnerable to the risk of a severe near-term impact?

.47 CPAs also should consider adding the following item to the client representation letter in a review engagement:

> We have no knowledge of concentrations existing at the date of the financial statements that make the company vulnerable to the risk of a near-term severe impact, that have not been properly disclosed in the financial statements. We understand that concentrations include individual or group concentrations of customers, suppliers, lenders, products, services, sources of labor or materials, licenses or other rights, or operating areas or markets. We further understand that severe impact means a significant financially disruptive effect on the normal functioning of the company.

New Statements on Quality Control Standards

.48 In May 1996, the Auditing Standards Board (ASB) issued two new Statements on Quality Control Standards (SQCS), 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). The new Statements (QC sections 20 and 30) supersede SQCS No. 1, *System of Quality Control for a CPA Firm* (QC section 10), and provide guidance for developing a system of quality control for a firm's accounting and auditing practice.

.49 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 ARSC under Rules 201, *General Standards* (ET section 201.01), and 202, *Compliance With Standards* (ET section 202.01), of the AICPA *Code of Professional Conduct*, and any other professional standards that may be issued by the aforementioned standard setters in the future. Prior to the issuance of SQCS No. 2 (QC section 20), attestation services were not specifically addressed in the quality control standards because

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Statements on Standards for Attestation Engagements had not been issued when SQCS No. 1 (QC section 10) was promulgated. The revised definition now makes it clear that attestation services must be included in a firm's quality control system.

.50 SQCS No. 2 (QC section 20) replaces the nine elements of quality control presented in SQCS No. 1 (QC section 10) with five broad elements of quality control. It does not establish any new elements but instead combines and renames the previous elements as shown in the following table.

Old *Nine Elements of SQCS No. 1*	*Change*	*New* *Five Elements of SQCS No. 2*
Independence	The independence element is expanded to include integrity and objectivity. Firms are now required to establish policies and procedures assuring that personnel perform all professional responsibilities with integrity, and maintain objectivity while performing those responsibilities.	Independence, integrity, and objectivity
• Hiring • Advancement • Assigning personnel to engagements • Professional development	These four elements are combined into a single element.	Personnel management
Acceptance and continuance of clients	The name of this element has been modified because SQCS No. 2 (QC section 20) requires that firms consider the acceptance of client engagements in addition to considering client relationships. SQCS No. 2 (QC section 20) also requires a firm to establish policies and procedures that provide reasonable assurance that a firm will accept only those engagements it can complete with due professional competence. Firms also must have policies and procedures in place requiring them to obtain an understanding with their client of the nature, scope, and limitations of the services they will perform.	Acceptance and continuance of clients and engagements
• Supervision • Consultation	These two elements are combined and referred to as activities within the new element of engagement performance.	Engagement performance
Inspection	Inspection becomes subsumed under the new element of monitoring. SQCS No. 3 (QC section 30) provides guidance on how a CPA firm can monitor its accounting and auditing practice.	Monitoring

.51 SQCS Nos. 2 (QC section 20) and 3 (QC section 30) are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 1997. To help firms implement the new standards, a booklet entitled *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* has been issued by the AICPA. The guide includes illustrative examples of four hypothetical firms and the suggested policies and procedures for the design and maintenance of a quality control system that is appropriate for each firm's accounting and auditing practice. One of the hypothetical firms is a sole owner without any professional staff who occasionally hires per diem professionals. Her accounting practice consists of only engagements subject to SSARSs. A firm's policies and procedures should be sufficient for it to obtain reasonable assurance of complying with the requirements of SQCS Nos. 2 (QC section 20)

and 3 (QC section 30), and the illustrative examples depict various types of policies and procedures that a firm may consider for each of the elements of quality control.

GAAP for Compiled and Reviewed Financial Statements

.52 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.

.53 An exception to that rule is found in SSARS 1 (AR section 100), which permits an 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.

.54 Footnote 3 of SSARS 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 SSARSs. 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

*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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.55 Because several standard-setting bodies establish GAAP, there is no single publication that contains all of the GAAP pronouncements. Each of the following publications contains certain pronouncements included in levels *a* through *d* of the GAAP hierarchy (must know GAAP).

FASB Original Pronouncements—Accounting Standards

.56 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 Bulletins, FASB Technical Bulletins, and AICPA Accounting Interpretations. The pronouncements are arranged chronologically and the text includes a topical index (available from the AICPA).

AICPA Technical Practice Aids (Including Statements of Position)

.57 Statements of Position and Practice Bulletins issued by the 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 (available from the AICPA).

FASB Emerging Issues Task Force Abstracts

.58 This text contains a summary of the proceedings of the FASB's EITF. Each abstract summarizes the accounting issues involved and the results of the discussion, including any consensus reached on the issue (available from the FASB).

FASB Implementation Guides (Qs and As)

.59 Implementation guides are published by the FASB staff and provide guidance, in the form of questions and answers, on the implementation of FASB Statements. The following implementation guides are available from the FASB.

- *A Guide to the Implementation of Statement 87 on Employers' Accounting for Pensions*
- *A Guide to the Implementation of Statement 88 on Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*
- *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*
- *A Guide to the Implementation of Statement 96 on Accounting for Income Taxes*
- *A Guide to the Implementation of Statement 106 on Employers' Accounting for Postretirement Benefits other than Pensions*
- *A Guide to the Implementation of Statement 109 on Accounting for Income Taxes*
- *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities*

Codification of Governmental Accounting and Financial Reporting Standards

.60 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 (available from the FASB).

AICPA Audit and Accounting Guides

.61 Audit and Accounting 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 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 Audit and Accounting Guides may not be relevant to practitioners performing compilation and review engagements, the accounting guidance, illustrative financial statements, and industry background that is provided should help accountants to acquire knowledge of a specific industry. The following industry Audit and Accounting Guides are available from the AICPA:

Agricultural Producers and Cooperatives

Airlines

Banks and Savings Institutions

Brokers and Dealers in Securities

Casinos

Certain Nonprofit Organizations

Colleges and Universities

Common Interest Realty Associations (CIRAs) (This Audit and Accounting Guide contains a chapter on compilations and reviews of CIRAs.)

Construction Contractors

Credit Unions

Employee Benefit Plans

Entities With Oil and Gas Producing Activities

Federal Government Contractors

Finance Companies

Health Care Organizations

Investment Companies

Not-for-Profit Organizations

Property and Liability Insurance Companies

State and Local Governmental Units

Stock Life Insurance Companies

Voluntary Health and Welfare Organizations

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.62 The following general Audit and Accounting Guides also may be of interest to CPAs performing compilation and review engagements:

Personal Financial Statements

Prospective Financial Information

Use of Real Estate Appraisal Information

Ordering Information

.63 To order FASB products, call (203) 847-0700, ext. 10.

.64 To order AICPA products, call: (800) 862-4272 (menu selection #1); write: AICPA Order Department, P.O. Box 2209, Jersey City, NJ 07303-2209; fax: (800) 362-5066.

Recent GAAP Pronouncements

Authoritative Accounting Pronouncements Becoming Effective in 1996

.65 As noted in paragraph .52 of this Alert, the accounting principles to be followed for compiled or reviewed financial statements are the same as those for audited financial statements. A number of authoritative accounting pronouncements, issued prior to 1996, have delayed effective dates for certain reporting entities and will be implemented for the first time in 1996 by those entities. Following is a brief overview of some of the pronouncements becoming effective in 1996 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. 107, *Disclosure 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 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 the 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 F25.117-132), provides examples of instruments that are included in and excluded from the definition of a financial instrument. FASB Statement No. 107 (AC F25) is effective for financial statements issued for fiscal years ending after December 15, 1992, except for entities with less than $150 million in total assets. For those entities, the effective date is for fiscal years ending after December 15, 1995.
- 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 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. FASB 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.

- FASB Statement No. 117 (AC 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 Statements No. 116 (AC C67) and No. 117 (AC 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 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. It also amends FASB Statement No. 105 (AC F25) and No. 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.

- FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC 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 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. FASB Statement No. 121 (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. Impairment losses resulting from the application of the Statement (AC I08) should be reported in the period in which the recognition criteria are first applied and met. The initial application of the Statement (AC I08) to assets that are being held

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

- FASB Statement No. 122, *Accounting for Mortgage Servicing Rights* (AC Mo4), was issued in May 1995 and amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (AC Mo4), to require that mortgage banking enterprises capitalize the cost of purchased and originated mortgage servicing rights as part of the cost of a mortgage loan and, for mortgage loans sold with servicing rights retained, allocate the cost of the loan between the servicing rights and the loan without the servicing rights based on the relative fair values of each of the components. The gain or loss on the sale of the loan is equal to the sales proceeds less the allocated cost of the mortgage loan; any cost allocated to the mortgage servicing rights is recognized as a separate asset. The Statement (AC Mo4) also includes guidance on estimating the fair values of the components and accounting for the impairment of the capitalized mortgage serving rights and expands the disclosure requirements of FASB Statement No. 65 (AC Mo4). The provisions of the Statement (AC Mo4) are to be applied prospectively in fiscal years beginning after December 15, 1995; special transition provisions apply.

- FASB Statement No. 123, *Accounting for Stock-Based Compensation* (AC C36), applies to all transactions in which an entity acquires goods or services by issuing equity instruments or by incurring liabilities to a supplier (an employee or nonemployee) in amounts based on the price of the entity's common stock or other equity instruments. The Statement (AC C36) provides a choice of accounting methods for transactions with employees that are within the scope of APB Opinion No. 25, *Accounting for Stock Issued to Employees* (AC C47). It presents a fair-value based method of accounting for employee stock options or similar equity instruments and encourages all entities to adopt that accounting method for all their employee stock compensation plans. Under the fair-value method, compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. Entities having transactions with employees that are within the scope of APB Opinion No. 25 (AC C47) may continue to measure compensation cost under that standard. However, if they choose that measurement option, they must make pro forma disclosures of net income and, if presented, earnings per share, as if the fair-value based method of accounting presented in FASB Statement No. 123 (AC C36) had been applied. The fair-value method is preferable to the method presented in APB Opinion No. 25 (AC C47) for purposes of justifying a change in accounting principle under APB Opinion No. 20, *Accounting Changes* (AC A06). Equity instruments issued to acquire goods and services from nonemployees should be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. The Statement (AC C36) is generally effective for fiscal years beginning after December 15, 1995; special transition provisions apply.

- FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations* (AC No5), establishes standards for accounting for certain investments held by not-for-profit organizations. It requires that investments in equity securities with readily determinable fair values and all investments in debt securities be reported at fair value with gains and losses included in a statement of activities. The Statement (AC No5) requires disclosures about investments held by not-for-profit organizations and the return on those investments. The Statement (AC No5) also establishes standards for reporting losses on investments held because of a donor's stipulation to invest a gift in perpetuity or for a specified term. The Statement (AC No5) is effective for annual financial statements issued for fiscal years beginning after December 15, 1995. Earlier application is encouraged. The Statement (AC No5) is applied either by restating the financial statements of all prior years presented or by recognizing the cumulative effect of the change in the year of the change. The expiration of restrictions on previously unrecognized net gains may be recognized prospectively.

- FASB Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power* (AC C67), interprets paragraph 4 of FASB Statement No. 116 (AC C67.103).

Paragraph 4 of Statement No. 116 (AC C67.103) states, "This Statement does not apply to transfers of assets in which the reporting entity acts as an agent, trustee, or intermediary, rather than as a donor or donee." Interpretation No. 42 (AC C67) clarifies that an organization that receives assets acts as a donee and a donor, rather than as an agent, trustee, or intermediary, if a resource provider specifies a third-party beneficiary or beneficiaries and explicitly grants the recipient organization the unilateral power to redirect the use of the assets away from the specified beneficiary or beneficiaries (variance power). The Interpretation (AC C67) is effective for financial statements issued for fiscal years ending after September 15, 1996. Earlier application is encouraged. The Interpretation (AC C67) may be applied either retroactively or by reporting the cumulative effect of the change in the year of the change.

- SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, 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 as to 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 No5) before its effective date, earlier application of the SOP is encouraged.

- SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*—See paragraphs .43 through .47 of this Alert for a discussion of SOP 94-6.

- Practice Bulletin 14,[9] *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships*, 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.

  — 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 1996

.66 Following is a list of various authoritative accounting pronouncements issued from January 1, 1996 to October 1, 1996, and their effective dates.

[9] SAS No. 69 (AU section 411) identifies AICPA practice bulletins as authoritative (meaning, "must know") accounting principles.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Statements of Financial Accounting Standards and Interpretations Issued by the FASB[10]

	Description	*Effective Date*
FASB Statement No. 125 (AC F38)	*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*	For transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996; should be applied prospectively.
FASB Interpretation No. 42 (AC C67)	*Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power.*	For financial statements issued for fiscal years ending after September 15, 1996; earlier application is encouraged.

To order copies, call the FASB at (203) 847-0700, ext. 10.

EITF Consensus Positions

EITF Issue No.	*Description*	*Date of Consensus*
96-1	*Sale of Put Options on Issuer's Stock That Require or Permit Cash Settlement*	January 18, 1996
96-3	*Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services under FASB Statement No. 123*	March 21, 1996
96-4	*Accounting for Reorganizations Involving Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners*	May 23, 1996
96-5	*Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination*	March 21, 1996
96-7	*Accounting for Deferred Taxes on In-Process Research and Development Activities Acquired in a Purchase Business Combination*	May 23, 1996
96-8	*Accounting for a Business Combination When the Issuing Company Has Targeted Stock*	May 23, 1996
96-10	*Impact of Certain Transactions on the Held-to-Maturity Classification under FASB Statement No. 115*	May 23, 1996
96-11	*Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115*	May 23, 1996
96-14	*Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*	July 18, 1996

[10] See the Audit Risk Alert *State and Local Governmental Industry Developments—1996* [AAM section 8070] for recently issued Statements of the Governmental Accounting Standards Board.

EITF Issue No.	*Description*	*Date of Consensus*
96-17	*Revenue Recognition under Long-Term Power Sales Contracts That Contain both Fixed and Variable Pricing Terms*	September 18–19, 1996
96-21	*Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities*	September 18–19, 1996
96-22	*Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan is Restructured in a Troubled Debt Restructuring into Two (or More) Loans*	September 18–19, 1996

To order copies call the FASB at (203) 847-0700, ext. 10.

SOP 96-1, *Environmental Remediation Liabilities*

.67 In October 1996, the AcSEC issued SOP 96-1, *Environmental Remediation Liabilities*, which provides accounting guidance for the recognition, measurement, display, and disclosure of environmental remediation liabilities. The SOP requires that environmental remediation liabilities be accrued when the criteria in FASB Statement No. 5 (AC C59) are met. The SOP includes benchmarks to aid in the determination of when environmental remediation liabilities should be recognized in accordance with FASB Statement No. 5 (AC C59). Examples of such benchmarks are when an entity is identified as a potentially responsible party (PRP) and when a feasibility study is completed. The SOP also requires that the accrual for environmental remediation liabilities include the incremental direct costs of the remediation effort and the costs of compensation and benefits for employees who are expected to devote a significant amount of time directly to the remediation effort, to the extent of the time expected to be spent directly on the remediation effort. The measurement of the liability should—

- Include the entity's allocable share of the liability for a specific site, and the entity's share of amounts that will not be paid by other PRPs or the government.
- Be based on enacted laws and existing regulations and policies, and on the remediation technology that is expected to be approved to complete the remediation effort.
- Be based on the entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed. The measurement may be discounted to reflect the time value of money if the aggregate amount of the liability or component of the liability and the amount and timing of the cash payments for the liability or component are fixed or reliably determinable.

.68 The SOP also provides guidance on the display of environmental remediation liabilities in financial statements and on the disclosures about environmental-cost-related accounting principles, environmental loss contingencies, and other loss contingency considerations. In addition to the accounting guidance, the document also contains a nonauthoritative section describing major federal legislation dealing with pollution control (responsibility) laws and environmental remediation (cleanup) laws and the need to consider various state and non-U.S. government requirements. The provisions of the SOP are effective for fiscal years beginning after December 15, 1996. Earlier application is encouraged. The effect of initially applying the SOP should be reported as a change in accounting estimate. Restatement of previously issued financial statements is not permitted.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Other AICPA Publications Relevant to SSARS Engagements

Codification of Statements on Standards for Accounting and Review Services

.69 *Statements on Standards for Accounting and Review Services* (SSARSs) are the standards by which compilation and review engagements are performed.

Codification of Statements on Auditing Standards

.70 *Codification of Statements on Auditing Standards* includes SAS Nos. 1 to 79 and SSAE Nos. 1 to 6. 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, SSARSs sometimes refer the reader to the SASs for amplification of topics mentioned in SSARSs.

AICPA Annual Audit Industry Risk Alerts

.71 AICPA annual Audit Industry Risk Alerts provide information about current economic, regulatory, and professional developments in specified industries. They assist CPAs in planning and performing engagements by highlighting reporting issues, recurring peer review problems, and lessons learned from litigation. The following 1996/97 Audit Risk Alerts are available from the AICPA:

- Banks and Savings Institutions [AAM section 8050]
- Construction Contractors [AAM section 8120]
- Credit Unions [AAM section 8020]
- Employee Benefit Plans [AAM section 8060]
- Health Care [AAM section 8030]
- High-Technology [AAM section 8200]
- Insurance [AAM section 8040]
- Investment Companies [AAM section 8150]
- Not-for-Profit Organizations [AAM section 8180]
- Real Estate [AAM section 8210]
- Retail Enterprises [AAM section 8230]
- Securities [AAM section 8170]
- State and Local Governmental Developments [AAM section 8070]

AICPA Services

Order Department

.72 To order AICPA products, call: (800) 862-4272 (menu selection #1); write: AICPA Order Department, P.O. Box 2209, Jersey City, NJ 07303-2209; fax: (800) 362-5066. Prices do not include shipping and handling.

Technical Hotline

.73 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call: (800) 862-4272 (menu selection #2).

Ethics Hotline

.74 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).

* * * *

.75 This Compilation and Review Alert replaces *Compilation and Review Alert—1995/96*.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.76

Appendix

Compilation and Review Quiz

Answer each question by circling either *True* or *False*. Answers appear following question number 10.

1. SSARS 1 (AR section 100) requires a "minimum" set of working papers in a compilation engagement.

   True False

2. SSARS 1 (AR section 100) requires that a CPA perform a compilation only when the financial statements will be submitted to third-party users.

   True False

3. SSARS 1 (AR section 100) does not require a CPA to perform a compilation if the financial statements are for interim periods.

   True False

4. SSARS 1 (AR section 100) requires that a compilation report be—

   a. Manually signed.

   True False

   b. Printed on the CPA's letterhead.

   True False

5. A CPA may delegate responsibilities, such as reading the financial statements and signing the compilation report, to a staff person of the accounting firm.

   True False

6. A CPA in public practice who is engaged as a controller (one who is authorized to hire and fire the bookkeeper and sign checks) for a client does not have to attach a compilation report to financial statements that he or she generates.

   True False

7. SSARS 1 (AR section 100) requires a CPA to perform a compilation if—

   a. The CPA does all of the work necessary to generate the financial statements, but permits the client to actually generate the financial statements on the computer by "pushing the print button."

   True False

   b. The CPA proposes adjustments to the client's books and records, either orally or in writing, that materially change client-prepared financial statements, and such adjustments are posted by the client.

   True False

   c. The CPA makes material changes to the client's financial statements by changing account classifications, amounts, or disclosures directly on the financial statements.

   True False

8. A CPA may perform a compilation engagement even though he or she is not independent as long as the CPA discloses his or her lack of independence in the compilation report.

   True False

9. A CPA who compiles financial statements using an OCBOA, such as the cash basis or income tax basis, must also disclose all the significant measurement departures from GAAP in the compilation report.

   True False

10. Accounting pronouncements issued by the FASB are applicable to audited financial statements but not to compiled or reviewed financial statements.

    True False

Answers to the Compilation and Review Quiz

1. SSARS 1 (AR section 100) requires a "minimum" set of working papers in a compilation engagement.

   False—Paragraph 31 of SSARS 1 (AR section 100.31) requires that an accountant prepare working papers for a review engagement but contains no such requirement for a compilation engagement.

2. SSARS 1 (AR section 100) requires that a CPA perform a compilation only when the financial statements will be submitted to third-party users.

   False—Paragraph 7 of SSARS 1 (AR section 100.07) states, "An accountant should not submit unaudited financial statements of a nonpublic entity *to his or her client or others* unless, as a minimum, he or she complies with the provisions of this statement applicable to a compilation engagement."

3. SSARS 1 (AR section 100) does not require a CPA to perform a compilation if the financial statements are for interim periods.

   False—The sentence from paragraph 7 of SSARS 1 (AR section 100.07), cited in item 2, uses no qualifying language as to which types of unaudited financial statements (interim or annual) are meant here. Also, the idea of excluding interim financial statements from the applicability of SSARSs has been considered and rejected by the ARSC several times.

4. SSARS 1 (AR section 100) requires that a compilation report be—

   a. Manually signed.

   False

   b. Printed on the CPA's letterhead.

   False

   SSARS 1 (AR section 100) contains no such requirements.

5. A CPA may delegate responsibilities, such as reading the financial statements and signing the compilation report to a staff person of the accounting firm.

   True—SSARS 1 (AR section 100) does not preclude a CPA from delegating responsibilities to staff persons in a compilation or review engagement, as long as the staff person is qualified to perform the procedures.

6. A CPA in public practice who is engaged as a controller (one who is authorized to hire and fire the bookkeeper and sign checks) for a client does not have to attach a compilation report to financial statements that he or she generates.

   True—A compilation report is used by an outside accountant to report on financial statements that are the representations of another party. If an accountant performs services for a client that are equivalent to those performed by management, including making management decisions, the financial statements would be deemed to be the accountant's representations.

7. SSARS 1 (AR section 100) requires a CPA to perform a compilation if—

   a. The CPA does all of the work necessary to generate the financial statements, but permits the client to actually generate the financial statements on the computer by "pushing the print button."

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

True—Paragraph 7 of SSARS 1 (AR section 100.07) requires that an accountant compile financial statements if he or she submits them to a client or others. One aspect of submission is generating the financial statements. The term *generating* is not defined in SSARS 1 (AR section 100) and some accountants believe that if the client "pushes the button," the client has generated the financial statements and the CPA is not required to comply with SSARS 1 (AR section 100). The authors of this Alert strongly believe that having the client push the button simply to avoid having to compile the financial statements is inappropriate and does not reflect the substance of SSARS 1 (AR section 100).

b. The CPA proposes adjustments to the clients books and records, either orally or in writing, that materially change client-prepared financial statements, and such adjustments are posted by the client.

False—SSARSs is not applicable to this engagement because paragraph 7 of SSARS 1 (AR section 100.07) identifies the following service as one that does not constitute a submission of financial statements.

> Proposing correcting journal entries or disclosures to the financial statements, either orally or in written form, that materiality change client-prepared financial statements, as long as the accountant does not directly modify the client-prepared financial statements

c. The CPA makes material changes to the client's financial statements by changing account classifications, amounts, or disclosures directly on the financial statements.

True—See the answer to item *7b.*

8. A CPA may perform a compilation engagement even though he or she is not independent as long as the CPA discloses his or her lack of independence in the compilation report.

   True—Paragraph 22 of SSARS 1 (AR section 100.22) provides for this type of engagement.

9. A CPA who compiles financial statements using an OCBOA, such as the cash basis or income tax basis, must also disclose all the significant measurement departures from GAAP in the compilation report.

   False—Only departures from the basis of accounting used in the financial statements must be identified in the accountant's compilation report.

10. Accounting pronouncements issued by the FASB are applicable to audited financial statements but not to compiled or reviewed financial statements.

    False—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.

[*The next page is 8089.*]

AAM Section 8020

Credit Union Industry Developments—1996/97

Industry and Economic Developments

Financial Trends

.01 *Natural Person Credit Unions.* Much of the rapid growth experienced by credit unions in 1995 continued in the first half of 1996. According to credit union call reports submitted in the first half of 1996, assets and shares grew by approximately 5.5 percent and 5.6 percent, respectively, while loans grew by 4.6 percent, and capital grew by 4.1 percent. Savings growth exceeded loan growth resulting in investment gains of 6.9 percent in the first half of 1996. Deposits in corporate credit unions increased nearly $1.6 billion or 6.4 percent, compared to $2.5 billion or a 10.3 percent increase last year.

.02 Many credit unions have begun offering more nontraditional services, such as electronic tax filing services with the Internal Revenue Service (IRS) for their members, and the sale of noninsured investment products to members through credit union service organizations (CUSOs).

.03 *Corporate Credit Unions.* Corporate credit unions (total of 41 as of June 1996) experienced a slight growth in investments in the first half of 1996 to $50.9 billion, a 1 percent increase from December 1995. Loans decreased by 14.2 percent during the same period to $852 million, and equity increased by 2.4 percent to approximately $1.19 billion. Income from operations decreased by 1.4 percent because of an increase (7.9 percent) in operating expenses largely for office operation and outside professional services, and a decrease (.9 percent) in total gross revenues principally due to a reduction of interest earned on loans.

Consolidation and Restructuring

.04 Consolidation and restructuring within the industry have continued during 1996 as credit unions attempt to control costs. Related reductions in staff or the 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.

.05 Credit unions also continue to achieve efficiency and reduce 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.

Regulatory Developments

.06 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, a number of laws and regulations

directly address the responsibilities of auditors. Auditors should be generally familiar with certain laws and regulations that affect the following:

- Acceptance of engagements in the industry
- Development of the expected conduct and scope of an engagement
- Responsibility for the 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

.07 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.

.08 Following are 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 Truth in Savings Act, are outside 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 Audit Risk Alert for a complete reading of related laws, regulations, rulings, or other documents where appropriate (see the "Information Sources" section herein). This Audit Risk Alert refers to related publications of the National Credit Union Administration (NCUA) and other entities as appropriate.

New and Proposed Regulations

.09 The NCUA insures 7,329 Federal credit unions and insures members deposits of an additional 4,358 state-chartered credit unions. Over the past several years, the NCUA has moved toward deregulation while, at the same time, increasing the role and responsibilities of credit union boards of directors and supervisory committees, especially relating to the credit union's investment activity and audit responsibilities. The NCUA also has announced plans to conduct a top-to-bottom review of all regulations older than three years and all interpretative rulings and policy statements (IRPS) to identify rules that can be eliminated and areas that can be streamlined.

.10 *Revised Supervisory Committee Audit Regulations.* In July 1996, the NCUA revised Supervisory Committee Regulation (Part 701.12), "Audits and Verifications" (*Federal Register*, August 8, 1996). The new regulations specify the requirements for performing annual credit union supervisory committee audits, and expand the audit scope responsibilities if the supervisory committee audit is performed by an independent compensated auditor. The new regulations are effective for audits conducted for and covering the audit period ending December 31, 1996, and thereafter.

.11 According to the new regulations, the requirement for Federal and Federally insured state chartered credit unions to have an annual supervisory committee audit may 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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

2. An agreed-upon procedures engagement performed by an independent, licensed certified public accountant (CPA).
3. A supervisory committee audit performed by a compensated auditor (as defined) other than a CPA 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.

With respect to either of the first two of the above options, the regulations require the independent auditor to certify in an engagement letter whether the contracted scope of the audit satisfies the requirements of a complete supervisory committee audit. If the auditor performs procedures that exclude any of the financial statement elements, accounts, or items and attributes listed in parts 701.12(c)(3) and (4) of the NCUA regulations, the auditor must state in the engagement letter that the procedures performed by the auditor will not, by themselves, fulfill the scope of a supervisory committee audit, and the auditor must caution the supervisory committee that the supervisory committee will remain responsible for fulfilling the scope of a supervisory committee audit with respect to the elements, accounts, or items and attributes not tested by the independent auditor.

.12 Practitioners are cautioned that the Audit Issues Task Force (AITF) of the AICPA Auditing Standards Board (ASB) concluded that an agreed-upon procedures engagement performed pursuant to SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622), or Statement on Standards for Attestation Engagements (SSAE) No. 4, *Agreed-Upon Procedures Engagements* (AT section 600), cannot, by itself, satisfy all of the objectives of a supervisory committee audit as specified in parts 701.12(c)(3) and (4) of the NCUA regulations. The AITF concluded that a CPA can only satisfy the supervisory committee requirement in its entirety by performing an audit of the credit union's financial statements in accordance with GAAS. See the "Audit Issues and Developments" section of this Audit Risk Alert for further discussion.

.13 The rule requires that the auditor prepare an engagement letter that, among other things, must—

- Specify the terms, conditions, and objectives of the engagement;
- Identify the basis of accounting to be used, for example, generally accepted accounting principles (GAAP) or regulatory accounting practices (RAP);
- Certify that NCUA staff or its designated representative will be provided unconditional access to the complete set of original work papers either at the credit union or at a mutually agreeable location, for purposes of inspection;
- Certify whether the procedures performed satisfies the requirements of a complete supervisory committee audit (see related discussion above);
- Acknowledge that working papers will be retained for a minimum of three years from the date of the written audit report.

.14 *Community Development Credit Unions—Secondary Capital.* In January 1996, the NCUA issued regulations that authorized credit unions having a low-income designation from the NCUA or the appropriate state regulator to offer secondary capital accounts to immediately boost their capital levels. Previously, low-income credit unions (LICUs) were allowed to accept public and private deposits from nonmember sources such as foundations, corporations, and other financial institutions. The new regulations allow LICUs to raise additional funds from these sources for use as secondary capital. This secondary capital would not be treated as share deposits, but as subordinated debt, and would be available to LICUs to absorb any losses. The regulations also established several safety and soundness conditions that Federal and state-chartered LICUs must follow prior to issuing the secondary capital accounts, including adopting a written plans and submitting it to the appropriate NCUA regional director and/or state supervisor.

.15 The NCUA rule states that, for regulatory capital purposes, the secondary capital accounts should be recorded in the equity section in the balance sheet. The amount to be treated as capital decreases as the deposit reaches maturity based on a sliding scale. The portion not treated as capital is to be reported in a liability account according to regulatory guidance. See the "Audit Issues and Developments" section of this Audit Risk Alert for further discussion of the auditor's consideration of the presentation of secondary capital accounts in a credit union's financial statements.

.16 *Natural Person Credit Union Investments.* In November 1995, the NCUA proposed regulations (Part 703) affecting investment and deposit activity of natural person credit unions (*Federal Register*, November 29, 1995). The proposed regulations were based, in part, on an NCUA survey of 300 credit unions with investments in collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs) in excess of capital. The study revealed that more than one-third of the credit unions did not understand the risks of CMOs and REMICs, that more than a quarter of the credit unions were taking unacceptable risks, and that almost half did not have acceptable asset-liability management policies.

.17 The proposed rule would allow a credit union to operate on one of three levels of investment activity. At the most conservative level, a credit union could invest in fully insured certificates of deposit (CDs) and shares and deposits in corporate credit unions.

.18 At the next level, a credit union could invest in potentially more risky securities in an amount up to capital and would have to comply with most of the proposed rule's policy and reporting requirements.

.19 Finally, at the most sophisticated level, a credit union investing in potentially more risky securities in an amount exceeding capital would be subject to all of the proposed rule's policy and reporting requirements.

.20 The proposed rule makes several changes to the current regulations in Part 703, including—

- Expanding the current requirements for written investment policies consistent with the Federal Credit Union Act, the NCUA Rules and Regulations, and other applicable laws and regulations to address CMO/REMIC prepayment models, concentration limits, trading activities, and the knowledge and experience of persons granted investment authority;
- Prohibiting certain investment activities such as purchasing stripped mortgage-backed securities, residual interests in CMO/REMICs, and interest-rate swap contracts;
- Limiting delegation of authority to an outside party up to 100 percent of capital;
- Establishing minimum credit ratings for financial institutions and municipal bonds;
- Requiring that the index for variable rate investments be tied to domestic interest rates only.

.21 The comment period on the proposed rule was extended to November 18, 1996.

.22 *Corporate Credit Unions.* In June 1996, The NCUA proposed changes to NCUA regulations (Part 704) related to factors affecting the safety and soundness of the existing forty-one corporate credit unions. These include proposed changes to capital requirements, asset/liability management, investments, lending, membership eligibility, borrowings, internal audits, and expanded authorities (*Federal Register*, June 4, 1996).

.23 Specifically, the rule proposes the following:

- Require that each corporate to maintain a 4-percent minimum capital level, unless expanded authorities are granted;
- Alter the definition of capital to include the sum of a corporate's reserves and undivided earnings, paid-in capital, and membership capital;

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- Substitute membership capital share deposits with membership capital accounts, which would require three-years notice of withdrawal, instead of the current one-year notice period;
- Require corporate boards to approve comprehensive written investment and asset/liability management plans and policies, and to oversee senior management to ensure that all activities are conducted in a safe and sound manner and consistent with the board's risk management philosophy;
- Require that corporates invest in instruments of high quality and limited risk. Permissible investments would include bank deposits, mutual funds, Treasury and agency securities, Fed funds, asset-backed and mortgage-backed securities, repurchase agreements, commercial paper, corporate notes/bonds, CUSOs, and deposits in other corporate credit unions. Investments that fall out of compliance with the regulation would have to be divested within twenty-five business days, unless an acceptable work plan is submitted to NCUA;
- Establish guidelines for managing the interest rate risk on the corporate's balance sheet;
- Require an internal audit function for corporates with assets greater than $400 million.

.24 The proposed rule retains the requirement for corporate credit unions to have an annual financial statement audit by an independent, licensed CPA. In addition, the proposed rule would require that all correspondence provided to a corporate credit union by the external auditor be made available to NCUA. This provision is subject to broad interpretation of the term *correspondence*. The AICPA asked the NCUA to clarify that such correspondence be related only to the auditor's findings based on the audit.

.25 The comment period on the proposed rule was extended to October 19, 1996.

.26 Auditors should be alert for issuance of final regulations and consider the effect on audit risk. Auditors should also be aware of the financial difficulties encountered by certain corporate credit unions and ensure that 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. See the "Audit Issues and Developments" section of this Audit Risk Alert for further discussion of noncompliance with regulatory requirements.

.27 *Unrelated Business Income Taxes.* Credit unions are exempt from Federal income taxes; however, they may realize income from certain activities that may be subject to unrelated business income taxes. In a December 1995 technical advice memorandum, the IRS ruled that the sale of credit life and disability insurance to member borrowers by a state-chartered credit union should be treated as unrelated business taxable income under section 511 of the Internal Revenue Code (IRC). Auditors should consider whether the financial statements include appropriate provisions for taxes on unrelated business income.

Other Regulatory Matters

.28 *NCUA World Wide Web Home Page.* The NCUA has over 600 documents available on its website (http://ncua.gov or http://www.ncua.gov). The NCUA website includes information on the NCUA organization and many reference materials affecting credit unions, including rules and regulations, the Federal Credit Union Act, accounting bulletins, legal opinion letters, accounting manual, regulatory alerts, interpretative rulings, and letters to credit unions. The site also includes credit union data from call reports and financial performance reports. Much of this information is useful to the auditor in planning and performing the audit, and performing analytic review of a credit union compared to industry trends and statistics.

.29 *AIRES.* NCUA examiners have been using the automated integrated regulatory examination system (AIRES) to conduct examinations of credit unions. NCUA expects to release in early 1997, an AIRES version for credit unions (Aires "lite") that would be available to credit unions as a management tool to analyze loan

and shared data. Recently, AIRES was used to detect a twenty-year fraud in a cover-up scheme by running a loan concentration query and finding numerous loans with a credit union's address. Auditors may find AIRES to be a useful tool in performing audit planning, such as in considering industry financial trends and ratios, and performing analytical review procedures.

.30 *Educational Loans.* Auditors should be alert that the Higher Education Act requires compliance engagements for Federal Family Education Loan (FFEL) program lenders and third-party servicers. The United States Department of Education's Office of the Inspector General (OIG) developed detailed requirements for lender engagements in its March 1995 guide, *Compliance Audits (Attestation Engagements) of Federal Family Education Loan Program at Participating Lenders*, in March 1995.

.31 In June 1996, the Department extended the due date for reports from lenders with portfolios equal to or less than $5 million (as defined) until June 30, 1997 (Dear Colleague Letter 96-L-188).

.32 The OIG plans to issue a guide in late 1996 that will supersede the March 1995 lender guide and will introduced detailed requirements for servicer engagements. The new guide likely will become effective within six months of issuance.

Audit Issues and Developments

Supervisory Committee Audits

.33 The NCUA's revised supervisory committee audit regulations (Part 701.12 of Title 12 of the Code of Federal Regulations) provide that a credit union's supervisory committee may satisfy the requirements of a supervisory committee audit by, among other approaches, engaging an independent CPA to perform an audit of the credit union's financial statements in accordance with GAAS or to perform an agreed-upon procedures engagement. As discussed below, the AITF of the AICPA's Auditing Standards Board concluded that an agreed-upon procedures engagement performed pursuant to SAS No. 75 (AU section 622) (or SSAE No. 4 [AT section 600]), cannot, by itself, satisfy all of the objectives of a supervisory committee audit as specified in parts 701.12(c)(3) and (4) of the NCUA regulations. The AITF concluded that a CPA can only satisfy the supervisory requirement in its entirety by performing an audit of the credit union's financial statements in accordance with GAAS. Practitioners requested to perform an agreed-upon engagement should advise their clients of this issue. (See the "Regulatory Developments" section of this Audit Risk Alert for further discussion of the new supervisory committee audit regulations.)

.34 The supervisory committee audit regulations state that the scope of a supervisory committee audit (whether such audit is satisfied by a GAAS audit or an agreed-upon procedures engagement) consists of—

1. Attaining an understanding of the internal control structure;
2. Assessing the level of control risk;
3. Based on the level of risk, determining the nature, timing, and extent of substantive testing necessary to confirm the assertions made by management regarding each of assets, liabilities, equity, income, and expenses for the following attributes (assertions):
   - Existence or occurrence
   - Completeness
   - Valuation or allocation

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- Rights and obligations
- Presentation and disclosures

.35 In addition, a supervisory committee audit performed by an independent, compensated auditor which includes any of the following areas must, with respect to audit scope but not with respect to reporting, satisfy GAAS for expressing an opinion on the financial statements taken as a whole:

1. Internal controls
2. Cash
3. Loans and interest thereon
4. Investments and interest thereon
5. Shares and dividends and/or interest thereon
6. Related party transactions
7. The reporting of identified errors and irregularities with regard to each of items 1 through 6 above

.36 The AITF concluded that the required audit objectives for each of the above areas can only be met by exercising professional judgment within the context of an audit performed in accordance with GAAS (the overall objective of which is the expression of an opinion on the fairness of a financial presentation *taken as a whole*). Procedures directed at fulfilling the complete scope and audit objectives would fail the conditions for an agreed-upon procedures engagement in paragraph 9 of SAS No. 75 (AU section 622.09). Procedures to "attain an understanding of an entity's internal control structure" and to "assess the level of control risk" are inappropriate procedures in an agreed-upon procedures engagement. (See paragraphs 17 through 20 of SAS No. 75 [AU section 622.17–.20] for a discussion of appropriate procedures.)

.37 Auditors may be able to perform certain agreed-upon procedures related to a financial statement element, account, or item and attributes (for example, test loans and interest thereon for valuation or allocation attributes) in accordance with SAS No. 75 (AU section 622). Auditors who perform an agreed-upon procedures engagement should clearly communicate to the client in the engagement letter the scope of work to be performed and state that the scope of the procedures does not meet the full supervisory committee audit scope requirements.

.38 The auditor should also ensure that the conditions in SAS No. 75 (AU section 622) for an agreed-upon procedures engagement are met. Paragraph 9 of SAS No. 75 (AU section 622.09) states that accountants may perform an agreed-upon procedures engagement provided that—

a. The accountant is independent.

b. The accountant and the specified users agree upon the procedures performed or to be performed by the accountant.

c. The specified users take responsibility for the sufficiency of agreed-upon procedures for their purposes.

d. The procedures to be performed are expected to result in reasonably consistent findings.

e. The basis of accounting of the specified elements, accounts, or items of a financial statement is clearly evident to the specified users and the accountant.

f. The specified subject matter to which the procedures are to be applied is subject to reasonably consistent estimation or measurement.

g. Evidential matter related to the specific subject matter to which the procedures are applied is expected to exist to provide a reasonable basis for expressing the findings in the accountant's report.

h. Where applicable, the accountant and the specified users agree on any materiality limits for reporting purposes.

i. Use of the report is restricted to the specified users.

.39 The auditor should also consider whether, in the particular facts and circumstances of the engagement, there are parties other than the credit union supervisory committee, such as the NCUA or state regulator, that should be included as specified users. The auditor should restrict the report to the specified users and obtain representations from all specified users that they take responsibility for the sufficiency of the agreed-upon procedures for their purposes.

.40 Auditors should discuss with the client the approach to be taken to satisfy the supervisory committee audit. Auditors should also consider obtaining representations from the supervisory committee on its responsibility for fulfilling the scope of the supervisory committee audit.

.41 With respect to the requirement to provide NCUA with access to the auditor's working papers, 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).

Secondary Capital Accounts

.42 Auditors of credit unions that have a low-income designation from the NCUA or the appropriate state regulator and that offer secondary capital accounts should give special consideration to the propriety of the presentation of secondary capital accounts in GAAP financial statements. See the "Regulatory Developments" section of this Audit Risk Alert for further discussion of community development (low-income designated) credit unions. Credit union regulations require secondary capital accounts to be recorded in the equity section account in the balance sheet for regulatory capital purposes. The amount to be treated as capital decreases as the deposit reaches maturity based on a sliding scale. The portion not treated as capital is to be reported in a liability account according to regulatory guidance. Such a regulatory reporting requirement may be inconsistent with GAAP and may present misleading information about a credit union's financial position. Based on the characteristics of the secondary capital account outlined in NCUA regulations, GAAP would likely require secondary capital accounts to be classified as debt not equity. Auditors should consider the effect on audit risk of differences between RAP used to prepare regulatory financial reports and GAAP, and should consider modification of the auditor's report if the financial statements are not fairly presented.

Noncompliance With Regulatory Requirements

.43 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.

.44 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 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,

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

Warning Flags and Fraud Indicators

.45 In 1995, the National Credit Union Share Insurance Fund (NCUSIF) took charges of $11.4 million, of which $10.3 million was due to fraud, weak management or recordkeeping, or planned closings or loss of sponsor. Factors identified in those cases included the following:

- Inadequate internal controls
- No independent audit or insufficient audit procedures
- Fictitious loans
- Hidden delinquency
- Insider dealings
- Fictitious shares
- Unauthorized disbursements
- Lack of segregation of duties
- Improper salary advance loans
- Overdraft scheme (negative shares)
- Required reports not provided to Federal examiners

.46 Recent cases of employee embezzlement have taken the form of employees stealing from their employers because of financial needs arising from personal or medical problems. Some methods used to steal money include the following:

- Alter or create member accounts, such as using the account of a customer with a bad credit rating to conceal stolen funds so that nothing would look out of the ordinary when a delinquent loan appears on their credit report;
- Make loan advances using unauthorized or inappropriate disbursement procedures;
- Manipulate or delete important computer records;
- Steal small amounts from dormant accounts over several years.

Auditing Pronouncements

.47 Four new Statements on Auditing Standards, which are discussed in the following exhibit, have been issued recently that may affect audits of financial statements of credit unions.

.48

Exhibit

Significant Provisions of Newly Issued SAS

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 following conditions for performing agreed-upon procedures engagements: — the nature, timing, and extent of the procedures — the responsibilities of practitioners and specified users — reporting on agreed-upon procedures.
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, 544, 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]).

.49 *SAS No. 75.* In September 1995, the ASB of the AICPA issued SAS No. 75 (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 in certain circumstances, as discussed in the Statement (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.

.50 *SAS No. 77.* In November 1995, the AICPA 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, 544, 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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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 is effective for engagements beginning after December 15, 1995.

.51 *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 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.

.52 *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, *Reports on Audited Financial Statements* (AU section 508), concerning emphasis paragraphs, matters involving uncertainties, and disclaimers of opinion. This Statement (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.

SAS No. 70 Auditing Procedure Study

.53 The AICPA issued an auditing procedure study that provides guidance to auditors on implementing SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (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 computer service center that provides the information system needs for a credit union.

Accounting Issues and Developments

Mortgage Servicing Rights

.54 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards 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.

.55 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.

.56 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 the 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.

.57 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.

Transfers and Servicing of Financial Assets

.58 FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, is effective for transfers and servicing of financial assets and the extinguishment of liabilities occurring after December 31, 1996. The Statement is to be applied prospectively, and earlier or retroactive application is not permitted. Auditors should be alert that FASB Statement No. 125 significantly affects accounting for (and disclosures about) sales of partial interests in financial assets, securitization of loans, servicing assets and liabilities, securities lending transactions, repurchase agreements, wash sales, loan syndications and participations, factoring arrangements, transfers of receivables with recourse, and the extinguishment of liabilities. On November 15, 1995, the FASB published a FASB Special Report, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities*. Among various questions and answers about the implementation of FASB Statement No. 115, *Accounting for Certain Investment in Debt and Equity Securities* (AC I80), the answer to Question 61 explains that the FASB directed its staff to provide guidance, in part, that is concurrent with the initial adoption of this implementation guidance but no later than December 31, 1995, an enterprise may reassess the appropriateness of the classifications of all securities held at that time and account for any resulting reclassifications at fair value in accordance with paragraph 15 of FASB Statement No. 115 (AC I80).

.59 The FASB staff also announced at the November 15-16, 1995, meeting of the Emerging Issues Task Force (EITF) that the FASB intends that the initial application of the Special Report and any resulting one-time reclassifications will occur as a single date between November 15, 1995, and December 31, 1995, not over a number of days throughout the period.

Impairment of Long-Lived Assets

.60 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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

.61 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.

.62 Paragraph 16 of FASB Statement No. 121 (AC I08) 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."

.63 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.)

.64 Auditors of credit unions should be aware that the current industry climate of consolidations and mergers 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 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.

.65 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, *Auditing Accounting Estimates* (AU section 342).

Disclosures About Derivatives

.66 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).

.67 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 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. Paragraph 12 of FASB Statement No. 119 (AC F25) encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

.68 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.

.69 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).

Consensus Decisions of the FASB's Emerging Issues Task Force

.70 The FASB's 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.

.71 EITF Issue No. 96-10, *Impact of Certain Transactions on the Held-to-Maturity Classification under FASB Statement No. 115*, Accounting for Certain Investments in Debt and Equity Securities. Consensus was reached that transactions involving held-to-maturity securities that are not accounted for as sales, such as wash sales and bond swaps, would not contradict an entity's stated intent to hold a security to maturity and, therefore, do not call into question the entity's intent to hold other debt securities to maturity. The EITF observed that unless the debt instrument received or retained as a result of the transaction is held to maturity, the transaction would call into question the entity's intent to hold other debt securities to maturity.

.72 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 topic of recent discussion:

> Appendix D-48, *The Applicability of FASB Statement No. 65 to Mortgage-Backed Securities that Are Held-to-Maturity*, which relates to questions about the applicability of FASB Statement No. 65 (AC Mo4) to transactions in which an enterprise securitizes mortgage loans and classifies the resulting mortgage-backed securities as held-to-maturity in accordance with FASB Statement No. 115 (AC I80).

Risks and Uncertainties

.73 In December 1994, the AICPA's Accounting Standards Executive Committee (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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

requires credit unions to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.74 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

.75 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 of loans or mortgages to a third party
- Concentration of revenue from mortgage banking activities

.76 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.

.77 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

.78 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.

Information Sources

.79 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.

.80 Fax services allow users to follow voice cues and request that selected documents be sent by fax. 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.

.81 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.

.82 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.83 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 data lines.

* * * *

.84 This Audit Risk Alert supersedes *Credit Union Industry Developments—1995/96.*

* * * *

.85 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1996/97* [AAM section 8010] and *Compilation and Review Alert—1996/97* [AAM section 8015].

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.86

Information Sources

Organization	General Information	Fax/Phone Services	Internet and Electronic Bulletin Board Services	Recorded Announcement
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. 1) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*AICPA World Wide Web home page* (http://www.aicpa.org) *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 Credit Union Administration	*Office of Public and Congressional Affairs* 1775 Duke Street Alexandria, VA 22314		*NCUA Bulletin Board* All information is available to guest users (703) 518-6480 *NCUA World Wide Web home page* http://www.ncua.gov or http://ncua.gov	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 (f) Telnet via internet: federal.bbs.gpo.gov 3001	

[*The next page is 8105.*]

AAM Section 8030

Health Care Industry Developments—1996/97

Industry and Economic Developments

.01 Although comprehensive health care reform legislation has not been passed by Congress, health care remains at the forefront of the national debate. Washington continues to debate the most far-reaching reform of Medicare and Medicaid since these programs were created as part of the Great Society of the 1960s. For the first time since the inception of these entitlement programs, lawmakers have offered budgets to curb long-term spending increases. Although it is unclear whether substantive reform legislation will be passed by Congress during an election year, one thing is certain—changes to Medicare and Medicaid could have significant effects on the financial results of health care providers.

.02 Market-driven changes continue to outpace federal initiatives. Market pressures to provide quality health care at reasonable costs have sustained the movement toward a managed care environment, resulting in an increasing number of mergers, acquisitions, and other affiliations among health care providers. As these providers come together to form integrated delivery systems and establish new alliances within a managed care structure, many are accepting more of the financial risk of treating patients. Furthermore, these transactions typically are the subject of close regulatory scrutiny. As a result, these transactions subject health care providers to new areas of financial and business risk. Health care providers are developing integrated delivery systems and establishing new alliances to gain operating and functional efficiencies. Specific auditing issues that have arisen from these market-driven changes are discussed in both the "Audit Issues and Developments" section of this Audit Risk Alert (see the discussion entitled "Risk-Related Issues in a Managed Care Environment") as well as the "Accounting Issues and Developments" section (see the discussion entitled "Accounting for Transfers Among Health Care Organizations").

.03 In addition to these industry and economic developments, the federal government is increasing its efforts to identify and prosecute fraudulent and abusive activities involving health care entities. The government's focus stems from United States Department of Justice estimates that health care fraud and abuse costs the national economy as much as $100 billion annually. This investigative activity, combined with the increased number of affiliations in the industry, raises the awareness of fraud and abuse, and other regulatory concerns. In this environment, auditors should be alert to potential issues raised by investigative activities.

.04 These and other developments that may affect audits of financial statements of health care organizations are discussed in this Audit Risk Alert.

Regulatory, Legislative, and Other Developments

Revisions to the Single Audit Act and OMB Single Audit Circulars

.05 Thus far in 1996, the following two important developments have occurred with respect to the Single Audit Act (the Act) and the United States Office of Management and Budget (OMB) Single Audit Circulars:

1. Legislation amending the Act was signed into law.

2. Revisions to OMB Circular A-133 were issued by the OMB.

The most significant effect of these developments on the health care industry is the fact that applicability of the Act and OMB Circular A-133 has been extended to all nonprofit hospitals.

Single Audit Act Amendments

.06 On July 5, 1996, legislation amending the Single Audit Act was signed into law by President Clinton. The new law (P.L. 104-156) makes several important changes to the Single Audit Act of 1984, which established audit requirements for non-federal entities receiving federal financial assistance. Highlights of important changes include the following:

- Extension of the Act's coverage to nonprofit organizations
- Implementation of a risk-based approach for auditors to select major federal programs to be audited
- Increase of the dollar threshold for single audit coverage to $300,000
- The requirement that auditors provide a summary of the results of their work concerning the audited entity's financial statements, internal controls, and compliance with laws and regulations
- Reduction of the audit report due date to nine months

The new law is effective for fiscal years beginning after June 30, 1996. An electronic version of the Single Audit Act Amendments of 1996 is available on the U.S. Government Accounting Office (GAO) Office of Policy Bulletin Board (in the Single Audit—GAO Conference), which can be accessed by dialing (202) 512-4286 via modem. Both ASCII and PDF versions are available. An electronic version is also available via the Internet at *http://thorplus.lib.purdue.edu/gpo/* in the Public Laws section (click on the box marked "104 Congress"). A copy of the Act is also available on the AICPA's Fax Hotline. To access the hotline, dial (201) 938-3787 from a fax machine, follow the voice cues, and select document number 402.

OMB Circular A-133 Revisions

.07 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. The revised Circular contains the following revisions:

- The definition of *nonprofit organization* has been revised to include all nonprofit hospitals.
- Auditors will now determine *major programs*, as defined in Circular A-133, on the basis of 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 has been clarified as being based on auditors' planning for a low assessed level of control risk.
- Minimum requirements for the Schedule of Federal Awards have been provided.
- Guidance is included concerning the following:
  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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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

- Guidance has been included concerning the assignment of cognizant agencies.
- Restrictions have been 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.

It is expected that the OMB will publish a notice 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 in the *Federal Register* in September 1996.

.08 A copy of the Circular may be obtained from any of the following:

- *Federal Register* notice (April 30, 1996, 61 FR 19134)
- The OMB fax information line is (202) 395-9063, document number 1133
- The OMB home page on the Internet which is located at *http://www.whitehouse.gov/WH/EOP/omb*
- The Office of Administration, Publications Office, Room 2200, New Executive Office Building, Washington, DC 20503 (202) 395-7332

Internal Revenue Service Developments

General

.09 Auditors should be aware of relevant tax laws and regulations and their potential effect on health care organizations and their financial statements. A not-for-profit health care 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 by both for-profit and not-for-profit health care organizations to comply with tax laws and regulations could have either a direct effect on the determination of financial statement amounts (for example, the result of an incorrect accrual for taxes on unrelated business income) or an indirect effect on the financial statements that would require appropriate disclosures. 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.

Intermediate Sanctions

.10 On July 30, 1996, the Taxpayer Bill of Rights (H.R. 2337) was enacted into law. This legislation established intermediate sanctions in the form of excise taxes that can be assessed against individuals for any non-fair-market-value payment, including excessive compensation by public charities (such as tax-exempt hospitals) to a disqualified person. A *disqualified person* is defined as any individual who is in a position to exercise substantial influence over the affairs of the tax-exempt organization, whether by virtue of being an organization manager or otherwise. The new penalty taxes generally apply retroactively to transactions occurring on or after September 14, 1995, subject to certain transaction rules.

.11 Health care organizations subject to these new provisions should be aware that the income tax law now provides for potential monetary sanctions against individuals who may be considered related to an organization. In addition, excess benefit transactions entered into by tax-exempt health care organizations may have additional significant implications with respect to the health care organization's compliance with other regulations, such as Medicare fraud and abuse provisions.

Focus of IRS Attention

.12 With respect to *tax-exempt* health care provider systems, the Internal Revenue Service (IRS) is paying particular attention to tax exemption issues that arise in conjunction with the development of an integrated delivery system. Such issues include the following:

- Valuation issues with respect to the purchase of physician practices
- Reasonableness of physician compensation
- Private inurement concerns relating to both the formation and operation of physician hospital organizations (PHO) and other managed care entities

Other areas and issues that may be subject to close scrutiny by the IRS include the following:

- Joint venture affiliations between exempt health care organizations and for-profit entities
- Physician recruitment activities
- Classification issues with regard to workers as independent contractors/employees
- Proper unrelated business income reporting

For *taxable* health care organizations, the current areas of focus for the IRS include the following:

- Possible incorrect utilization of the cash method of accounting
- Incorrect application of the nonaccrual experience method for service providers (This special method of accounting allows a service provider to not accrue income which, based on experience, is not expected to be collected.)
- Proper timing of deductions with regard to capitation holdbacks that may occur with managed care entities
- Proper tax treatment of HMOs and circumstances that may indicate that they might more appropriately be considered insurance companies for tax purposes

Issues such as the preceding 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.

Governmental Investigations Relating to Fraud and Abuse Violations

.13 Although Medicare and Medicaid Anti-Fraud and Abuse legislation has been in existence for nearly twenty years, regulatory developments, legal interpretations, and enforcement activities have heightened the risk of penalties for providers. A broadening interpretation in the application of the laws addressing false claims for Medicare and Medicaid payments, in conjunction with civil legislation such as the False Claim Act have opened the door for significant new civil penalty risks. Such civil penalties can be assessed on a per claim basis at rates in excess of $5,000 per false claim plus treble damages, and relate to each service claim submitted for payment or entry in a cost report. Broad interpretations of false claims are exposing ordinary billing mistakes to scrutiny and penalty consideration. Both federal and state law enforcement agencies have redirected substantial enforcement resources from other areas for the investigation and prosecution of health care fraud. In addition, a whistle-blower statute that rewards private parties for false claim identification has further spurred enforcement activity and provider risk.

.14 In 1995, the President announced a two-year federal fraud and abuse project ("Operation Restore Trust") aimed at five states: New York, Florida, Illinois, Texas, and California. The entities affected are nursing homes, home health agencies, hospices, and durable medical equipment suppliers. Operation Restore Trust includes the following:

- The issuance of special fraud alerts to notify the public about fraud schemes

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- The establishment of a new fraud and waste report hotline
- The creation of a fund to recycle fines
- A voluntary disclosure program

The voluntary disclosure program, the centerpiece of the project, allows companies to come forward with evidence of fraud or errors within their own organizations in consideration for reduced penalties, according to the Federal Inspector General (IG).

.15 One area of recent concern in teaching settings has been the IG and United States Attorney's attention devoted to the billing practices and billing patterns of physician clinical practice plans to determine whether attending physician services billed by the plans or hospitals were for services actually rendered by interns and residents. If the services are deemed to be rendered by interns and residents, they are not eligible for Medicare billing.

.16 Other areas of current interest to the IG include the following:

- Violations of the 72-hour diagnosis-related group (DRG) billing window
- Kickbacks
- Improper outpatient billing
- Non-arms-length transactions
- Credit balance reporting
- Outpatient lab billing
- Illegal DRG upcoding
- Billing for services not rendered
- Managed care underutilization

.17 In addition to the preceding investigative and enforcement activities, a number of recent legislative developments have expanded the legal force behind the government's fraud and abuse prevention efforts. Effective January 1, 1995, the Stark II anti-referral law was extended to practically all Medicare and Medicaid services. In addition, President Clinton signed the Health Insurance Portability and Accountability Act of 1996 (H.R. 3103) into law on August 21, 1996. This legislation will expand the role of the government in looking for, investigating, and prosecuting private health care fraud. The legislation also creates several new programs, increases funding, increases fines and penalties, and coordinates government efforts to fight fraud and abuse. A summary of the legislation can be obtained from the United States House Committee on Ways and Means Web Site, which can be accessed at *http://www.house.gov/ways_means/fc-29a.htm*. A copy of the text of the new law is available at *http://thomas.loc.gov/cgi-bin/query/z?c104:H.R.3103.ENR:*

.18 The auditor's procedures relating to fraud and abuse violations will vary based on his or her assessment of the risk of material misstatement resulting from such illegal acts. SAS No. 54 (AU section 317) states that the auditor should plan and perform the audit to provide reasonable assurance of detecting illegal acts having a direct and material effect on the determination of financial statement amounts. SAS No. 54 (AU section 317) also notes that an audit in accordance with generally accepted auditing standards (GAAS) does not include audit procedures specifically designed to detect illegal acts that have only an indirect effect on the financial statements (for example, illegal acts that have a material effect as the result of fines or penalties that may be imposed on the entity). The Statement (AU section 317) also provides guidance on the auditor's responsibilities if specific information concerning the possible existence of this kind of illegal act comes to the auditor's attention. Whether an act is actually illegal is a determination that is normally beyond the auditor's professional competence.

.19 Auditors of health care providers should consult Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (AC C59), SAS No. 54 (AU section 317), and paragraphs 2.37 through 2.41 of the AICPA Audit and Accounting Guide *Health Care Organizations* when evaluating the accounting and reporting implications of fraud and abuse issues. Auditors should also be aware that the far-reaching nature of alleged fraud and abuse violations may represent a significant risk and uncertainty that would require disclosures in accordance with Statement of Position (SOP) 94-6, *Disclosure of Certain Risks and Uncertainties.*

.20 Circumstances have been noted in practice in which Assistant Inspector Generals have stated that the independent auditor has the obligation to report any identified fraud to the IG. In responding to such requests, auditors should consider the guidance in paragraph 29 of SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU section 316A.29), which states:

> Disclosure of irregularities to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and would be precluded by the auditor's ethical or legal obligation of confidentiality unless the matter affects his opinion on the financial statements. The auditor should recognize, however, that in the following circumstances a duty to disclose outside the client may exist:
>
> *a.* When the entity reports an auditor change under the appropriate securities law on Form 8-K [9]
>
> *b.* To a successor auditor when the successor makes inquiries in accordance with section 315, *Communications Between Predecessor and Successor Auditors* [10]
>
> *c.* In response to a subpoena
>
> *d.* To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive financial assistance from a government agency
>
> Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing irregularities with parties outside the client.
>
> [9] Disclosure to the Securities and Exchange Commission may be necessary if, among other matters, the auditor withdraws because the board of directors has not taken appropriate remedial action. Such failure may be a reportable disagreement on Form 8-K.
>
> [10] In accordance with section 315, communications between predecessor and successor auditors require the specific permission of the client.

.21 Auditors should be aware that the requirements in item (*a*) above also include reports that may be required, under certain circumstances, pursuant to the Private Securities Litigation Reform Act of 1995 (codified in section 10A(b)1 of the Securities Exchange Act of 1934) relating to an illegal act that has a material effect on the financial statements.

Audit Issues and Developments

Risk-Related Issues in a Managed Care Environment

.22 In an effort to respond to market pressures to provide quality health care at reasonable costs, many health care providers at all levels (for example, physicians and hospitals) are entering into managed care contracts. These contracts usually result in the providers assuming a greater share of the risk associated with underwriting health care services. Auditors should be aware of the following implications that result if health care providers enter into the managed care environment:

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- 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 services rather than the actual provision of services.
- 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.
- 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.
- If 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.
- Retroactive changes to covered (or enrolled) members generally have corresponding impact on revenues and expenses.

.23 Guidance on accounting and financial reporting issues associated with capitation contracts is found in chapter 13 of the AICPA Audit and Accounting Guide *Health Care Organizations* (the Guide). 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 the Guide. Auditors may also find the guidance in SAS No. 57, *Auditing Accounting Estimates* (AU section 342), useful in auditing the accounting estimates (such as IBNR accruals and risk pool settlements) that relate to participation in such arrangements.

.24 Many of the characteristics of the business transactions resulting from the movement towards capitated or other risk-based contracts are very similar to transactions resulting from insurance contracts, which follow guidance under specific industry-related authoritative literature. Additionally, ongoing structural and operational changes occurring throughout both the health care and insurance industries have created a need for additional accounting guidance in order to establish common guidance to resolve current divergent accounting practices for similar transactions. A project has been undertaken by a joint task force of the AICPA Health Care Committee and the AICPA Insurance Companies Committee to develop a Statement of Position (SOP) addressing the emerging accounting issues for organizations entering into certain predetermined health care arrangements. The proposed SOP would apply to the accounting for contractual arrangements that administer, assume, or transfer the risk for cost of health care services for a predetermined payment regardless of the services rendered.

Obligated Group Financial Statements

.25 Obligated group financial statements often exclude entities that are required to be consolidated by generally accepted accounting principles (GAAP). Although the AICPA Audit and Accounting Guide *Health Care Organizations* (paragraph 12.06) does not preclude the issuance of such financial statements, because they are not prepared in accordance with GAAP, they cannot be used as the reporting entity's general-purpose external statements. However, such financial statements may be issued as special-purpose financial statements. As such, the statements should include disclosures about the nature of the reporting entity (for example, the fact that the reporting entity is comprised of various entities that form an obligated group, as defined in certain debt agreements) and the auditor's report should be modified to reflect the fact that the financial statements are special-purpose financial statements and are not intended to be a presentation in conformity with GAAP. Furthermore, the distribution of special-purpose financial statements is limited to specified users (i.e., parties to an agreement and other specified parties-in-interest to whom the special-purpose nature of the presentation has been explained). The auditors' report on the special-purpose financial statements includes a paragraph indicating that the financial statements are intended solely for the informa-

tion and use of those named users. Auditors should be aware that the limited distribution requirement of obligated group financial statements that are not prepared in conformity with GAAP presents an issue for health care organizations issuing debt. Because distribution of the accountant's report on the special-purpose financial statements is limited to only the company and other parties to the debt agreement, it cannot be included in broadly distributed documents (for example, offering statements).

Auditing Pronouncements

.26 The following exhibit and discussion summarizes five new SASs that have been recently issued.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.27

Exhibit

Pronouncement	Pronouncements Affected	Key Provisions	Effective Date
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.	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.
SAS No. 76, *Amendments to Statement on Auditing Standards No. 72,* Letters for Underwriters and Certain Other Requesting Parties (AU section 634)	SAS No. 72 (AU section 634)	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.	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.
SAS No. 77, *Amendments to Statement 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 sections 311, 341, and 623)	SAS Nos. 22 (AU section 311), 59 (AU section 341), and 62 (AU section 623)	Clarifies that a written audit program should be prepared. Precludes the use of conditional language in a going concern report.	The Statement (AU sections 311, 341, and 623) is effective for engagements beginning after December 15, 1995.
SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards* No. 55 (AU section 319)	SAS No. 55 (AU section 319A)	Recognizes the COSO definition of internal control.	The Statement (AU section 319) is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application encouraged.
SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements (AU section 508)	SAS No. 58 (AU section 508)	Eliminates the requirement to add an uncertainties paragraph to the auditor's report (does not affect SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* [AU section 341]).	The Statement (AU section 508) is effective for reports issued on or after February 29, 1996, with earlier application permitted.

Accounting Issues and Developments

Health Care Audit Guide Project

.28 In July 1996, the AICPA Health Care Committee issued the Audit and Accounting Guide *Health Care Organizations* that supersedes the existing Audit and Accounting Guide *Audits of Providers of Health Care Services* as well as SOP 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services,* and SOP 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities.* The Guide incorporates the guidance in FASB Statement Nos. 116, *Accounting for Contributions Received and Contributions Made* (AC C67), and 117, *Financial Statements of Not-for-Profit Organizations* (AC C25 and No5).

.29 The Guide applies 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 and 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 applies 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 and services
3. Governmental

.30 The Guide contains a number of significant changes in the accounting and reporting requirements for health care providers. The most significant changes relate to the following:

1. The scope of the Guide
2. Accounting for investments
3. Accounting for contributions
4. Accounting for business combinations and consolidations
5. Financial statement display

The Guide is effective for financial statements for periods beginning after June 15, 1996. Earlier application is permitted.

Securities and Exchange Commission Issues and Developments

.31 In recent months, the Securities and Exchange Commission (SEC) has issued a number of comments to health care registrants on issues pertaining to purchase accounting, the reporting entity, and third-party reserves. Auditors of health care providers should be aware of the staff's concerns if they audit health care companies that are registered with the SEC.

Purchase Price Allocation

.32 In reviewing business combinations involving publicly traded health care providers, the SEC continues to focus on whether registrants are complying with the requirements of Accounting Principles Board (APB) Opinion No. 16, *Business Combinations* (AC B50), and APB Opinion No. 17, *Intangible Assets* (AC I60), to allocate a portion of the purchase price to specifically identifiable intangible assets rather than solely to goodwill. The SEC is concerned that in certain sectors of the health care industry (such as in the physician practice management sector), identifiable assets such as customer lists, workforce in place, and covenants not to compete are not being valued separately and amortized. As a result, the SEC staff may raise questions on filings in which most or all of any excess purchase price is allocated to goodwill. As they evaluate the

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

Amortization of Intangibles

.33 Another frequent area of comment pertains to the period of amortization used for intangible assets, particularly with regard to the assignment of longer lives to goodwill. Although the SEC's formal position of challenging goodwill lives that are longer than twenty years has not changed, it should be noted that longer lives of up to forty years continue to be sustained in filings by health care companies when the company's facts and circumstances demonstrate that a longer life is appropriate. Auditors of health care entities undergoing purchase acquisitions should be aware of the SEC staff's concerns when reviewing amortization lives assigned to goodwill.

Contingent Consideration

.34 In acquisitions involving health care providers, the SEC is carefully scrutinizing contingent considerations/ "earn-out" arrangements in situations where the owners of the selling company are 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. FASB Emerging Issues Task Force (EITF) 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Company in a Purchase Business Combination,* provides factors to consider in determining whether earn-outs should be accounted for as additional purchase price or as compensation expense. 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.

Consolidation of Medical Practice Management Companies

.35 In states that prohibit the direct employment of or control over physicians/dentists by non-physicians/dentists (for example, by a physician management company), companies desiring to merge these functions frequently form two separate companies—an administrative company (AC) and a medical company (MC)—solely to comply with these "corporate practice of medicine" laws and regulations. Although neither company has legal ownership of the other, in substance they exist and operate for the exclusive mutual benefit of one another. The SEC staff has been raising issues in conjunction with filings by physician management companies in which the AC and MC are presented as a consolidated/combined entity unless it is clear that the management company exerts unilateral and perpetual control over the medical practices. Auditors should be aware of the staff's concerns, as well as the requirements in chapter 11 of the Audit and Accounting Guide *Health Care Organizations,* if they audit physician management companies that have formed medical practice management companies.

Medicare/Medicaid Reserves

.36 The SEC staff has expressed concern that providers may in some cases use reserves for Medicare and Medicaid settlements as discretionary reserves to manage the amount of income that is reported in a particular year. For example, if a provider involved in an acquisition accrues excess third-party reserves at the acquisition date, the later release of the excess reserve would result in an overstatement of income. Consequently, in certain situations, the SEC may require provider registrants to provide information pertaining to third-party reserves and environmental reserves (for example, significant detail about reserve movements, the timing of the movements and the rationale behind the movements) in the registrant's financial statements and/or Management's Discussion and Analysis (MD&A). As auditors evaluate the propriety of reserves reported by health care organizations, they should pay particular attention to third-party reserves and environmental reserves and carefully consider the evidential matter supporting the amount of the liability.

.37 Auditors of health care organizations that register with the SEC should also be aware that on July 31, 1996, the SEC staff issued Staff Accounting Bulletin (SAB) No. 97, *The Inappropriate Application of Staff Ac-*

counting Bulletin No. 48, Transfers of Nonmonetary Assets by Promoters or Shareholders, *to Purchase Business Combinations Consummated Just Prior to or Concurrent With an Initial Public Offering, and the Identification of an Accounting Acquirer in Accordance With APB Opinion No. 16,* Business Combinations, *for Purchase Business Combinations Involving More Than Two Entities.* The SAB expresses the views of the SEC staff regarding (1) the inappropriate application of SAB No. 48, *Transfers of Nonmonetary Assets by Promoters or Shareholders,* to purchase business combinations consummated just prior to or concurrent with an initial public offering, and (2) the identification of an accounting acquirer in accordance with APB Opinion No. 16 (AC B50) for purchase business combinations involving more than two entities. A copy of the SAB may be obtained from the SEC's World Wide Web home page at *http://www.sec.gov.*

Classification of Net Appreciation on Investments of Donor-Restricted Endowment Funds

.38 A donor's stipulation that requires a gift to be invested in perpetuity or for a specified term creates a donor-restricted endowment fund. The Uniform Management of Institutional Funds Act (Uniform Act), which has been adopted in varying forms in at least twenty-nine states since its development in 1972, requires that in appropriating appreciation in an endowment fund, members of a governing board exercise ordinary business care and prudence.

.39 Where the Uniform Act is in force, there has been some uncertainty regarding whether the requirement to exercise ordinary business care and prudence allows the governing board the authority to designate a portion of investment income as permanently restricted to preserve the purchasing power of endowment funds. At the March 21, 1996, meeting of the EITF, the FASB staff commented on this issue and concluded that "a legal limitation that requires a governing board to exercise ordinary business care and prudence when appropriating net appreciation is not the equivalent of a law that extends a donor-imposed restriction and, therefore, does not result in classification of net appreciation as donor-restricted, either permanently or temporarily."

.40 There may be exceptions to this conclusion in states in which the Uniform Act has been modified. To determine what the law in a particular state requires, a practitioner may request the opinion of legal counsel. In general, legal counsel's advice on what constitutes "ordinary business care and prudence" would only be helpful if case law applicable to the Uniform Act was being interpreted. In the absence of the interpretation of case law, or modification to the Uniform Act through state legislation, the provisions of the Uniform Act would be interpreted in the manner noted above by the FASB staff.

.41 When reviewing a health care organization's classification of net appreciation on investments of donor-restricted endowment funds, auditors should consider the guidance in FASB Statements No. 117 (AC C25 and No5) and No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations* (AC No5) as well as the status of the applicable state's legal requirements related to donor-restricted gifts.

Agency Transactions

.42 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 provides that an organization would be presumed to be acting as an agent or trustee in the event of any of the following:

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
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 period for commenting on the proposal has expired.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.43 After considering the comments received on the exposure draft, the FASB has decided to split this project into two separate pieces: one to address situations in which the recipient organization has the unilateral power to redirect the use of the assets away from the specified beneficiary (FASB Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power, (An Interpretation of FASB Statement No. 116)* (AC C67), issued in September 1996, addresses this piece) and another to address other situations in which a donor specifies a third-party beneficiary, including accounting by that beneficiary for the contribution received.

.44 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 institutional foundations 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.

Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities

.45 In June 1996, the FASB issued Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (AC F38). This Statement (AC F38) provides accounting and reporting standards for transfers and servicing of financial assets and the extinguishments of liabilities. Those standards are based on consistent application of a *financial-components approach* that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets if control has been surrendered, and derecognizes liabilities when extinguished. This Statement (AC F38) provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

.46 This Statement (AC F38) requires the following:

- Liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets must be initially measured at fair value, if practicable
- Servicing assets and other retained interests in the transferred assets must be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer
- Servicing assets and liabilities must be subsequently measured by the following:
  - — Amortization in proportion to and over the period of estimated net servicing income or loss
  - — Assessment for asset impairment or increased obligation based on their fair values
- Debtors must reclassify financial assets pledged as collateral and secured parties must recognize those assets and their obligation to return them in certain circumstances in which the secured party has taken control of those assets.
- A liability must be derecognized if and only if either of the following occur.
  - — The debtor pays the creditor and is relieved of its obligation for the liability
  - — The debtor is legally released from being the primary obligor under the liability either judicially or by the creditor.

Therefore, a liability is not considered extinguished by an in-substance defeasance.

.47 FASB Statement No. 125 (AC F38) supersedes FASB Statements No. 76, *Extinguishment of Debt (an amendment of APB Opinion No. 26)*, and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse.*

.48 It also amends FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), to clarify that a debt security may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. This Statement (AC F38) amends and extends to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (AC Mo4), and supersedes FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*. This Statement (AC F38) also supersedes Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt*, No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*, and No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*.

.49 This Statement (AC F38) is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996, and is to be applied prospectively. Earlier or retroactive application is not permitted.

Developments Related to Governmental/Nongovernmental Issues Affecting Health Care Entities

.50 In recent years, the AICPA and the Governmental Accounting Standards Board (GASB) have issued a number of documents that clarify accounting and reporting requirements for governmental and nongovernmental entities. This section summarizes these documents and provides a road map to applicable guidance for various accounting and reporting issues facing investor-owned, not-for-profit nongovernmental and not-for-profit governmental health care organizations.

.51 In January 1992, the AICPA issued SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AU section 411), which redefined the GAAP hierarchy between FASB and GASB. The provisions of SAS No. 69 (AU section 411) establish two separate hierarchies, one for governmental entities and one for nongovernmental entities.

.52 In September 1993, the GASB issued Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and other Governmental Entities That Use Proprietary Fund Accounting*, that clarifies how GASB statements affect governmental entities that use business type accounting and financial reporting. Alternative approaches are available to a governmental health care provider, although the alternative selected must be used consistently. One alternative is to follow the GASB hierarchy exclusively regarding pronouncements issued after November 30, 1989. The other alternative is to follow the FASB hierarchy regarding pronouncements issued after November 30, 1989, unless GASB pronouncements conflict.

.53 This additional authoritative guidance for governmental and nongovernmental entities had some limitation because there was no precise definition of government. In March of 1996, the FASB and GASB agreed to the following definition of *governmental entity*, which is included in paragraph 1.02 of the AICPA Audit and Accounting Guide *Health Care Organizations*:

> Public corporations and bodies corporate and politic are governmental entities. Other organizations are governmental entities if they have one or more of the characteristics listed below:
>
> - 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
> - 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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

.54 An entity meeting any of the preceding criteria is classified a governmental entity and as such is subject to the rules promulgated by the GASB. The following matrix illustrates how an organization's classification as investor-owned, not-for-profit nongovernmental, and not-for-profit governmental determines the appropriate authoritative guidance to be applied to various accounting and reporting issues.

Area	Investor-Owned For-Profit	Not-for-Profit Nongovernment	Not-for-Profit Government
Pensions	FASB Statement No. 87, *Employers' Accounting for Pensions* (AC P16)	FASB Statement No. 87 (AC P16)	GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employees;* GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers,* for years beginning after June 15, 1997
Post Retirement Benefits	FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (AC P40)	FASB Statement No. 106 (AC P40)	GASB Statement No. 12, *Disclosure of Information on Postemployment Benefits Other Than Pension Benefits by State and Local Governmental Employers;* supplemented by GASB Statement No. 27
Cash Flows	FASB Statement No. 95, *Statement of Cash Flows* (AC C25)	FASB Statement No. 95 (AC C25)	GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*
Investments	FASB Statement No. 115 (AC I80)	FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations* (AC No4)	GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements;* FASB Statement No. 115 (AC I80) if following the "FASB Option" provided in paragraph 7 of GASB Statement No. 20
Financial Statement Display	FASB Statement No. 116 (AC C67)	FASB Statement Nos. 116 (AC C67) and 117 (AC C25 and No5)	GASB Statement No. 29, *The Use of Not-for-Profit Accounting Principles,* prohibits following FASB Statement Nos. 116 (AC C67) and 117 (AC C25 and No5)

Area	Investor-Owned For-Profit	Not-for-Profit Nongovernment	Not-for-Profit Government
Reporting Entity	APB No. 18, *The Equity Method of Accounting for Investments in Common Stock* (AC I82), and FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* (an amendment of ARB No. 51, with related amendments of APB Opinion No. 18 and ARB No. 43, Chapter 12) (AC C51)	SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*	GASB Statement No. 14, The Financial Reporting Entity
Debt Refundings	APB No. 26, *Early Extinguishment of Debt* (AC D14), FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt* (an amendment of APB Opinion No. 30) (AC D14 and I17), and FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (AC F38)	APB No. 26 (AC D14), FASB Statement Nos. 4 (AC D14 and I17) and 125 (AC F38)	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 Proprietary Activities*
Compensated Absences	FASB Statement No. 43, *Accounting for Compensated Absences* (AC C44), and FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits* (an amendment of FASB Statement Nos. 5 and 43)	FASB Statement Nos. 43 (AC C44) and 112	GASB Statement No. 16, *Accounting for Compensated Absences*
Deposits with Financial Institutions	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. 105 (AC F25)	GASB Statement No. 3
Operating Leases	FASB Statement No. 13, *Accounting for Leases* (AC L10)	FASB Statement No. 13 (AC L10)	GASB Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases*

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Governmental Not-for-Profit Accounting Developments

.55 The following accounting pronouncements and projects of the GASB were recently released and may affect governmental health care organizations.

GASB Statements Effective During 1996

- GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*
- GASB Statement No. 29, *The Use of Not-for-Profit Accounting Principles*

GASB Statements Effective After 1996, With Early Application Encouraged

- GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*
- GASB Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Plans*
- GASB Statement No. 27, *Accounting for Pensions by State and Local Government Employers*
- GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*
- GASB Statement No. 30, *Risk Financing Omnibus*

GASB Interpretations Effective After 1996, With Early Application Encouraged

- GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations*
- GASB Interpretation No. 3, *Financial Reporting for Reverse Repurchase Agreements*
- GASB Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools*

Recent GASB Exposure Drafts Issued

- *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*
- *The Financial Reporting Entity—Affiliated Organizations*

A detailed summary of these documents can be found in the Audit Risk Alert *State and Local Governmental Developments—1996* [AAM section 8070]. This Audit Risk Alert also contains valuable information on current issues and audit risks facing governmental entities.

Accounting for Transfers Among Health Care Organizations

.56 In response to the pressure to contain health care costs, health care providers are developing integrated delivery systems and establishing new alliances to gain operating and functional efficiencies. As a result, transfers of resources between organizations frequently occur within the health care industry. The accounting treatment for such transfers in practice has been varied. With the issuance of the new Audit and Accounting Guide *Health Care Organizations* (see the section of this Audit Risk Alert entitled "Health Care Audit Guide Project"), additional guidance has been provided with respect to these kinds of transactions. Auditors of health care providers should be alert to the new guidance set forth in chapter 11 (paragraphs 19–24) of the Guide which differentiates and defines the various kinds of transfers among health care organizations and provides guidance on the appropriate accounting for each kind of transfer.

Accounting for Exchange Transactions in Health Care Organizations

.57 Foundations, business organizations, and other entities may provide resources to health care organizations under programs referred to as grants, awards or sponsorships. Confusion has arisen in practice with respect to the appropriate classification of these resources as either contributions or exchange transactions. FASB Statement No. 116 (AC C67) provides the following guidance:

- *Contributions.* Contributions are (*a*) *nonreciprocal* transfers, (*b*) are transfers to or from entities acting other than as owners, and (*c*) are made or received voluntarily (paragraph 48).
- *Exchange Transactions.* Exchange transactions are *reciprocal* transfers in which each party receives and sacrifices approximately equal value (paragraph 48).

Proper classification based on the preceding guidance is essential as it determines the appropriate accounting treatment the entity must follow (i.e., contributions must be accounted for in accordance with the provisions of FASB Statement No. 116 (AC C67); exchange transactions do not). Auditors of not-for-profit health care organizations should be familiar with the factors that distinguish a contribution from an exchange transaction. The AICPA Audit and Accounting Guide *Not-for-Profit Organizations* (chapter 5, table 5.1) includes a chart of indicators that are useful in distinguishing the two kinds of transactions.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

.58 The AICPA Audit and Accounting Guide *Health Care Organizations* 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. Copies may be obtained by calling the AICPA Order Department at (800) TO-AICPA, Department No. 1, and asking for product no. 012429.

Health Care Financial Reporting Checklist

.59 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. Copies may be obtained by calling the AICPA Order Department at (800) TO-AICPA, Department No. 1, and asking for product no. 008639.

Technical Practice Aids Publication

.60 *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. Ordering information may be obtained by calling the AICPA Order Department at (800) TO-AICPA, Department No. 1, and asking for product no. 005055. Auditors should be aware that the next subscription service update of *Technical Practice Aids* (due out in November) will include two new questions and answers relating to joint operating agreements and the use of the pooling-of-interests method of accounting.

National Health Care Conference

.61 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 finan-

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

cial 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

.62 The following are publications pertaining to health care industry trends and statistics that may be of interest to auditors of health care entities (see the table entitled "Information Sources" that follows). The list is not all-inclusive and is presented for informational purposes only. It is not to be construed as an endorsement of any of the following publications or organizations. Many nongovernment and some government publications and services involve a charge or membership requirement.

.63 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.

.64 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.

.65 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.66 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.

* * * *

.67 This Audit Risk Alert supersedes *Health Care Industry Developments—1995/96.*

* * * *

.68 Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1996/97* [AAM section 8010].

.69 Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB and GASB publications referred to in this document may be obtained directly from the FASB or GASB by calling the FASB/GASB Order Department at (203) 847-0700, ext. 10.

.70 Copies of federal documents referred to in this document are available for sale from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20401; order desk telephone: (202) 512-1800; FAX: (202) 512-2250.

.71

Information Sources

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)

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Information Sources *(cont'd)*

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. 1) 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.gov3001	
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)	World Wide Web home page: http://www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)

[*The next page is 8121.*]

AAM Section 8040

Insurance Industry Developments—1996/97

Industry and Economic Developments

.01 Economic conditions in the United States have exhibited signs of improvement and growth in 1996. In 1996, the bond and stock markets were strong; the U.S. dollar strengthened; mergers, consolidations, and reorganizations continued; and U.S. companies expanded their operations into foreign markets. Generally, U.S. economic developments have various implications on audit risk of insurance enterprises.

.02 Because the assets of an insurance company consist mainly of investments, which include bonds, stocks, mortgage loans, and real estate, fluctuations in these markets have a direct effect on an insurance enterprise's investment income. In addition, for most life and health insurers, profits are indirectly affected by interest rates. Changes in general interest rates may prompt contractholders to withdraw funds prematurely (referred to as *disintermediation*) or result in prepayment of fixed income securities (referred to as *reinvestment risk*). Enterprises attempt to manage interest rate risk by adjusting crediting rates and dividend scales. Auditors should be alert to companies' interest crediting strategies. Further, stock market fluctuations could adversely affect sales and surrenders of variable annuity life 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.

.03 With the continuation of soft market conditions and increased competition between insurer and financial service companies, the insurance industry has been extremely active in an attempt to seek economies of scale. The insurance industry is looking for various vehicles to position itself in the marketplace. During 1996, insurers continued to enter the international market. Although entering into the international market has its advantages, some accounting issues between U.S. generally accepted accounting principles (GAAP) and other countries' GAAP may arise when consolidating a subsidiary which uses a different reporting basis than the parent's reporting basis. Exploration into new markets also occurred predominately in fast-growing sectors such as managed care.

Competitive Market

.04 The insurance industry is dramatically changing as a result of fierce competition. Because of this competition, companies are redefining their strategic focus. Internal and external competition continues to reshape the industry. For life and health insurers, increased competition from banks, mutual funds, and other financial institutions for investable consumer dollars has been a factor contributing to suppressed premium growth. The Clinton Administration, through the Glass-Steagall reform bill, 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 efforts against the proposed legislation have 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. Furthermore, competitive pressures have made expense reduction and consolidation high priorities for many life and health insurers.

Mergers and Acquisitions

.05 The number of mergers and acquisitions continues to increase. Consolidation appears to be taking place in more mature sectors of the insurance industry such as traditional life and property and casualty lines of business. The trend in 1996 has been for insurers to concentrate on a few areas and grow those areas internally and through acquisitions. In 1996 there was heightened activity in reinsurance company mergers. For further discussion, see the section entitled "Mergers, Acquisitions, and Consolidations" under "Audit Issues" in this Audit Risk Alert.

Property and Casualty Insurers

.06 *Underwriting.* Another year of stagnant growth for property casualty insurers reflected stiff rate competition and the industry's slowing financial pace resulting from catastrophes, emerging environmental and asbestos claims, loss reserve strengthening, and declining profitability in a number of lines of business. Underwriting performance of the commercial and private passenger automobile and homeowner lines of business, however, has improved during the past year. Many companies respond to low premium growth by increasing their retentions in core lines of business, purchasing less reinsurance, or both. Ongoing expense reductions, improved underwriting efficiencies, and concentration of capital on more profitable lines of business provide some relief from the stagnant premium growth in the industry. Others pursue acquisitions and consolidations to enhance their results while providing significant cost savings.

.07 *Environmental and Asbestos-Related Liabilities.* During 1995 and continuing into 1996, the industry witnessed significant increases in reported liabilities related to environmental and asbestos claims due to improved capabilities to develop estimates in this area. In response, some companies have restructured their business into active and inactive entities. Active entities house continuing operations and the inactive entities house the entity's discontinued lines of business, which could include asbestos and environmental claims. Readers should be alert that generally restructuring the lines of business within to separate companies does not give rise to an accounting event. However, the reader should refer to the FASB's Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)* for guidance on accounting for restructuring costs. For further discussion, see the section entitled "Liabilities for Unpaid Claims" under "Audit Issues" in this Audit Risk Alert.

.08 *Catastrophes.* In the first eight months of 1996 there were several costly catastrophes, including the blizzard that swept across the East Coast and Hurricane Bertha. Many believe catastrophe losses are not an abnormal event anymore and may now in fact be a normal occurrence. Auditors should consider significant concentrations of coverage in a specific geographic location or line of business when performing the audit and determine if the company has adequate financial resources, reinsurance coverage, or both, particularly as pressures on profit margins have caused some enterprises to reduce the amount of reinsurance obtained.

.09 An issue that property casualty insurers face is catastrophe financing. In the aftermath of high catastrophe losses which occurred several years ago, as well as large catastrophes occurring each year over the past eight years, property catastrophe reinsurance coverage has been difficult to obtain. To alleviate this problem an evolving class of reinsurance arrangements is emerging. Some 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). Such new products have characteristics of derivative financial instruments. Examples of these products include catastrophe-linked structured notes and traded catastrophe options and futures. Auditors should carefully evaluate the instruments being used in lieu of traditional catastrophe coverage in order to determine the proper accounting treatment as well as any potential audit risks. See the sections entitled "Investments in Derivatives" and "Reinsurance Arrangements" under "Audit Issues" in this Audit Risk Alert.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Life and Health Insurers

.10 *Underwriting.* Sluggish premium growth continues in various sectors of the life and health insurance industry. Capital adequacy and general business conduct issues, predominately sales practices and ethical market conduct, are making it more difficult for insurers to maintain or improve financial results. Insurers are reacting to flat results by cutting staff, merging with competitors, and developing innovative distribution strategies. Weak sales of traditional ordinary life products continued but were partially offset by expanded annuity volume and increased sales of variable products. Other issues currently facing the life insurance industry include: operational efficiency, revenue generation from new products, continuing fallout from mortgage and real estate investments, shifting consumer demographics and preferences, and adverse tax legislation.

.11 *Expansion Into the Managed Care Sector.* Considerable debate is currently occurring over the future of the nation's health care system and its ability to provide quality health care to citizens at affordable prices. This debate has sensitized health-care providers to the need for maintaining high levels of efficiency and quality while also maintaining strict control over costs. Perhaps the most notable response to pressures to control costs is a movement toward a managed care environment in which physicians, insurers, and other health care providers create integrated delivery systems and networks that combine inpatient, outpatient, and physician services into a single contracting organization. The managed care-insurance industry merger trend is creating strategic alliances likely to revolutionize and reshape health delivery systems. As the health care environment continues to develop, insurance companies are entering this sector and are seeking competitive advantages by striving to attain critical mass and the technology necessary to compete in a cost effective manner in the marketplace.

.12 *Market Conduct.* The negative publicity from allegations of improper sales practices and potentially misleading policyholder illustrations may have handicapped insurers' efforts to sustain strong premium growth. As negative public perceptions persist, downward pressure on sales will continue to challenge life insurers' viability in the marketplace. The industry is taking steps to change consumers' negative perceptions and deal with factors that encourage market misconduct. Many companies are considering changes to their compensation systems. The American Council of Life Insurance (ACLI), the largest life insurance trade organization, has designed a Code of Life Insurance Ethical Market Conduct (the Code) in response to the recent regulatory and political focus on the life insurance industry's sales and marketing practices. The Code consists of six principles that member life insurance companies would adhere to within their normal course of operations.

.13 To assess the life insurance company's compliance with the Code, the ACLI is developing a Questionnaire for Assessment of Compliance With the Principles of Ethical Market Conduct (the Questionnaire). The Questionnaire is designed to provide the insurer with a means of evaluating its compliance with the Code consistently relative to other members of the ACLI, and is in a format of providing questions, framework criteria, and indicators for each of the principles listed above. The ACLI is in the process of determining how the Code will be adopted, and how companies will measure their compliance with the Code. The ACLI would like insurers to use the Questionnaire to self-certify their compliance with the Code and then obtain a third-party assessment of that compliance on a triannual basis. The process would be entirely voluntary.

Regulatory Developments

.14 The regulatory developments contained in this section include matters that may affect audits of statutory financial statements. Regulation of the insurance industry is the responsibility of the individual states. 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."

Reinsurance Accounting on a Statutory Basis

.15 *Property and Casualty Insurers.* Chapter 22 of the NAIC's *Accounting Practices and Procedures Manual* applies 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. Prospective reinsurance contracts need to be signed within nine months of the effective date or the contract will be deemed to be retroactive, with certain exceptions.

.16 Chapter 22 also provides accounting guidance for funded covers, as described in the FASB consensus decision in 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 provision is effective January 1, 1996, but applies to all contracts entered into, renewed, or amended on or after January 1, 1994.

.17 *Life and Health Insurers.* The NAIC Accounting Practices and Procedures Task Force revised the reinsurance section (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. If a reinsurance contract does not provide for sufficient transfer of risk, amounts paid are to be accounted for as deposits. The revised accounting and reporting practices were adopted on December 4, 1995 and are effective for all accounting periods beginning after January 1, 1996. The provisions apply to reinsurance agreements entered into or amended on or after January 1, 1996; however, they do not apply to reinsurance agreements in force on January 1, 1996.

.18 Auditors should be aware of these regulatory accounting provisions.

Significant Changes to the NAIC Annual Statement Instructions

.19 *Lloyd's of London.* Auditors should be aware that for 1996 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 *Derivatives.* Insurers must disclose in their 1996 statutory annual statements the following information by category of derivative financial instruments:

1. A description of the company's objectives for holding or issuing derivative financial instruments, the context needed to understand those objectives, and the company's strategies for achieving those objectives, including the classes of derivative financial instruments held
2. The nature and terms of derivative financial instruments, including, at a minimum, a discussion of (*a*) the credit and market risk of those instruments, and (*b*) the cash requirements of those instruments (including the effects of possible termination payments).

Codification of Statutory Accounting Principles

.21 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 also for insurance enterprises within a state. The codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance enterprises. Current statutory accounting practices are considered an other comprehensive basis of accounting (OCBOA) under Statement on Auditing Standards (SAS) No. 62, *Special Reports* (AU section 623). When codification is complete, it is anticipated that a statutory basis of accounting for insurance enterprises other than NAIC-codified statutory accounting will be considered neither GAAP nor OCBOA. 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.*" When codification is complete, certain amendments to SAS No. 62 (AU section 623) would be required.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.22 As part of the codification project, the NAIC is exposing a series of issue papers for public comment. As of August 31, 1996, a total of seventy-six issue papers had been released for public comment. An exposure draft of the statements of statutory accounting principles is scheduled for release in March 1997. A six-month comment period will be provided. A tentative effective date for applying the new statutory accounting practices would be for 1998 financial statements, with specified transitional provisions. Because the codification will not be effective for 1996 statutory financial statements, 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.

Change in Florida Department of Insurance Requirements

.23 Often, state insurance departments implement or amend regulations. A significant change in state regulations effective for 1996 audits affects certified public accountants (CPAs) who audit insurance companies authorized to transact business in the state of Florida. The Florida Department of Insurance adopted Statute 624.424 Section 8(d) in 1991. The statute states that the rotation period for CPAs who audit an insurance company (authorized to transact business in the state of Florida) is every five years. This deviates from the Model Audit Rule and all other state requirements, which require a rotation period of seven years. The effective date is for audits of statutory financial statements performed for periods ending on or after December 31, 1996. Auditors should be aware of this change and plan their engagements accordingly. Auditors should also monitor other state regulatory developments to determine whether they are applicable to their engagement.

Audit Issues

Mergers, Acquisitions, and Consolidations

.24 The insurance industry continued to see a 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 products diversification. Historically, most of the mergers and acquisitions came from smaller companies, which are most vulnerable to unexpected losses and have the greatest difficulty complying with minimum state capital requirements. However, the recent trend is for substantial deals by some of the larger insurers, concentrating on core lines of business and growth through acquisition. 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). For life and health 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.

.25 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.

.26 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. Further, auditors should also be alert to the increased risk of material misstatement by enterprises attempting to appear more attractive to potential buyers.

Investments in Derivatives

.27 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, swaps, 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 financial institutions have incurred significant losses as a result of their use. The use of derivatives creates unique audit concerns and may increase 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.

.28 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*, No. 107, *Disclosures about Fair Value of Financial Instruments*, 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. In addition, auditors may wish to refer to the FASB's Special Report, *Major Issues Related to Hedge Accounting*, issued in October 1995. The SEC issued a proposal on comprehensive disclosure requirements for derivatives and other financial instruments for public comment in early 1996, and anticipates a final staff bulletin to be issued on this topic by December 31, 1996.

Liabilities for Unpaid Claims

.29 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.

.30 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.

.31 *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. Since the early 1980s, certain environmental and asbestos exposures have been a major concern for insurance enterprises. Throughout 1995 and 1996, the press reported that many insurance companies significantly increased their environmental and asbestos-related loss reserves due to improved capabilities to develop estimates in this area. Some insurance enterprises increased loss reserves for certain environmental and asbestos exposures as a result of improvements in actuarial techniques, while others have experienced increasing pressure from various sources such as rating agencies, the SEC, and shareholders to improve methodologies used to quantify and record an estimate of the insurance enterprise's obligation. Competitive market pressures as well as ownership changes also contributed to significant reserving actions. As a result of recent improvements in actuarial techniques, more insurance enterprises are likely to increase reserves for certain environmental and asbestos exposures in the near-term. However, there is still significant uncertainty surrounding defendant activity, unresolved coverage issues, and policy and claim data availability issues for many insurers.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.32 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 SEC 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. Disclosure of the gross amounts of reasonably possible losses is required. 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.

.33 *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.

.34 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.

.35 *Statutory Environmental Disclosure Requirements.* The NAIC requires environmental disclosure for property and casualty annual statement filings. The disclosure requirements specify that environmental and asbestos liabilities should be disclosed separately and that the following should be disclosed in a prescribed table:

1. Five-year history, including incurred losses and calendar year payments on both a gross and net basis segregated between current accident year and prior accident year
2. Incurred but not reported (IBNR) reserves on a gross and net basis as of the year end
3. Allocated loss adjustment expense (LAE) reserves as of the year end

.36 *Exposure to Breast-Implant Claims.* Some reports indicate that claims related to injuries from defective breast implants could exceed $7 billion.

.37 *Long-Term Exposures.* Long-term exposures (commonly referred to as mass tort exposures) involve bodily injury or property damage which arise from and are related to exposure over time to any alleged toxic, harmful, or defective material, device, substance, agent, activity or condition including but not limited to chemicals, drugs, petroleum-based products, pharmaceutical products, medical devices, radiation, noise, electromagnetic fields, or repetitive motion. Recent reports indicate that insurers may be liable to cover certain long-term exposures that range from tobacco-related illnesses to injuries caused by use of computer equipment, such as carpal tunnel syndrome.

.38 *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.

.39 *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 price risks inappropriately, which also could affect the recoverability of deferred acquisition costs and result in premium deficiencies.

.40 *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.

.41 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 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.

.42 *Purchase Accounting.* In purchase business combinations involving acquisitions of property and casualty insurance companies, the Securities and Exchange Commission (SEC) staff has taken the position that needed changes in liabilities for claim losses and loss adjustment expenses of an acquired insurance company ordinarily should be made through losses incurred in the income statement rather than through purchase accounting adjustments (see the SEC's Staff Accounting Bulletin [SAB] No. 61 for further discussion).

Reinsurance Arrangements

.43 Reinsurance is an important part of many insurance companies' businesses, 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, as well as large catastrophes occurring each year over the past eight years, property catastrophe coverage has been difficult to obtain. Many believe catastrophe losses are not an abnormal event anymore and may now in fact be a normal occurrence. A number of insurers, both primary insurers and reinsurers, 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.

.44 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-transfer 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 (the AICPA's Accounting Standards Executive Committee [AcSEC] currently has a project on its agenda to provide guidance on how to apply deposit accounting, if appropriate; and (3) whether the substance of the contract is that of a derivative financial instrument and which accounting is therefore appropriate. A number of these new variations of traditional reinsurance contracts are perceived to be vehicles for insurance companies to better manage or fund their catastrophe exposures. 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:

1. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.
2. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

.46 Generally, contracts that do not meet the conditions for reinsurance accounting should be accounted for as deposits.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.47 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).

.48 For many reinsurance contracts, a great deal of judgment is involved in determining whether the risk-transfer conditions are met, particularly for multiple-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.*

.49 *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. *Auditing Life Reinsurance,* guidance on auditing reinsurance for life and health insurance enterprises.

.50 *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 may also require disclosure of the reinsurers' related balances. 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.

.51 *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, statu-

tory 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 enterprise'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

.52 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 may still have asset quality problems. Credit 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.

.53 Auditors also should be alert to valuation issues related to classification and impairment of securities. Paragraph 16 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I08.120 and 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.

.54 Paragraph 69 of FASB Statement No. 115 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.

Audit Developments

Elimination of Uncertainty Reporting

.55 In December 1995, the Auditing Standards Board (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.

.56 SAS No. 79 (AU section 508) also clarifies and reorganizes the guidance in SAS No. 58, *Reports on Audited Financial Statements* (AU section 508), concerning emphasis paragraphs, matters involving uncertainties, and disclaimers of opinion.

.57 SAS No. 79 (AU section 508) 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), nor does it preclude the auditor from adding a paragraph to the auditor's report to emphasize a matter disclosed in the financial statements.

.58 Ordinarily, the auditor of a property and liability insurance company would look to historical data to obtain evidential matter that will provide reasonable assurance that management's estimate of loss reserves

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

is reasonable in the circumstances. 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 volumes of claims. The Guide is currently being revised to eliminate any indications that this is a requirement. When historical data is not sufficient to resolve uncertainty about the reasonableness of management's estimate of loss reserves and the auditor is unable to resolve the uncertainty through other means, the auditor should consider whether management has adequately disclosed the uncertainty in the notes to the financial statements as required by FASB Statement No. 5 (AC C59), paragraphs 4 and 6 of FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss (an interpretation of FASB Statement No. 5)* (AC C59.124 and 126), and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. A matter involving an uncertainty is one that is expected to be resolved at a future date at which time conclusive evidential matter concerning its outcome would be expected to become available. Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertion about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate. If the auditor is unable to obtain sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualification or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

.59 SAS No. 79 (AU section 508) is effective for reports issued or reissued on or after February 29, 1996, with earlier application permitted.

Internal Control

.60 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 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 (COSO) 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.

Planning, Supervision, and Going Concern

.61 In November 1995, the ASB issued 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 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.

Letters for Underwriters

.62 The ASB released SAS No. 76, *Amendments to Statement on Auditing Standards No. 72,* Letters for Underwriters and Certain Other Requesting Parties (AU section 634). SAS No. 76 (AU section 634) provides reporting guidance and an example letter for situations in which 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 (AU section 634) are effective for letters issued pursuant to paragraph 9 of SAS No. 72 (AU section 634.09) after April 30, 1996.

Agreed-Upon Procedures

.63 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.

.64 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.*

.65 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, including—

- 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.

.66 The primary difference between the two Standards (AU section 622 and AT section 600) 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 (AU section 622 and AT section 600) 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.

.67 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 Statements (AU section 622 and AT section 600) prohibit 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.

.68 Both SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) are effective for reports dated after April 30, 1996.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Auditor's Reports on Statutory Financial Statements

.69 The AICPA issued SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises,* which addresses 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—

- Supersedes SOP 90-10, *Reports on Audited Financial Statements of Property and Liability Insurance Companies.*
- Discusses matters auditors should include in their reports when issuing limited or general distribution reports on statutory financial statements.
- Discusses matters auditors should evaluate when considering issuing limited or general distribution reports on statutory financial statements.
- Discusses 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

.70 The AICPA issued SOP 95-4, *Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule,* which provides guidance to auditors on the form and content of communications with state insurance regulators, 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

.71 The AICPA incorporated the guidance of SOP 93-8, *The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises,* into the Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* in response to the NAIC's implementation of a risk-based capital program for 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. Auditors should be aware of this guidance.

Accounting Developments

Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities

.72 In June 1996, the FASB issued FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (AC F38). This Statement (AC F38) provides accounting and reporting standards for transfers and servicing of financial assets and extinguishment of liabilities. Those standards are based on consistent application of a financial-components approach that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. This Statement (AC F38) provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

.73 A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interest in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

1. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
2. Either (*a*) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right—to pledge or exchange the transferred assets or (*b*) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.
3. The transferor does not maintain effective control over the transferred assets through (*a*) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (*b*) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

.74 FASB Statement No. 125 (AC F38) requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interest in transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

.75 FASB Statement No. 125 (AC F38) requires that servicing assets and liabilities be subsequently measured by (1) amortization in proportion to and over the period of estimated net servicing income or loss and (2) assessment for asset impairment or increased obligation based on their fair values.

.76 FASB Statement No. 125 (AC F38) requires that debtors reclassify financial assets pledged as collateral and that secured parties recognize those assets and their obligation to return them in certain circumstances in which the secured party has taken control of those assets.

.77 FASB Statement No. 125 (AC F38) requires that a liability be derecognized if and only if either (1) the debtor pays the creditor and is relieved of its obligation for the liability or (2) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

.78 FASB Statement No. 125 (AC F38) provides implementation guidance for assessing isolation of transferred assets and for accounting for transfers of partial interest, servicing of financial assets, securitizations, transfers of sales-type and direct financial lease receivables, securities lending transactions, repurchase agreements including "dollars rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishment of liabilities.

.79 FASB Statement No. 125 (AC F38) supersedes FASB Statements No. 76, *Extinguishment of Debt*, and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. This Statement (AC F38) amends FASB Statement No. 115 (AC I80) to clarify that a debt security may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. This Statement (AC F38) amends and extends to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (AC Mo4), and supersedes FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*. This Statement (AC F38) also supersedes FASB Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt*, No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*, and No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*.

.80 FASB Statement No. 125 (AC F38) is effective for transfers and servicing of financial assets and extinguishment of liabilities occurring after December 31, 1996, and is to be applied prospectively. Earlier or retroactive application is not permitted.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Stock-Based Compensation

.81 In October 1995, the FASB issued Statement No. 123, *Accounting for Stock-Based Compensation* (AC C36), which establishes financial accounting for stock-based employee compensation plans. The Statement (AC C36) encourages companies to account for stock compensation awards using a fair value method. Fair value is determined based on the stock price at the date the awards are granted. The resulting compensation cost would be recognized as an expense in the income statement over the service period. FASB Statement No. 123 (AC C36) also applies to equity instruments issued for goods or services provided by persons other than employees. The accounting requirements of this Statement (AC C36) are effective for transactions entered into in fiscal years that begin after December 15, 1995, though they may be adopted on issuance.

Long-Lived Assets

.82 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 and 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, 1995.

.83 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 Statements No. 60 and 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). The Statement (AC I08) amends several FASB statements including FASB Statement No. 61, *Accounting for Title Plant* (AC Ti7).

.84 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.

.85 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). 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

.86 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 GAAP, and distribute those financial statements to regulators, should not describe these financial statements as prepared "in conformity with generally accepted accounting principles."

.87 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).

.88 FASB Statement No. 120 (AC In6) extends the requirements of FASB Statements No. 60 (AC In6), No. 97 (AC In6), and No. 113 (AC In6), to mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies.

.89 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.

.90 The AICPA issued SOP 95-1 on January 18, 1995. 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).

.91 *Auditor's Reports.* Prior to the effective date of FASB Statement No. 120 (AC In6), mutual life insurance enterprises issued statutory financial statements and described those financial statements as being in conformity with GAAP. This practice is no longer permitted. Financial statements prepared in conformity with statutory accounting practices for periods prior to the effective date of FASB Statement No. 120 (AC

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

In6) are not considered GAAP presentations when presented in comparative form with financial statements for periods subsequent to the effective date of FASB Statement No. 120 (AC In6). General distribution reports on an insurance company's statutory financial statements must express either an adverse or qualified opinion as to conformity with GAAP. An additional paragraph in the auditor's report, auditors also may express an opinion on whether the statutory financial statements are presented in conformity with the statutory basis of accounting (see SAS No. 1, section 544, *Lack of Conformity With Generally Accepted Accounting Principles* [AU section 544]).

.92 A mutual life insurance enterprise may want a general distribution independent auditor's report on its 1996 statutory financial statements presented in comparative form with its 1995 statutory financial statements (which were considered to be in conformity with GAAP in 1995). In this situation, the auditor may have issued an unqualified opinion on the 1995 financial statements when they were first issued, and he or she is precluded from updating and issuing the same opinion on the 1995 financial statements that are presented in comparative form with the 1996 statements. SAS No. 58 (paragraph 69, as amended by SAS No. 79 [AU section 508.69]) states that if, in an updated report, the opinion is different from the opinion previously expressed on the financial statements of a prior period, the auditor should disclose all of the substantive reasons for the different opinion in a separate explanatory paragraph proceeding the opinion paragraph.

.93 The following is an illustration of an independent auditor's report on the general distribution comparative statutory financial statements of an insurance enterprise prepared in conformity with prescribed or permitted statutory accounting practices, which contains an explanatory paragraph disclosing all the substantive reasons for the different opinion, an adverse opinion as to conformity with GAAP, and an unqualified opinion as to the conformity with the statutory basis of accounting. In this illustrative report, it is assumed that the effects on the statutory financial statements of the differences between GAAP and the statutory basis of accounting are not reasonably determinable.

Independent Auditor's Report

To the Board of Directors
Example Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of Example Insurance Company as of December 31, 19X6 and 19X5, and the related statutory statements of income and changes in capital and surplus, and cash flow 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, 19X6, we expressed an opinion that the 19X5 financial statements, prepared using accounting practices prescribed or permitted by the Insurance Department of the State of [*state of domicile*], presented fairly, in all material respects, the financial position of Example Insurance Company as of December 31, 19X5, and the results of its operations, and its cash flows for the year then ended in conformity with generally accepted accounting principles. As described in Note Y to these financial statements, pursuant to the pronouncements of the Financial Accounting Standards Board, the 19X5 financial statements of Example Insurance Company, prepared using accounting practices prescribed or permitted by insurance regulators (statutory financial statements) are not considered presentations in conformity with generally accepted accounting principles when presented for comparative purposes with the company's financial

statements for periods beginning after December 15, 19X5. Accordingly, our present opinion on the presentation of the 19X5 financial statements in accordance with GAAP, as presented herein, is different from that expressed in our previous report.

In our opinion, because of the effects of the matter discussed in the third paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of Example Insurance Company as of December 31, 19X6 and 19X5, or the results of its operations or its cash flows for the years then ended.

As described more fully in Note X to these financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of [*state of domicile*], which practices differ from generally accepted accounting principles. The effects on the financial statements of the variances between the statutory basis of accounting and generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

Also, in our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of Example Insurance Company as of December 31, 19X6 and 19X5, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in Note X.

.94 The following is an example of Note Y which is referred to in the above illustration of an independent auditor's report.

Note Y - Statement of Financial Accounting Standards No. 120 and Interpretation No. 40

Statement of Financial Accounting Standards (Statement) No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, extends the requirements of Statements No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, to mutual life insurance enterprises. It also provides the effective date for implementation of FASB Interpretation (Interpretation) No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*. Statement No. 120 is effective for financial statements for fiscal years beginning after December 15, 1995, and requires restatement of all previously issued annual financial statements presented for comparative purposes for fiscal years beginning after December 15, 1992.

In 1995, prior to the effective date of Interpretation No. 40 and Statement No. 120, mutual life insurance enterprises could issue financial statements prepared using accounting practices prescribed or permitted by the Insurance Department of the State of [*state of domicile*], (statutory financial statements) and describe those financial statements as being in conformity with generally accepted accounting principles (GAAP). Pursuant to the provisions of Interpretation No. 40 and Statement No. 120, statutory financial statements of mutual life insurance enterprises for periods ending on or before December 15, 1996, are no longer considered presentations in conformity with generally accepted accounting principles when presented for comparative purposes with the enterprise's financial statements for periods subsequent to the effective date of Interpretation No. 40 and Statement No. 120. Accordingly, the 1995 statutory financial statements presented herein are no longer considered presentations in conformity with generally accepted accounting principles.

.95 Auditors should be aware of this guidance when auditing a mutual life insurance enterprise and enterprises with participating life insurance contracts.

AcSEC Conforming Changes

.96 In February 1996, AcSEC updated its technical guidance in certain SOPs and practice bulletins to conform with pronouncements issued recently by the FASB. AcSEC made conforming changes to the following SOPs and practice bulletins:

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- SOP 75-2, *Accounting Practices of Real Estate Investment Trusts*, and the related SOP 78-2, *Accounting Practices of Real Estate Investment Trusts*
- SOP 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans*
- SOP 78-9, *Accounting for Investments in Real Estate Ventures*
- SOP 90-11, *Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*
- SOP 93-7, *Reporting on Advertising Costs*
- AICPA Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletin and Procedures for Their Issuance*—Exhibit F—Accounting and Disclosure for Reinsurance Transactions
- AICPA Practice Bulletin 9, *Disclosure of Fronting Arrangements by Fronting Companies*

Auditors should be aware of these changes.

Exposure Draft—Accounting by Insurance and Other Enterprises for Guaranty-Fund and Certain Other Insurance-Related Assessments

.97 Insurance enterprises are subject to a variety of assessments, including those by state guaranty funds and workers' compensation second-injury funds. Current accounting practice by insurance enterprises for assessments and related recoveries is diverse. The AICPA expects to issue an exposure draft of an SOP, *Accounting by Insurance and Other Enterprises for Guaranty-Fund and Certain Other Insurance-Related Assessments*, by the end of 1996. The exposure draft will provide:

- Guidance for determining when an insurance or other enterprise should recognize a liability for guaranty-fund and other assessments.
- Guidance on how to measure the liability and will allow for the discounting of the liability, if the amount and timing of the cash payments are fixed and reliably determinable.
- Criteria for when an asset may be recognized for a portion or all of the assessment liability or paid assessment that can be recovered through premium tax offsets or policy surcharges.
- Requirements for disclosure of certain information.

AcSEC anticipates to finalize this SOP in 1997 and to issue an SOP that would be effective for financial statements for fiscal years beginning after December 15, 1997. Early adoption would be encouraged.

Accounting by the Issuer of Surplus Notes

.98 The AICPA plans to issue a practice bulletin on accounting by the issuer of surplus notes in the first quarter of 1997. The practice bulletin will apply to insurance enterprises that issue surplus notes. A surplus note is a financial instrument issued by mutual and stock insurance enterprises that is includable in surplus for statutory accounting purposes as prescribed or permitted by state laws and regulations. The practice bulletin will provide guidance on accounting, financial statement presentation, and disclosure for surplus notes. It will require surplus notes to be recorded as liabilities in the financial statements of the issuer. The accounting for surplus notes by the issuer, including the accrual of interest, would be consistent with that of other debt.

Certain FASB Statement No. 115 Implementation Issues

.99 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 they 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 nonpublic 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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

.100 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.

Special Report on FASB Statement No. 115

.101 The FASB staff issued a Special Report, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities*, which provides implementation guidance in a question and answer format.

Consensus Decisions of the FASB's Emerging Issues Task Force

.102 The EITF frequently discusses accounting issues involving financial instruments, real estate, or insurance contracts that are important to insurance companies. To order copies of the following publication, call the FASB at (203) 847-0700, ext. 10.

- EITF Issue No. 94-7, *Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*
- 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*
- EITF Issue No. 95-11, *Accounting for Derivative Instruments Containing Both a Written Option-Based and a Forward-Based Component*
- EITF Issue No. 96-10, *Impact of Certain Transactions on the Held-to-Maturity Classification under FASB Statement No. 115*
- EITF Issue No. 96-12, *Recognition of Interest Income and Balance Sheet Classification of Structured Notes*
- EITF Issue No. 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*
- EITF Issue No. 96-15, *Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-For-Sale Debt Securities*

.103 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-34, *Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113*
- Appendix D-35, *FASB Staff Views on Issue No. 93-6, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises"*
- Appendix D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value*
- Appendix D-45, *Implementation of FASB Statement No. 121 for Assets to Be Disposed Of*

Information Sources

.104 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.

.105 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.

.106 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. In 1996 many organizations have established Web Sites on the World Wide Web.

.107 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.108 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.

* * * *

.109 This Audit Risk Alert supersedes *Insurance Industry Developments—1995/96.*

* * * *

.110 Practitioners should also be aware of the economic, regulatory, and professional developments described in *Audit Risk Alert—1996/97* [AAM section 8010] and *Compilation and Review Alert—1996/97* [AAM section 8015].

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.111

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. 1) 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. WebSite: http://www.aicpa.org	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		WebSite: http://www.fasb.org	*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	WebSite: http://www.naic.org	
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 (f) Telnet via internet: federal.bbs.gpo.gov3001	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8090	*Information Line* (202) 942-8088, ext. 3 (202) 942-7114 (tty)	WebSite: http://www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)

[*The next page is 8139.*]

AAM Section 8050

Banks and Savings Institutions Industry Developments—1996/97

Industry and Economic Developments

.01 Banks and savings institutions showed continued profitability during 1996. However, auditors should be alert to the following circumstances that may increase the audit risk associated with related financial information or internal control:

- Personnel reductions that result in a single employee performing duties previously divided among a number of employees
- The increased use of technology that is complicated by difficulty in making data secure
- The reclassification of amounts used in operating ratios and other financial measures to improve these measures
- Rapid expansion into nontraditional activities (such as insurance and mutual fund sales) or increase in volumes of high-risk, new products
- Weak information supporting mortgage servicing rights and the volatility of fair value information (both at origination and when impairment is measured)

.02 Also, steady growth in residential real estate and consumer lending have been accompanied by record-setting levels of delinquency, increasing audit risk with respect to the valuation of related assets. In some circumstances, institutions may have increased origination volumes by easing credit standards or loosening contractual terms. Institutions may be—

- Lending to weaker borrowers or reducing the scrutiny of credit risk.
- Originating loans with longer repayment periods, lower down payments, or with periods in which no payment is required.
- Failing to enforce loan covenants, to follow established loan policies, or to obtain guarantees on small business loans.

Such actions may increase credit risk and, by that, affect the audit risk associated with the institution's valuation of related assets or incurrence of liabilities for credit losses.

Audit and Accounting Guide

.03 In April 1996, the AICPA issued an AICPA Audit and Accounting Guide *Banks and Savings Institutions* (Guide). 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 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).

.04 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 are required to be applied prospectively to audits of financial statements for fiscal years ending after June 15, 1996.

Legislative and Regulatory Developments

.05 Chapter 2 of the Guide explains why and how auditors should consider legislative and regulatory matters. Following is a summary of developments that involve accounting and auditing matters. Auditors should be alert also to the effect of laws and regulations on planned mergers or acquisitions.

.06 This Audit Risk Alert does not provide a comprehensive discussion of each issue, but refers to laws, regulations, rulings, or other documents and 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), which collectively are referred to as the agencies. Readers should consult the "Information Sources" section of this Audit Risk Alert to find out how to get copies of the referenced documents.

Legislative Matters

.07 Enacted September 30, 1996, the Deposit Insurance Funds Act requires that the FDIC assess a special premium on deposits insured by the Savings Association Insurance Fund. The premium will raise the ratio of SAIF insurance funds to insured deposits to 1.25 percent. The Act also amends Section 162 of the Internal Revenue Code to make the assessment deductible in the year paid.

.08 The FASB staff addressed related accounting questions in an announcement at the November 15, 1995, meeting of the FASB's Emerging Issues Task Force (EITF). In part, the FASB staff said that when legislation requiring the special assessment was enacted, "a liability should be accrued and a charge should be reported as a component of operating income in the period that includes the enactment date. The charge to income should not be reported as an extraordinary item." Further guidance is provided in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (AC C59).

.09 Also enacted September 30, 1996, the Economic Growth and Regulatory Paperwork Reduction Act repealed Section 36(e) of the Federal Deposit Insurance Act. That section required auditors to report on agreed-upon procedures relative to insured institutions' compliance with specified safety and soundness laws and regulations. (The Federal Deposit Insurance Act continues to require that management make a written assertion about compliance.)

.10 The Small Business Job Protection Act was signed into law, which includes provisions that repeal the bad-debt-reserve method for savings institutions' income taxes and addresses the potential recapture by savings institutions of percentage-of-taxable-income deductions of bad debts for tax purposes. These changes will affect the recognition and measurement of taxes in certain institutions' financial statements.

.11 During 1996, Congress continued to pursue, but did not pass, legislation to—

- Amend the Higher Education Act of 1965 to exempt certain originators of student loans from related audit requirements.
- Reform the Glass-Steagall Act (which effectively prohibits commercial banks from underwriting securities or otherwise engaging in investment banking activities).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

Regulatory Capital Matters

.12 Capital regulations are complex and their application requires an understanding of specific requirements. Chapter 2 of the Guide explains how auditors consider regulatory capital matters and required disclosures about regulatory matters. 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 the specific requirements for full definitions of the terms used.

.13 *Interest-Rate Risk.* Risk-based capital standards of the FDIC, OCC, and FRB explicitly identify concentrations of interest-rate risk as qualitative factors to be considered in examiner assessments of an institution's overall capital adequacy; however, the standards require no specific quantitative measure of such risks. Paragraph 2.36 of the Guide explains OTS requirements.

.14 The FDIC, OCC, and FRB augmented their requirements through a joint policy statement that explains how examiners will assess institutions' interest-rate risk exposure (OCC Bulletin 96-36; FDIC Financial Institutions Letters [FILs] 52-96 and 54-96; *Federal Register*, June 26, 1996). The policy statement suggests that institutions with complex systems for measuring interest-rate risk may seek assurance about the institution's risk management process from external auditors.

.15 *Market Risk.* The FRB, OCC, and FDIC amended their respective risk-based capital requirements to for market risk (FDIC FIL-84-96).

.16 *RAP-GAAP Differences.* Paragraphs 2.82 through 2.85 of the Guide explain the effect on audit risk of differences between the regulatory accounting practices (RAP) used to prepare regulatory financial reports and the generally accepted accounting principles (GAAP) used to prepare general-purpose financial statements. Also, paragraph 2.86 of the Guide explains that certain balances and transactions accounted for in conformity with GAAP for regulatory reporting purposes receive different treatment in regulatory capital calculations.

.17 The Federal Financial Institutions Examination Council (FFIEC) issued an optional worksheet for reporting regulatory capital amounts in regulatory financial reports (FDIC FIL-20-96). Auditors may find the worksheet helpful in auditing disclosures about regulatory matters.

Other Regulatory Matters

.18 *Bank Secrecy Act Compliance.* The FDIC revised its guidelines for banks' self-monitoring of compliance with the Bank Secrecy Act. Included are minimum requirements that independent testing be conducted at least annually by internal auditors, external auditors, or consultants (FDIC FIL-29-96). Auditors engaged to provide independent assurance should consider the guidance in AICPA Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AT section 500).

.19 *HUD Recertifications.* The United States Department of Housing and Urban Development (HUD) requires financial institution subsidiaries and affiliates and other mortgagees under HUD's mortgage insurance programs to be recertified annually. HUD Mortgagee Letter 95-6 sets out the recertification criteria, which include the filing of audited financial statements, independent accountants' reports on internal control and compliance, and a schedule of the mortgagee's adjusted net worth (as defined). HUD has reported that recertification requests frequently include net worth schedules that are deficient because the mortgagee has not used new calculations specified in HUD Mortgagee Letter 95-6.

.20 *FHA Mortgagee Requirements.* HUD revised its requirements for Federal Housing Administration (FHA) loan correspondents (*Federal Register*, July 10, 1996). HUD eliminated certain compliance and internal

control reporting requirements and announced its intention to eliminate the requirement that audits of financial statements of loan correspondents comply with *Government Auditing Standards* issued by the Comptroller General of the United States.

.21 *Student Loans.* The Higher Education Act requires compliance engagements for Federal Family Education Loan (FFEL) program lenders and third-party servicers. The United States Department of Education's Office of the Inspector General (OIG) developed detailed requirements for lender engagements in its March 1995 guide, *Compliance Audits (Attestation Engagements) of Federal Family Education Loan Program at Participating Lenders.*

.22 In June 1996, the department extended until June 30, 1997, the due date for reports from lenders with portfolios equal to or less than $5 million, as defined (Dear Colleague Letter 96-L-188).

.23 The OIG plans to issue a guide in late 1996 that will supersede the March 1995 lender guide and will introduce detailed requirements for engagements at third-party servicers. The new guide likely will become effective within six months of its issuance.

.24 The OIG is also working on a guide addressing management and auditor reports to be provided by lenders and lender servicers voluntarily seeking the department's special designation rewarding the entity's exceptional performance collecting delinquent and defaulted FFEL program loans.

.25 *Asset Quality Standards.* The agencies issued qualitative standards for asset quality and earnings (FDIC FIL-79-96; *Federal Register,* August 27, 1996). Auditors may wish to familiarize themselves with the standards during planning (as part of understanding regulatory matters and the institution's business).

.26 *Agricultural Loans.* The FDIC gave examiners information on analyzing and classifying agricultural loans (FDIC FIL-61-96). Auditors of the financial statements of institutions that engage in material agricultural lending may find the memorandum's background and risk information helpful for planning purposes.

.27 *Credit Derivatives.* The FDIC and OCC issued guidance to bankers and examiners on credit derivatives (FDIC FIL-62-96; OCC Bulletin 96-43). Credit derivatives are financial instruments that allow counterparties to transfer credit risk. Auditors may find the background information helpful for identifying and understanding credit derivatives.

Audit Issues and Developments

Agreed-Upon Procedures Engagements

.28 AICPA Statement on Auditing Standards (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), became effective for reports dated after April 30, 1996. SAS No. 75 (AU section 622) superseded SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement.* Also, SSAE No. 4 (AT section 600) amends SSAE No. 3 (AT section 500).

.29 The new Standards affect various industry-related engagements, including those to report on agreed-upon procedures relating to management assertions about the following:

- Collateral for Federal Home Loan Bank advances
- Compliance with electronic funds transfer (EFT) association requirements

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- Compliance with student loan program requirements (see the section, "Other Regulatory Matters")
- Compliance with bonding company requirements
- Compliance with safety and soundness laws and regulations designated in 12 CFR Part 363 (see the section, "Other Regulatory Matters")
- Compliance with bond-selling-group agreements
- Officers' expenses
- Trust activities

.30 Auditors should be alert to the requirements of SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600) on these and similar engagements. Among other significant provisions, the Statements—

- Prohibit reporting of negative assurance about whether management's assertion is fairly stated.
- 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 specified users have agreed to the definition of materiality.
- Require that specified users take responsibility for the sufficiency of the agreed-upon procedures for their purposes.

SSAE No. 4 (AT section 600) further requires a written management assertion as a condition of engagement performance.

.31 In June 1995, the AICPA asked the FDIC to update or withdraw its January 16, 1990, *Statement of Policy Providing Guidance on External Auditing Procedures for State Nonmember Banks*, because of changes in FDIC reporting requirements effected by the Federal Deposit Insurance Corporation Improvement Act of 1991 and the anticipated changes introduced by SAS No. 75 (AU section 622) and SSAE No. 4 (AT section 600). For example, many of the policy statement's proposed procedures are overly subjective and open to varying interpretations.

.32 Until the FDIC policy statement is revised, auditors should agree with affected institutions and specified users on the procedures to be performed. This includes working with specified users to modify the FDIC's suggested procedures as necessary to ensure they are not overly subjective or open to varying interpretations (see paragraphs 17 through 19 of SSAE No. 4 [AT section 600.17–.19]).

.33 As required by paragraph 11 of SSAE No. 4 (AT section 600.11) and paragraph 10 of SAS No. 75 (AU section 622), if the practitioner cannot obtain agreement from a party (such as the FDIC) on the procedures to be performed or the party's acceptance of responsibility for sufficiency of the agreed-upon procedures for the party's purposes, the practitioner should not include that party as a specified user. Further, those standards say practitioners should not report on an engagement when specified users do not agree upon the procedures to be performed and do not take responsibility for the sufficiency of the procedures for their purposes.

SAS No. 70 Auditing Procedure Study

.34 The AICPA published an Auditing Procedure Study, *Implementing SAS No. 70*, Reports on the Processing of Transactions by Service Organizations (product no. 021056). The study provides guidance to service auditors engaged to issue reports on the internal control policies and procedures of a service organization. It also provides guidance to user auditors engaged to audit the financial statements of entities that use service organizations. Examples of service organizations include (*a*) bank trust departments that invest and hold assets for employee benefit plans and (*b*) entities that service loans for others.

Elimination of Uncertainty Reporting

.35 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). SAS No. 79 (AU section 508) eliminates the requirement that the auditor add an uncertainties explanatory paragraph to the auditor's report, if certain criteria are met. SAS No. 79 (AU section 508) also clarifies and reorganizes SAS No. 58 (AU section 508) guidance on emphasis paragraphs, matters involving uncertainties, and disclaimers of opinion. This SAS does not affect 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. SAS No. 79 (AU section 508) is effective for reports issued or reissued on or after February 29, 1996, with earlier application permitted.

Other Newly Effective Auditing Pronouncements

.36 Auditors should be alert to provisions of the following pronouncements, which are discussed in the Guide.

- SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment of SAS No. 55* (AU section 319), is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.
- SSAE No. 6, *Reporting on an Entity's Internal Control Structure Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AT section 400), is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

Accounting Developments

Transfers and Servicing of Financial Assets

.37 In June 1996, the FASB issued FASB Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* The Statement is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996. The Statement is to be applied prospectively and earlier or retroactive application is not permitted.

.38 Auditors should be alert that FASB Statement No. 125 significantly affects accounting for (and disclosures about) many bank and savings institution transactions, including the following:

- Sales of partial interests in financial assets
- Assets subject to prepayment risk (including interest-only securities)
- Collateral controlled by an institution as a secured party
- Securitization of loans or other financial assets
- Servicing assets and liabilities
- Securities lending transactions
- Repurchase and reverse-repurchase agreements
- Wash sales
- Loan syndications and participations

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- Risk participations in banker's acceptances
- Factoring arrangements
- Transfers of receivables with recourse
- Extinguishment of liabilities

Because the Statement's criteria focus on control, conclusions about accounting will depend increasingly on elements of underlying legal agreements. For example, paragraph 76 of the Statement explains that, if a loan participation agreement constrains participating institutions from pledging or exchanging their participations, the originating institution "has not relinquished control over the loan and shall account for the transfers as secured borrowings." Auditors may wish to encourage client institutions to analyze the potential effect on the institution's transactions so that the institution can make any desired changes in legal agreements or otherwise plan for application of the Statement's requirements to transfers occurring on January 1, 1997, and thereafter.

Debt and Equity Securities

.39 On November 15, 1995, the FASB published a FASB Special Report, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities*. Among various questions and answers about the implementation of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), the answer to Question 61 explains that the FASB directed its staff to provide guidance, in part, that

> concurrent with the initial adoption of this implementation guidance but no later than December 31, 1995, an enterprise may reassess the appropriateness of the classifications of all securities held at that time and account for any resulting reclassifications at fair value in accordance with paragraph 15 [of FASB Statement No. 115].

.40 The FASB staff also made the following announcement at the November 15-16, 1995 meeting of the EITF.

> The FASB intends that the initial application of the Special Report and any resulting one-time reclassifications will occur as a single date between November 15, 1995, and December 31, 1995, not over a number of days throughout the period.

Other Newly Effective Accounting Pronouncements

.41 Auditors should be alert to the effective dates of the following pronouncements, the provisions of which are addressed in the referenced sections the Guide.

- FASB Statement No. 122, *Accounting for Mortgage Servicing Rights* (AC Mo4). See paragraphs 8.21 through 8.31 of the Guide. FASB Statement No. 125 supersedes FASB Statement No. 122.
- FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). See paragraphs 9.08 through 9.10 of the Guide.
- AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, is effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years after the year for which SOP 94-6 is first applied. See paragraphs 1.31 through 1.45 of the Guide.

.42 The AICPA Audit and Accounting Guide *Banks and Savings Institutions* explains that certain provisions of AICPA SOP No. 92-3, *Accounting for Foreclosed Assets*, are inconsistent with the provisions of FASB Statement No. 121 (AC I08) and notes that, though AcSEC and the FASB are considering actions that should be taken to resolve the inconsistencies, FASB Statement No. 121 (AC I08) takes precedence for transactions within its scope.

Discussions of the FASB's EITF

.43 The EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to banks and savings institutions. A description of new issues discussed during the year follows; readers should consult detailed minutes for additional information.

- EITF Issue No. 96-22, *Applicability of the Disclosures Required by FASB Statement 114 When a Loan Is Restructured in a Troubled Debt Restructuring into Two (or More) Loans*
- EITF Issue No. 96-20, *Impact of FASB Statement 125 on Consolidation of Special-Purpose Entities*
- EITF Issue No. 96-15, *Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities*
- EITF Issue No. 96-13, *Accounting for Sales of Call Options or Warrants on Issuer's Stock with Various Forms of Settlement*
- EITF Issue No. 96-12, *Recognition of Interest Income and Balance Sheet Classification of Structured Notes* (This addresses (1) whether investments in structured notes may be classified as held-to-maturity under FASB Statement No. 115, (2) how an investor in a structured note should estimate the cash flows that will be received, (3) how changes in those cash flow estimates should be recognized and measured in interest income.)
- EITF Issue No. 96-11, *Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115* (This addresses how to account for forward contracts and purchased options with no intrinsic value at acquisition that will be accounted for under FASB Statement No. 115 (AC I80) during the period that the forward or option is outstanding and when the securities are acquired.)
- EITF Issue No. 96-10, *Impact of Certain Transactions on the Held-to-Maturity Classification under FASB Statement No. 115* (This discusses whether certain transactions involving held-to-maturity securities that are not accounted for as sales, such as wash sales and bond swaps, contradict the institution's stated intent to hold a security to maturity and, therefore, call into question or "taint" the entity's intent to hold other debt securities to maturity.)

.44 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 recent discussions:

- Appendix D-50, *Classification of Gains and Losses from Determination of an Interest Rate Swap Designated to Commercial Paper* (which contains Securities and Exchange Commission staff views)
- Appendix D-48, *The Applicability of FASB Statement No. 65 to Mortgage-Backed Securities that are Held-to-Maturity* (which contains FASB staff views)
- Appendix D-47, *Accounting for the Refund of Bank Insurance Fund and Savings Association Insurance Fund Premiums* (which contains FASB staff views)

.45 Readers also should be aware that FASB Statement No. 125 affected various consensuses reached by the EITF before issuance of the Statement. The FASB staff has issued an analysis entitled *Impact of FASB Statement No. 125,* Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, *on EITF Issues.*

Ethics Developments

.46 The AICPA Professional Ethics Executive Committee issued the following ethics rulings and interpretation under Rule 101 (ET section 101.01), which relate to extended audit services, including those performed for clients that are banks and thrifts:

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- Ruling No. 103, *Member Providing Attest Report on Internal Controls* (ET section 191.206 and .207)
- Ruling No. 104, *Member Providing Operational Audit Services* (ET section 191.208 and .209)
- Ruling No. 105, *Frequency of Performance of Extended Audit Procedures* (ET section 191.210 and .211)
- Interpretation 101-13, *Extended Audit Services* (ET section 101.15)

The rulings were published in the August 1996 *Journal of Accountancy*.

Information Sources

.47 Further information on matters addressed in this Audit Risk Alert is available through various publications and services listed at the end of this document. Many nongovernment 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 the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.49 Many private companies, professional and trade associations, and government agencies allow users to read, copy, and exchange information electronically through the Internet's world wide web.

.50 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.51 All telephone numbers listed are voice lines, unless otherwise designated as fax (f) lines.

* * * *

.52 This Audit Risk Alert supersedes *Banks and Savings Institutions Industry Developments—1995/96.*

* * * *

.53 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1996/97* [AAM section 8010] and *Compilation and Review Alert—1996/97* [AAM section 8015].

.54

Information Sources

Organization	General Information	Fax Services	World Wide Web	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	www.aicpa.org	*AcSEC Telephone Line* (212) 596-6008
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700 (ext. 10)		www.fasb.org	*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		www.fhlmc.org	
Federal Deposit Insurance Corporation	*Corporate Communications* 550 17th Street, NW Washington, DC 20429-0001 (202) 898-6996	*Facsimile Bulletin Board System* (804) 642-0003/2036	www.fdic.gov	*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	www.frb.gov	*Federal Reserve Board Highlights* (202) 452-3206 *Bank Holding Company Applications and Orders* (202) 452-3207
Mortgage Bankers Association of America	*Publications Department* 1125 15th Street, NW Washington, DC 20005-2766 (800) 793-MBAA	*MBA Fax on Demand* This service is available only to MBA members. For more information, call (800) 909-6222.	www.mbaa.org	
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	www.ustreas.gov	
U.S. Department of the Treasury—Office of Thrift Supervision	*OTS Dissemination Branch* 1700 G Street, NW Washington, DC 20552-0001 (202) 906-5900	*PubliFax* (202) 906-5660		

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

Organization	General Information	Fax Services	World Wide Web	Recorded Announcements
U.S. Department of Education	*Federal Student Aid Information Center* (800) 433-3243		www.ed.gov	
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250 (f)		www.gpo.gov	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8078	*Information Line* (202) 942-8090 (ext. 3) (202) 942-8092 (tty)	www.sec.gov	*Information Line* (202) 942-8090 (202) 942-8092 (tty)

[*The next page is 8161.*]

AAM Section 8060

Employee Benefit Plans Industry Developments—1997

Industry and Economic Developments

.01 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. The following list is based on a survey conducted by Buck Consultants, *401(k) Plans—Employer Practices & Policies, September 1996 Survey Results*, eighth edition:

- 95 percent of all 401(k) plans offer four or more investment options.
- Voice response systems are used in 76 percent of all respondents' plans, as opposed to 35 percent in 1993 and 58 percent in 1995.
- 86 percent of all 401(k) plans offer a participant loan feature, whereas in 1984 only 39 percent did.
- 53 percent of plans surveyed allowed for daily changes in investment elections, whereas in 1989 only 4 percent did.
- 49 percent of plans surveyed allow participants to change investment of new monies every pay period, whereas in 1989 only 4 percent did.

Regulatory and Legislative Developments

Regulatory Developments

.02 *Department of Labor Nonenforcement of GAAP Disclosures of Postretirement Benefit Obligations by Multiemployer Health and Welfare Benefit Plans.* On March 13, 1997, the Department of Labor (DOL) published in the *Federal Register* a notice and request for comment on an annual enforcement policy pursuant to which the DOL would not reject the Form 5500 annual report, filed for the 1996 and 1997 plan years, of a multiemployer welfare benefit plan solely because the accountant's opinion accompanying such report is qualified or adverse due to a failure to account and report for postretirement benefit obligations in accordance with the financial statement disclosure requirements of AICPA Statement of Position (SOP) 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*. The AICPA is on record opposing the DOL's nonenforcement position. The DOL's action does not affect generally accepted accounting principles (GAAP) for multiemployer health and welfare benefit plans. However, if a plan decides not to fully comply with the requirements of SOP 92-6, then the auditor must consider the effect of a GAAP departure on his or her audit report. See related discussion under Audit Issues and Developments section of this alert.

.03 *Final Regulation Relating to Definition of Plan Assets: Participant Contributions.* On August 7, 1996, the DOL published in the *Federal Register* final rules that lower the maximum period that employers may hold contributions to contributory employee benefit pension plans (both defined benefit and defined contribution plans). These new regulations amend an existing regulation, adopted in 1988, as to when participant contributions become plan assets.

.04 Previous rules required employers to remit money withheld from employees to their plans as soon as reasonably possible, but in no event longer than ninety days. However, some employers misinterpreted

the prior rule to mean that contributions could be held for ninety days even though these contributions could have been remitted to the plan in a shorter period.

.05 The new regulation, effective February 3, 1997, includes the following changes:

- For pension plans (both defined benefit and defined contribution plans), the maximum period for remittance of employee contributions to the plan has been reduced to fifteen business days after the month in which the participant contribution was withheld or received by the employer.
- To accommodate the special situation of employers who, on occasion and for good cause, cannot remit participant contributions to pension plans within the fifteen business day limit, the DOL has established a procedure by which an employer may obtain an extension of the limit for an additional ten business days.
- For welfare plans, the maximum period for remittance of employee contributions to the plan was not changed, remaining ninety days after the day the contribution was withheld or received by the employer.

.06 Failure to remit, or untimely remittance of, participant contributions may constitute 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 independent auditors' opinion on the required supplemental schedule accompanying the plan's financial statements. When auditing contributions for defined contribution plans, auditors should consider inquiring about the timing of employee contribution remittances to the plan. Consideration should also be given to expanding the client representation letter to include specific prohibited transactions, such as the untimely remittance of employee contributions. (See paragraph A.14 for further discussion of the remittance rules, and paragraph 11.09 for a discussion of prohibited transactions, in the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide), with conforming changes as of May 1, 1997.)

.07 For collectively bargained plans, there is a special effective date of the later of February 3, 1997, or the first day of the plan year that begins after the end of any collectively bargained agreement in effect on February 3, 1997. To accommodate the special situation of employers who, for good cause, need additional time to complete their benefit system changes, the DOL has established a procedure by which an employer may obtain an extension of the effective date of up to ninety days. (For questions or further information, contact the Office of Regulations and Interpretations at the DOL at (202) 219-7461.)

.08 *PWBA Review of Plan Audits and Related Peer Review Developments.* The PWBA has established an ongoing quality review program to insure the quality of audit work performed by independent auditors in audits of plan financial statements that are required by the Employee Retirement Income Security Act of 1974 (ERISA). Practitioners 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, 1996, 69 referrals had been made to state licensing boards and 286 referrals had been made to the AICPA Professional Ethics Division; of the 286, the Professional Ethics Division has resolved 223 cases. Of those resolved cases, 71 were referred to the AICPA's Trial Board or were settled without a Trial Board hearing, 110 resulted in letters of recommended corrective action,[1] 11 were found to contain no deficiencies, and 31 were closed for other reasons. Common deficiencies noted in the referrals included the following:

[1] Disciplinary actions available to the Professional Ethics Executive Committee include termination or suspension of membership in the AICPA (and possibly in the state society), publicizing such actions in the *CPA Letter*, completion of specified continuing professional education, review of additional work product, imposition of mandatory independent preissuance review of some or all financial statements and accountant's reports, and accelerated quality review. The action taken is determined by the severity of the violations of the Code of Professional Conduct.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- Inadequate or no audit program or planning[2]
- Inadequate or no documentation of the auditor's understanding of the internal control structure
- Inadequate or no documentation supporting the audit work performed[3]
- Deficiencies in the auditor's report[4]
- Deficiencies in the note disclosures[5]

.09 Because ERISA holds plan administrators responsible for assuring that plans' financial statements are audited in accordance with generally accepted auditing standards (GAAS), deficient audit work can also expose plan administrators to significant penalties under ERISA section 502(c)(2). The PWBA will continue to conduct periodic working paper review, and, in time, will conduct another assessment of the level and quality of audit work performed by independent auditors.

.10 The AICPA, working with the PWBA, has made a concerted effort to improve the guidance and training available to auditors of employee benefit plans. Such efforts include issuing annual Audit Risk Alerts, conducting annual national conferences on employee benefit plans, developing continuing professional education courses and technical checklists, and issuing accounting and auditing pronouncements aimed at improving plan financial reporting and providing guidance for plan auditors. Also, the AICPA has consulted with the PWBA on additional actions the AICPA and PWBA can take to strengthen the quality of ERISA audits. These actions include communicating to AICPA members the findings noted in the PWBA's report and the importance of ERISA audits; developing additional audit programs, manuals, checklists, or other technical practice aids; strengthening additional technical support for auditors through the AICPA technical hotline; offering additional training programs on employee benefit plan audits; identifying ways the AICPA can work with state CPA societies to enhance training opportunities in employee benefit plan audits; and improving the AICPA's peer review process in ERISA audits.

.11 Also, the AICPA self-regulatory teams continue to be concerned about deficiencies noted on audits of employee benefit plans. The common GAAS and GAAP deficiencies noted by the AICPA are the same as those already listed in this section. In the spirit of protecting the public interest and in response to the high rate of noncompliance, both the SEC Practice Section (SECPS) and AICPA Peer Review Programs have special criteria for selecting audits of employee benefit plans for review during a peer review. The SECPS Peer Review Program requires that such audits be reviewed if the firm plans to continue performing these engagements. Effective for peer review years beginning on or after January 1, 1997, the AICPA Peer Review

---

[2] Such deficiencies included lack of a specific audit program tailored to the audit of employee benefit plans; failure to obtain or review relevant documents such as plan agreements, summary plan descriptions, annual reports, and investment advisor agreements; and failure to determine the operations of the plan or current developments affecting the plan.

[3] Such deficiencies included failure to perform sufficient audit work related to participant data, benefit payments, plan obligations, or all three. Also, in certain instances the auditor did not test the fair market valuations, investment transactions, or authorizations for investment transactions. In limited-scope engagements, the auditor did not obtain the proper certification from the bank or insurance company or the certification did not cover all of the plan assets. The audit program used by the auditor did not address the area of prohibited transactions. In the audit of multi/multiple-employer plans, the auditor performed inadequate work relating to the contributions received from contributing employers. In participant-directed plans, the auditor did not test the allocation of employee contributions to selected investment options.

[4] Such deficiencies included failure to reflect a departure from GAAP and failure to report on all the years presented.

[5] Such deficiencies included failure to disclose—
- The investments that represent 5 percent or more of the plan's net assets available for benefits.
- Information as to whether or not the plan has received a favorable tax determination ruling from the IRS.
- The priorities upon termination of the plan.
- The basis for determining contributions of the plan.
- The funding policy of the plan.
- Information regarding the method and significant assumptions used to determine the actuarial present value of the plan's accumulated plan benefits as required by Financial Accounting Standards Board (FASB) Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans* (AC Pe5).

Program will require reviewers to assess employee benefit plan audits at a higher level of peer review risk. If the firm performs such audits, and at least one is not selected for review, the reviewer will be required to document his or her justification for such omission in the summary review memorandum. Under both programs, peer review teams performing a review of employee benefit plan audits, must have experience in audits of employee benefit plans, as well as knowledge about current rules and regulations of ERISA.

.12 This is a serious effort by the PWBA and AICPA. Practitioners need to understand that severe consequences, including loss of membership in the AICPA and loss of license, can result from inadequate plan audits.

.13 *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. In 1996 the PWBA rejected over fifty-one hundred filings, many for audit reporting deficiencies, 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 who fail to file acceptable annual reports on a timely basis.

.14 In addition, the PWBA continues to actively identify and target both late filers and nonfilers. More than 980 late filers and nonfilers have been identified and assessed over $56 million in late filing and nonfiling penalties. The following penalties may be assessed by the DOL against late filers or nonfilers:

- *Late filers*—Plan administrators who voluntarily file annual reports for 1988 and subsequent reporting years after the due date and are subsequently identified by the PWBA will be considered late filers. They may be assessed $50 per day, per plan filing, for the period for which they failed to file timely.
- *Nonfilers*—Plan administrators who fail to file required reports for 1988 and subsequent reporting years and are subsequently identified by the PWBA will be considered nonfilers. They may be assessed a penalty of $300 per day, per plan filing, with the penalty continuing to accrue up to $30,000 per year for each plan year until a filing is submitted.

.15 The Internal Revenue Service (IRS) may also impose penalties, including a late filing penalty of $25 a day, up to $15,000 for not filing returns for certain plans of deferred compensation, certain trusts and annuities, and bond purchase plans.

.16 *PWBA Outreach and Customer Service Efforts.* PWBA continues to encourage auditors and plan filers to call its Division of Accounting Services at (202) 219-8794 with ERISA-related accounting and auditing questions. Questions concerning the filing requirements and preparation of Form 5500 should be directed to the Division of Reporting Compliance at (202) 219-8770. In addition to handling technical telephone inquiries, PWBA is involved in numerous outreach efforts designed to provide information to practitioners to help their clients comply with ERISA's reporting and disclosure requirements. Questions regarding these outreach efforts should be directed to the Office of the Chief Accountant at (202) 219-8818. Practitioners and other members of the public may also wish to contact PWBA at their website—*Internet: http://www.dol.gov/dol/pwba.* The website provides information on PWBA's organizational structure, current regulatory activities, and customer service and public outreach efforts.

.17 *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 who failed to file or who filed their Form 5500 Series annual reports late to apply for relief from full delinquency penalties. Auditors should be aware of this program if their clients' plan reports have not been filed or have been filed late and they qualify for this program.

.18 This program was designed to be less burdensome for 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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

does not preclude assessment of nonfiling or late-filing penalties by the IRS. The IRS has recommended that plan administrators participating in the DFVC program attach a reasonable-cause statement to their original Form 5500 Series filing with the IRS. In the case of Form 5500 filings which are filed on or before twelve months after the due date (without regard to any extensions), plan administrators who qualify for the DFVC program will be assessed a penalty of $50 per day, up to a maximum of $2,500 per Form 5500 filing. The maximum penalty for Form 5500-C filings who file under these circumstances is $1,000. In the case of Form 5500 filings which are filed more than twelve months after the due date (without regard to any extensions), plan administrators who qualify for the DFVC program will be assessed a penalty of $5,000 per filing. Form 5500-C filers will be assessed a penalty of $2,000 per filing.

.19 In addition, plan administrators of certain employee benefit plans for highly compensated individuals (known as *top hat* plans) and apprenticeship and training plans who missed their filing deadlines may submit statements and elect an alternative method of compliance in lieu of making annual report filings. Participation by these filers in the DFVC program will be assessed $2,500 per statement.

.20 To date, participation in the DFVC program by plan administrators has been successful. As of December 31, 1996, the DOL has received 5,607 annual report filings and 288 statements by top hat plans and apprenticeship and training plans, totaling $17.3 million in reduced penalties.

.21 Questions concerning the DFVC program should be directed to the PWBA's Division of Reporting Compliance at (202) 219-8770.

.22 *Revision of the Form 5500 Series and Related Regulations Under the Employee Retirement Income Security Act of 1974.* The Form 5500 Series of reports are filed annually by pension and health and welfare benefit plans to provide information about plan operations to plan participants and the regulatory agencies. Since 1976, the forms have been processed by the IRS which provides the data to the respective agencies.

.23 As part of the President's Pension Simplification proposal, the regulatory agencies are undertaking a comprehensive review of the annual return report forms in an effort to streamline the information required to be reported and the methods by which such information is filed and processed. The proposed revision to the Form 5500 Series is being coordinated among the DOL, the IRS, and the Pension Benefit Guaranty Corporation.

Legislative Developments

.24 *Pension Audit Legislation.* Several bills aimed at repealing the limited-scope audit exemption that currently exists under Section 103(a)(3)(C) of the ERISA are expected to be introduced in the 105th Congress. The DOL and the U.S. General Accounting Office have recommended that Congress repeal the limited-scope audit exemption that, according to the DOL, is utilized in about half of the approximately 70,000 audits of employee benefit plans subject to ERISA. The AICPA supports repeal of the limited-scope audit exemption. Further, the proposed legislation would require auditors to report certain significant events to the DOL and to establish additional educational and quality control review requirements for plan auditors. As of the date of this Alert, two bills (S.14, Retirement Security Act of 1997, and H.R.83, Comprehensive Pension and Retirement Security Act of 1997) have been introduced. Senator Jim Jeffords (R-VT), chair of the Senate Labor and Human Resources Committee, and other Senate and House members are expected to introduce pension audit legislation. The DOL is also expected to have its recommendations introduced in proposed legislation. Pension audit legislation, if enacted, would be effective for plan years beginning after the date of enactment of the legislation.

.25 *Other Legislation Affecting Plans.* Employee benefit plan issues continue to receive emphasis by Washington policy makers and regulators. 1996 was a busy year for legislation affecting employee benefit plans. Following is some of the legislation passed in 1996:

- The *Health Insurance Portability and Accountability Act of 1996* (HIPAA) was signed into law on August 21, 1996. HIPPA includes important new protections for an estimated 26 million Americans who move from one job to another, who are self-employed, or who have preexisting medical conditions, and places requirements on employer-sponsored group health plans, insurance companies, and health maintenance organizations (HMOs).
- The *Newborns' and Mothers' Health Protection Act of 1996* (NMHPA) was signed into law on September 26, 1996. NMHPA includes important new protection for mothers and their newborn children regarding the length of the hospital stays following the birth of a child. The requirements under NMHPA apply to group health plans, insurance companies, and HMOs for plan years beginning on or after January 1, 1998.
- The *Mental Health Parity Act of 1996* (MHPA) was signed into law on September 26, 1996. MHPA provides for parity in the application of limits to certain mental health benefits. Under MHPA, group health plans, insurance companies, and HMOs will no longer be allowed to set annual or lifetime limits on mental health benefits that are lower than any such limits for medical and surgical benefits. Generally, these requirements apply to group health plans for plan years beginning on or after January 1, 1998, that meet certain requirements.

Further information regarding the above legislation can be obtained from the Pension and Welfare Benefits Administration (PWBA), U.S. Department of Labor, 200 Constitution Avenue, N.W., Room N-5625, Washington, D.C. 20210, 202/219-8776 (*Internet: http://www.dol.gov/dol/pwba*).

Audit and Accounting Developments

Audit Issues and Developments

.26 *Multiemployer Health and Welfare Benefit Plan Accounting for Postretirement Benefit Obligations.* Employee health and welfare benefit plans that prepare financial statements in accordance with GAAP must follow the accounting and reporting requirements set forth in chapter 4 of the AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, which incorporates the guidance of SOP 92-6. SOP 92-6 is effective for all single-employer plans, and became effective for multiemployer plans for plan years beginning after December 15, 1995.

.27 Among other requirements, SOP 92-6 required plans that provide postretirement benefits to include in their financial statements the amount of the accumulated postretirement benefit obligation representing the actuarial present value of all future benefits attributed to plan participants' services rendered to date. Because accumulated benefit obligations are not reported on Form 5500 submitted to the DOL, plans adopting SOP 92-6 should include a note to their financial statements reconciling the amounts reported in the financial statements to amounts reported on Form 5500.

.28 As noted in the Regulatory Developments section of this alert, the DOL will not enforce the postretirement benefit obligation disclosure requirements in SOP 92-6 for multiemployer health and welfare benefit plans for plan years 1996 and 1997. If a plan does not adopt all of the provisions of SOP 92-6, including presenting the postretirement benefit obligation amount in the statement of plan's benefit obligations and statement of changes in plan's benefit obligations, which is required to fairly present the plan's financial statements in conformity with GAAP, the auditor should consider the effect of this departure from GAAP on his or her 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 departure from GAAP (AU section 508.35–.60). A qualified opinion is expressed when the auditor believes, on the basis of his or her audit, that the financial statements contain a departure from GAAP, the effect of which material, and he or she has concluded not to express an adverse

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

.29 *Trend Toward Outsourcing and the Use of SAS No. 70 Reports.* 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. For example, outside service organizations such as bank trust departments, data processing service bureaus, insurance companies, and benefits administrators may keep records and process benefit payments. Often 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 internal control 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 components of internal control maintained by the service organization. This understanding can be efficiently achieved by obtaining and reviewing 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 that addresses the controls at the service organization that are relevant to the audit of the plan.

.30 If the independent auditor determines that the service organization had effective controls in place for processing plan transactions during the reporting period, the auditor generally would conclude that it is not necessary to visit or perform additional procedures at the service organization. However, in some situations, the auditor may conclude that additional audit work should be performed at the service organization. Following are some examples of such situations. (See chapter 6 of the Guide for audit guidance on the situations listed below.)

- The service organization issued a SAS No. 70 (AU section 324) report describing the controls placed in operation ("Type I" report) and the auditor wishes to determine whether to reduce the assessed level of control risk at the service organization.
- The service organization's SAS No. 70 (AU section 324) report covers a reporting period different from the plan's fiscal year.
- The service organization's SAS No. 70 (AU section 324) report covers only some of the services used by the plan (for example, the report might cover custodial services but not allocation services) or the report does not cover activities performed by subservice organizations.
- The service organization's SAS No. 70 (AU section 324) report identifies instances of noncompliance with the service organization's controls.

.31 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.

.32 *Auditing in a Mutual Fund Environment.* Many employee benefit plans, particularly 401(k) plans and profit sharing plans, hold investments in mutual funds (also known as *registered investment companies*). Typically, a plan holds units of the mutual funds which are valued at quoted market prices that may fluctuate daily, representing the net asset value of the units held by the plan.

.33 When auditing mutual fund investments, difficulties are often encountered with daily valuations, participant-directed automated transactions (for example, voice-activated telephone systems), and other "paperless transactions." In such circumstances, the plan is often unable to maintain independent records of such transactions, necessitating that the auditor obtain an understanding of internal control of the service

organization in order to plan the audit in accordance with SAS No. 55, *Consideration of Internal Control 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). This understanding can be efficiently achieved by obtaining and reviewing a report prepared in accordance with SAS No. 70 (AU section 324) on the relevant controls of the service organization (typically the record keeper, which in certain circumstances may be a service division of the mutual fund organization). (See paragraphs 6.07 through 6.14 in the Guide for a further discussion of SAS No. 70 [AU section 324].) The auditor should consider the areas and findings addressed in the SAS No. 70 (AU section 324) report, and whether the SAS No. 70 (AU section 324) report is a Type I or Type II report, to determine the extent of substantive procedures to perform.

.34 Many of the audit procedures discussed in chapter 7 of the Guide are applicable for mutual funds. Such procedures may include the following:

1. Confirming transactions (contributions, transfers, and withdrawals) account balances, or both, with individual participants
2. Tracing contributions and withdrawals from the plan record keeper's records to the mutual fund's activity statements for the applicable time period
3. Confirming directly with the mutual fund the number of units of participation held by the plan
4. Testing the fair value of the investments in mutual funds by agreeing per-unit values as of year end to market quotations
5. Obtaining a copy of the mutual fund's recent financial statements (or alternative source of yield information, such as business journals) and analytically comparing for reasonableness the information in the mutual fund's financial statements to the information recorded by the plan for its units of participation, including market values and the net change in fair value of investments (that is, realized and unrealized gains and losses) for the period under audit. The mutual fund's financial statements need not cover the exact period covered by the plan's financial statements; they should, however, be sufficiently recent to satisfy the plan auditor's objectives (The financial statements of mutual funds are typically readily available.)

.35 *Synthetic GICs.* Many plans hold guaranteed investment contracts (GICs) in their investment portfolio. Normally issued through the general account, in its simplest form a GIC is a contract between an insurance company and a plan that provides for a guaranteed return on principal invested over a specified time period. For defined contribution plans, one variation of a GIC is commonly referred to as a *synthetic GIC*. A synthetic GIC is an investment contract that simulates the performance of a traditional GIC through the use of financial instruments. A key difference between a synthetic GIC and a traditional GIC is that the plan owns the assets underlying the synthetic GIC. (With a traditional GIC, the plan owns only the investment contract that provides the plan, with a call on the contract issuer's assets in the event of default.) Those assets may be held in a trust owned by the plan, and typically consist of government securities, private and public mortgage-backed and other asset-backed securities, and investment-grade corporate obligations. To enable the plan to realize a specific known value for the assets if it needs to liquidate them to make benefit payments, synthetic GICs utilize a benefit-responsive "wrapper" contract issued by a third party that provides market and cash flow risk protection to the plan. (The third-party issuer of the wrapper is an entity other than the plan sponsor, administrator, or trustee, and could be the entity that issues the investment contract.) Synthetic GICs are unallocated and are to be included as plan assets at their contract or fair values, as appropriate. (See paragraphs 3.17 and 4.24 of the Guide for a further discussion of measuring and valuing investment contracts.) Because the assets underlying a synthetic GIC are owned by the plan, those assets and the wrapper should be separately valued and disclosed in the Form 5500 *Schedule of Assets Held for Investment Purposes.* The value of the benefit responsive wrapper would be the difference between the fair value of the underlying trust assets and the contract value attributable by the wrapper to those assets. (See example 5 in the appendix to SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, found in appendix I, paragraphs I.12 and I.13, in the Guide, for a discussion of synthetic GICs.)

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.36 For defined contribution plans for which the "wrapper" is benefit responsive, the auditing procedures to be applied to synthetic GICs should include tests of the individual securities or other investments that constitute the assets underlying a synthetic GIC and tests of the related wrapper contract to ascertain the fairness of the values of each to be disclosed by the plan in the Form 5500 *Schedule of Assets Held for Investment Purposes.*

.37 *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.

.38 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 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. 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 full-scope audit procedures. The auditor's responsibilities in limited-scope engagements are discussed in detail in paragraphs 7.51 and 7.52 of the Guide.

.39 *Limited-Scope Audits (When Only a Portion of the Investments Are Certified).* Plan investments not held by a qualified trustee or custodian that meets the limited-scope exemption criteria set forth in the DOL regulations (see paragraphs A.57 and A.58 of the Guide, for a discussion of such criteria) should be subjected to appropriate audit procedures. Plans may hold investment assets of which only a portion are covered by certification by a qualified trustee or custodian. In that case, the balance of the investments are not eligible for the limited-scope exemption and should be subjected to auditing procedures by the plan auditor. In these circumstances, the limited-scope audit report would be required if the plan's assets that are not audited (that is, those assets covered by the trustee or custodian's certification) are material to the plan's financial statements taken as a whole. See paragraph 13.26 of the Guide for limited-scope reporting guidance.)

.40 *Auditing Funded Welfare Plans.* A trust may be established to hold the assets of an employee welfare benefit plan; it may or may not be tax-exempt. A common form of tax-exempt trust is a an Internal Revenue Code (IRC) Section 501(c)(9) trust, referred to as a voluntary employee beneficiary association (VEBA). The audit requirement for a health and welfare plan that utilizes a VEBA trust applies to the plan, not to the VEBA trust. VEBA trusts generally have no language covering the plan's operations. The governing instrument is limited to the investment and management of plan assets. Disbursements are made as authorized by the plan administrator. Operational attributes of the related plan must still be audited in accordance with chapter 4 of the Guide. However, the tax status is unique to the VEBA and, for the trust to be tax-exempt, the tax requirements of the IRC must be satisfied.

.41 Paragraph 4.09 of the Guide explains that a VEBA is one of several arrangements available to hold plan assets of an employee welfare plan. Key considerations in auditing VEBAs arise from the distinct tax regulations associated with VEBAs, and often assets of several welfare plans are commingled into a single VEBA.

.42 The audit and reporting issues for a VEBA that holds the assets of a single plan of a single sponsor are discussed fully in chapter 4 of the Guide. When the VEBA holds the assets of several plans of a single employer, additional audit issues are present. If the VEBA qualifies as a master trust, the master trust rules discussed in paragraph 4.09 of the Guide will apply. In cases in which the underlying welfare plans have no assets other than those held by the VEBA, Form 5500 schedules are generally attached to the master trust filing and need not be included with the separate filing of each participating plan. (See the instructions to

Form 5500 for guidance on master trust filing information.) If the VEBA does not qualify as a master trust, Form 5500 schedules should be prepared for each plan. (See appendix A of the Guide for a discussion of Form 5500 schedules.)

.43 *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 4.43 of the Guide). However, financial statement preparers and auditors often are unclear about what the estimated ultimate cost should include. In some cases, plans may only 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 without considering 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.

.44 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. (See paragraph 4.43 in the Guide.) For example, a participant 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 in the IBNR calculation.

.45 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).

New Pronouncements[6]

.46 There are no new auditing standards affecting 1996 plan audits; however early adoption of the following pronouncements is permitted.

.47 *SAS No. 78.* In December 1995 the Auditing Standards Board (ASB) issued SAS No. 78 (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. SAS No. 78 (AU section 319) is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted. In March 1997 the ASB issued conforming changes to SAS No. 70 (AU section 324) to reflect the issuance of SAS No. 78 (AU section 319) and to conform the SAS No. 70 (AU section 324) reports to COSO terminology.

.48 *SAS No. 82.* In February 1997 the ASB issued SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AU section 316), which describes the auditor's responsibilities relating to fraud in a financial statement audit and provides guidance on what should be done to meet those responsibilities. SAS No. 82 (AU section 316) supersedes SAS No. 53,[7] *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU

[6] Practitioners should also be aware that SAS No. 80, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter (AU section 326), was issued in December 1996 and is effective for engagements beginning on or after January 1, 1997; and SAS No. 81, *Auditing Investments* (AU section 332), was issued in December 1996 and is effective for audits of financial statements for periods ending on or after December 15, 1997.

[7] SAS No. 82 (AU section 316) also amends SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312), and SAS No. 1, sections 110, *Responsibilities and Functions of the Independent Auditor,* and 230, *Due Care in the Performance of Work* (AU sections 110 and 230).

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

section 316A), and is effective for audits of financial statements for periods ending on or after December 15, 1997. Early application is permitted. (See the appendix, "Fraud Risk Factors for Employee Benefit Plans" [paragraph .62], in this Alert for further guidance on SAS No. 82 [AU section 316].)

Accounting Issues and Developments

.49 *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 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.

.50 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 by the end of 1997. This exposure draft will be a three-part SOP that will also include a proposed SOP on accounting for and reporting on certain health and welfare benefit plan transactions, and a proposed SOP on accounting for and reporting of certain employee benefit plan investments (including amending paragraph 3.28*k* of the Guide). This project would not affect plan accounting and reporting for 1996 plan year-end reporting; however, auditors should be alert for further developments on this project.

.51 *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 the Guide and updated this chapter to incorporate Statements issued by the FASB.

.52 SOP 92-6 is now effective for all 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 SOP 92-6, the plan must adopt it in its entirety.

.53 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, *Reports on Audited Financial Statements* (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 12.21 and A.51 of the Guide.

.54 If a plan does not adopt the provisions of SOP 92-6, including presenting a statement of plan benefit obligations and a statement of changes in plan benefit obligations, which are required to present fairly the plan's financial statements in conformity with GAAP, the auditor should consider the effect of this departure from GAAP on his or her report. SAS No. 58 (AU section 508) describes the circumstances that may require a qualified or adverse opinion when the financial statements contain a departure from GAAP (specifically AU section 508.35–.60). A qualified opinion is expressed when the auditor believes, on the basis of his or her audit, that the financial statements contain a departure from GAAP, the effect of which is material and he or she has concluded 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.

.55 Some plan administrators prepare plan financial statements on a modified cash basis or an other comprehensive basis of accounting (OCBOA) rather than in conformity with GAAP. Paragraph 5 of SOP 92-6 (see also paragraph 4.05 of the Guide), states that the presentation of a plan's benefit obligation information in GAAP-basis financial statements, as required by paragraph 20 of SOP 92-6, (see also paragraph 4.20 of the Guide), is consistent with the disclosures required in OCBOA financial statements (as defined by the requirements of financial reporting to the DOL). 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. (See paragraphs 9 and 10 of SAS No. 62, *Special Reports* [AU section 623.09 and .10], for guidance on evaluating the adequacy of disclosures prepared in conformity with an other comprehensive basis of accounting. See also paragraph 13.22 of the Guide for further guidance on non-GAAP-basis financial statements.)

.56 *Valuation of Insurance and Investment Contracts.* In September 1994 the AICPA Employee Benefit Plans Committee issued SOP 94-4, which provides guidance on how those plans should report investment contracts issued by insurance companies, banks, thrift institutions, and others. In addition, SOP 94-4 provides guidance for determining the fair value of investment contracts held by all types of plans. SOP 94-4 was 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, was delayed to plan years beginning after December 15, 1995.

.57 As discussed in paragraph 4 of SOP 94-4, certain fully benefit responsive 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) and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*

New Pronouncements

.58 *FASB Statement No. 126.* In December 1996 FASB issued FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities* (AC F25). FASB Statement No. 126 (AC F25) amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 (AC F25) optional for (1) entities that are nonpublic entities, (2) entities whose total assets are less than $100 million on the date of the financial statements, and (3) entities that have not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), other than loan commitments, during the reporting period. FASB Statement No. 126 (AC F25) is effective for fiscal years ending after December 15, 1996, with earlier application permitted for financial statements not previously issued. Plans filing a Form 11-K under the Securities Exchange Act of 1934 (the 1934 Act) with the Securities Exchange Commission would not meet this disclosure exemption even when plans elect to file ERISA financial statements in lieu of financial statements filed in accordance with the 1934 Act filing requirements.

* * * *

.59 This Audit Risk Alert supersedes *Employee Benefit Plans Industry Developments—1996.*

* * * *

.60 Auditors should also be aware of the economic, regulatory, and professional developments described in *Audit Risk Alert—1996/97* [AAM section 8010].

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.61

Information Sources

Organization	General Information/ Products Available	Fax/Phone Service
American Institute of Certified Public Accountants	Technical Hotline	(800) 862-4272 (phone)
	AICPA Order Department	(800) 862-4272
	Products Available:	
	Audit and Accounting Guide: *Audits of Employee Benefit Plans*	
	Checklists and Illustrative Financial Statements: *Defined Benefit Pension Plans* *Defined Contribution Plans* *Employee Health and Welfare Benefit Plans* *Health and Welfare Benefit Plans*	
	Self-study CPE courses: *Audits of Employee Benefit Plans* *Employee Benefit Plans I: Accounting Principles* *Employee Benefit Plans II: Audit Considerations*	
Pension and Welfare Benefits Administration division of Accounting Services (ERISA-related questions)	ERISA/Form 5500 preparation questions	(202) 219-8794
	Filing requirements	(202) 219-8770
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116	(203) 847-0700, ext. 10 (*Action Alert Telephone Line*, ext. 444)

.62

Appendix

Fraud Risk Factors for Employee Benefit Plans

The following section is based on material from the AICPA publication *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82.*

Instructions: Statement on Auditing Standards (SAS) No. 82 (AU section 316) describes the auditor's responsibilities relating to fraud in a financial statement audit and provides guidance on what should be done to meet those responsibilities. There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit: material misstatements arising from fraudulent financial reporting, and material misstatements arising from misappropriation of assets. Misstatements of fraudulent financial reporting refer to intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Misstatements arising from misappropriation of assets involves the theft of an entity's assets, in which the effect of the theft is that the financial statements are not presented in conformity with generally accepted accounting principles. Although fraud usually is concealed, the presence of risk factors or other conditions may alert the auditor to a possibility that fraud exists. SAS No. 82 (AU section 316) describes fraud and its characteristics in more detail and requires the auditor to specifically assess the risk of material misstatement due to fraud and provides categories of fraud risk factors that should be considered in the auditor's assessment. The SAS (AU section 316) also provides guidance on how the auditor should respond to the results of the assessment and on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud. In addition, the SAS (AU section 316) describes related documentation requirements and provides guidance regarding the auditor's communication about fraud to management, the audit committee, and others.

Fraud risk factors may be identified throughout the entire engagement process (for example, during client acceptance or continuance procedures, planning, fieldwork, or review). Other conditions, which may support or alter an auditor's judgment about the risk of material misstatement due to fraud, may be identified during audit fieldwork. The following fraud risk factors and other conditions are intended to help auditors of employee benefit plans tailor the five broad risk factor categories defined in SAS No. 82 (AU section 316). This list is intended to supplement the risk factors, other conditions, and related guidance found in the SAS (AU section 316). (It is a companion to but not a substitute for the guidance in the SAS [AU section 316].)

Also, the presence of these example risk factors and other conditions identified during the engagement do not necessarily indicate the existence of fraud.

When fraud risk factors or other conditions are found to be present during the engagement, professional judgment should be exercised when assessing their significance and relevance. As the auditor assesses the risk of material misstatement, it is important to keep in mind that the presence of a risk factor or condition should not be considered in isolation, but rather in combination with other risk factors and conditions or mitigating circumstances.

The Auditor Responses sections include some suggested alternative procedures to consider when fraud risk factors and other conditions are present. Like the fraud risk factors and conditions, these suggestions supplement the responses already described in SAS No. 82 (AU section 316).

The following list should be used in conjunction with SAS No. 82 (AU section 316) because not every example risk factor in paragraphs 17 and 19 of the SAS (AU section 316.17 and .19) have been tailored, interpreted, or reprinted here and some of the example risk factors not reprinted may be applicable to the engagement.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Fraudulent Financial Reporting

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement.* Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

A. RISK FACTORS AND OTHER CONDITIONS RELATING TO MANAGEMENT CHARACTERISTICS AND INFLUENCE OVER THE CONTROL ENVIRONMENT

- *A motivation for management to engage in fraudulent financial reporting.*
  - — Senior management of the plan sponsor appoints itself trustee of the plan and uses that position to benefit the plan sponsor—for example, uses the plan's money to do speculative investing or to support the company through buying employer assets or supporting a supplier.
- *A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.*
  - — Failure by management to have adequate valuations performed, including actuarial valuations.
  - — The plan administrator lacks an understanding of the major regulations that govern the plans (ERISA, IRS Code, and so forth).
- *Management displaying a significant disregard for regulatory authorities.*
  - — Management displaying a significant disregard toward compliance with ERISA, IRS Code, and Department of Labor regulations.
  - — The plan administrator or trustees have been investigated by the Department of Labor or IRS for fiduciary violations in operating the plan.
- Lack of management candor in dealing with plan participants, claimants, actuaries, and auditors regarding decisions that could have an impact on plan assets, including restructuring or downsizing arrangements.
- The plan has participated in a voluntary compliance program in conjunction with the IRS or DOL. (Such participation could be an indication of ineffective management of the plan or controls over the plan.)

B. RISK FACTORS AND OTHER CONDITIONS RELATING TO INDUSTRY CONDITIONS

- *Declining industry, with increasing business failures and significant declines in customer demand.*
  - — The plan sponsor is in an industry that is declining in stability. This could lead to difficulties in meeting financial commitments to the plan, including contributions.
- The plan holds employer securities and the employer is in an industry in which the value of the securities is subject to significant volatility or is not readily determinable.
- The plan has limited investment options or the plan has invested significantly in employer securities or other employer assets (for example, owning franchise stores).

C. RISK FACTORS AND OTHER CONDITIONS RELATED TO OPERATING CHARACTERISTICS AND FINANCIAL STABILITY

- *Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.*

— Indications of significant or unusual parties-in-interest transactions not in the ordinary course of operations.

— Excessive or unusual transactions with the plan sponsor/administrator.

D. AUDITOR RESPONSES

In addition to the sample responses presented in SAS No. 82 (AU section 316), an auditor in an employee benefit plan audit engagement may want to consider the following responses.

- *Investment Results.* Obtain the requisite investment information directly from the plan trustee, and obtain the same information from the party named as having discretion to make investment decisions, such as the plan administrator, the plan's investment committee, or the plan's investment advisor (the directing party) and review and reconcile the directing party's reports (investment position and activity) with those of the trustee.
- *Claim Reserves.* Confirm, with third parties, the historical and statistical information that is being used to prepare the reserves. Review the qualifications of the individuals preparing the reserves.
- Apply the following procedures to fully understand a party-in-interest transaction:[1]
  - — Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.
  - — Inspect evidence in possession of the other party or parties to the transaction.
  - — Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.
  - — Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.
  - — With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.
- For single-employer plans, obtain the most recent financial statements of the plan sponsor and review for indicators of financial difficulties. For multiple-employer plans, obtain an understanding of the industry.

Misappropriation of Assets

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances *do not present a risk of material misstatement.* Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

A. RISK FACTORS AND OTHER CONDITIONS RELATED TO CONTROLS

- *Lack of appropriate management oversight.*

[1] See chapter 11 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* for further audit guidance.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

— Lack of review of investment transactions by trustees, sponsor, or investment committee.

- *Lack of appropriate segregation of duties or independent checks.*
  - — Lack of independent preparation and review of reconciliations of trust assets to participant accounts or accounting records of the plan.
  - — Lack of segregation of duties related to benefit payments, contributions, investment transactions, and loans.
  - — No independent records of the plan are maintained to enable the plan administrator to periodically check the information to the custodian.
- *Lack of appropriate system of authorization and approval of transactions.*
  - — Insufficient approval over transactions with parties-in-interest that could lead to prohibited transactions.
- *Lack of timely and appropriate documentation for transactions.*
  - — Trustee does not prepare required supplemental information (for example, historical cost records not maintained.)
- Lack of controls surrounding benefit payments, including the termination of payments in accordance with plan provisions.
- Lack of appropriate segregation of plan assets from the sponsors assets or inappropriate access to plan assets by plan sponsor.
- SAS No. 70 (AU section 324) report indicating a lack of adequate controls at an outside service provider.
- Use of a service provider that does not provide a SAS No. 70 (AU section 324) report.
- Unreconciled differences between net assets available for benefits per the trustee/custodian records and the recordkeeping amounts for a defined contribution plan (unallocated assets or liabilities).

B. AUDITOR RESPONSES

In addition to the sample responses presented in SAS No. 82 (AU section 316), an auditor in an employee benefit plan audit engagement may want to consider the following responses.

- Review reconciliations of the assets held by the trust with participant records throughout the year. Review any reconciling adjustments for propriety.
- Review the account activity for participants who have access to plan assets or assist in administering the plan.
- The auditor may have concluded that a risk of material misstatement exists with regard to a lack of a qualified outside service provider acting as trustee, custodian, or both for plan assets. In these instances, the auditor should physically inspect assets and examine other evidence relating to ownership. In addition, the fair value of investments should be tested by reference to market quotations or other evidence of fair value in accordance with SAS No. 57, *Auditing Accounting Estimates* (AU section 342).
- The auditor may have concluded that a risk of material misstatement exists with regard to unreconciled differences between net assets available for benefits per the trustee/custodian records and the recordkeeping amounts for a defined contribution plan. If the trustee/custodian records are higher than the recordkeeping totals (excluding accrual adjustments), an unallocated asset exists that should be allocated to participant accounts. If the trustee/custodian records are lower than the recordkeeping totals (excluding accrual adjustments), plan assets may have been misappropriated, requiring

further investigation by the auditor (for example, reconciliation of monthly trustee/custodian activity to the record keeper).

- The auditor may have concluded that a risk of material misstatement exists with regard to remittance of employee contributions for a defined contribution plan with a sponsor experiencing cash flow problems. In this instance, the auditor may perform a reconciliation of total employee contributions per the payroll register to the recordkeeping report for the year. In addition, the auditor may select certain months to test for the timely remittance of employee contributions in accordance with regulations.
- The auditor may have concluded that a risk of material misstatement exists with regard to expenses being paid by an overfunded defined benefit plan on behalf of an underfunded plan. In this instance, the auditor might select expense amounts paid by the overfunded plan and trace them to specific invoices, noting that the expense pertained to the proper plan. Alternatively, the auditor could ask to review expense invoices pertaining to the underfunded plan paid by the company to make sure the overfunded plan did not pay them.
- Review the timeliness of contributions from the plan sponsor throughout the year.
- Compare canceled checks to disbursement records. Where benefits are paid by check disbursements, compare the signature on the canceled check to participant signatures on other employee documents.
- Confirm benefit payments with participants or beneficiaries.
- Confirm medical bills directly with service providers.

Fraud Examples

Listed below are actual instances of fraudulent activity on employee benefit plan engagements. They are presented to help auditors become better acquainted with fraudulent activities. Although none of these particular examples resulted in a material misstatement of the financial statements, similar fraudulent activity at other benefit plans may cause a material misstatement of the financial statements, depending upon the circumstances.

- A pension plan notifies participants who have reached the age of seventy and one half that they must, under law, take their distributions from the plan. An employee of the company is responsible for notifying the participants and providing distribution forms. Once the forms are completed, they are provided to a supervisor for approval and submitted to the insurance company (custodian) for payment. For all participants reaching the age of seventy and one half, the employee decides to forge the distribution forms and not notify the participants of the distributions. The forged forms are provided to the supervisor, who approves them, and the insurance company is directed to make lump sum distributions via wire transfers into an account set up with the employee's name as a relative for the beneficiary. The fraud continues for several months until a participant notifies the supervisor that he would like to receive his distribution, and the supervisor notices that a lump sum was already distributed.
- A long-time employee at a company is responsible for reporting loan repayments (for loans not paid off by automatic payroll deduction) to the record keeper by providing copies of the face of the repayment checks to the record keeper. The employee is also a participant in the plan and currently has a $20,000 loan from her account. The employee decides to take a second loan but, under plan provisions, cannot do it until her first loan is paid off. The employee makes out a check to pay off the $20,000 loan from her personal account and provides a copy of the check to the record keeper. A second loan for $25,000 is taken out for the employee. However, the first loan is never paid off because the employee never deposits the $20,000 check into the plan. Cash reconciliations continually show immaterial unreconciled items that are not followed up in a timely manner and the fraud is not discovered for months.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- A company has two defined benefit plans; one is overfunded and one is underfunded. In past years, administrative expenses were paid from each plan's assets. However, this year the company decides it will pay the expenses for the underfunded plan. The overfunded plan continues to pay its own expenses. Because of an administrative error, the overfunded plan ends up paying the expenses for both plans. When management discovers this fact, a decision is made not to reimburse the plan that paid the expenses because it is fully funded.

[*The next page is 8179.*]

AAM Section 8070

State and Local Governmental Developments—1997

Industry and Economic Developments

.01 The steady growth of the economy has been favorable to most state and local governments. The trend in recent years toward generally good fiscal conditions will likely continue in 1997. On the revenue side, state tax revenues grew 5.4 percent in fiscal 1996 according to the Center for the Study of the States. This growth was stronger than budgeted for in many states and contributed to year-end balances that were higher than at any time since the early 1980s. Similar trends have been noted in many local governments. Personal income taxes generated the largest gains with increases in sales tax revenues a close second. Going forward, the myriad of complex issues involved in state taxation of electronic commerce will dominate the picture for state revenue agencies. The use of the Internet is exploding, and a number of difficult tax issues will have to be sorted out.

.02 Many state and local governments approved tax cuts during the past year, however, most of the cuts were relatively small. The modest size of the tax cuts reflects a general concern that federal deficit reduction activity could end up shifting costly responsibilities to state and local governments. In addition to federal 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, there has been much recent discussion in Washington, DC, about a potential cut in the capital gains tax rate. Such a change would likely alter 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, any new tax cuts enacted in 1997 will probably be small and, state and local officials will likely continue to develop budgets that are conservative.

.03 In the future, it will become more difficult for state and local governments to increase taxes. Voters in several states passed referendums during the November 1996 election making it more difficult for state legislatures to raise taxes. This reflects a trend toward more taxpayer control of the tax levy process.

.04 One of the more significant developments for state and local governments in 1997 will be welfare reform. In the wake of the recently passed Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (Public Law 104-193), state and local governments will have to move quickly to address a wide range of issues to implement sweeping changes in services to poor families and children. The new law eliminates the automatic entitlement to welfare benefits for mothers and children who qualify. Instead, beginning October 1, 1996, states gained broad authority over their own welfare programs, and the form of federal funding was changed to block grants. These changes will shift the entitlement burden to the states and likely have a bearing on the economic outlook and future spending priorities of state and local governments. Although the law provides states with more flexibility to implement policies and provisions that promote self-sufficiency and personal responsibility, it will also challenge state and local governments, particularly in meeting new work participation rates.

.05 Like organizations in the private sector, many governments are scrutinizing their operations and looking for reengineering opportunities. There has also been a trend toward privatizing functions and services that have traditionally been performed by governments. These activities have resulted in deep structural changes for many state and local governments. Auditors should consider the effects of these changes on their consideration of internal control.

Industry Conferences

.06 The AICPA will hold its fourteenth annual National Governmental Accounting and Auditing Update Conference on August 25–26, 1997, in Washington, DC, and again on September 29–30, 1997, in Denver, CO. This high-level conference is designed for practitioners; officials working in federal, state, or local governmental finance and accounting; and recipients of federal awards. It is the premier forum for the discussion of important governmental accounting and auditing developments. Participants will receive updates on current issues, practical advice, and timely guidance on recent developments from experts. The AICPA also offers an annual training program called the National Governmental Training Program. This year's program will be held on October 20–22, 1997, in Phoenix, AZ. It is designed for practitioners or accountants, auditors, and other staff in government who want in-depth, hands-on training in government accounting and auditing. For more information about the conference or the training program, please call the AICPA CPE Conference Hotline at (800) 862-4272.

Regulatory, Legislative, and Other Developments

Major Changes to Single Audits of Federal Awards

.07 The promise of major change in single audit policy became a reality during 1996. These changes continue to be finalized during the first half of 1997. Auditors performing audits of federal awards should follow developments in this area closely to ensure that the appropriate guidance is followed. The sections below summarize four key pieces of guidance which have been or are currently being revised for single audits and program-specific audits of federal awards. The latter three, U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the *Compliance Supplement*, and the AICPA Statement of Position, were not completed at the time of publication of this Audit Risk Alert. Information on the status of these documents will be published in the *Journal of Accountancy* and *The CPA Letter* and will be made available on the AICPA Fax Hotline and home page (http://www.aicpa.org). See the section of this Audit Risk Alert entitled "References for Additional Guidance" under the heading "AICPA" for further information on the AICPA Fax Hotline and home page.

.08 *Single Audit Act Amendments of 1996 (1996 Amendments).* On July 5, 1996, President Clinton signed into law legislation amending the Single Audit Act of 1984 (Public Law 104-156), which is effective for fiscal years beginning after June 30, 1996. The 1996 Amendments extend the act's jurisdiction to not-for-profit organizations, raise the dollar threshold for audit coverage to $300,000 from $25,000, implement a risk-based approach to identify the major federal programs to be audited, and shorten the audit report due date to nine months after a transition period of two years. The 1996 Amendments are discussed further in a November 1996 *Journal of Accountancy* article entitled "Auditing Federal Awards, A New Approach." A copy of the 1996 Amendments is also available on the AICPA Fax Hotline; dial (201) 938-3787 from a fax machine and select document number 402. The full text of the 1996 Amendments is located on IGnet at http://www.sbaonline.sba.gov/ignet/ under the listing "Single Audit."

.09 *OMB Circular A-133.* A revised OMB Circular A-133, applicable only to not-for-profit organizations, was issued on April 22, 1996. Once the 1996 Amendments were passed (see above), it became necessary for the OMB to propose another revision to OMB Circular A-133 to add states and local governments to the scope of the Circular and to comply with certain other aspects of the 1996 Amendments. This proposed revision was issued in the November 5, 1996, *Federal Register* (61 FR 57231) and a final document is expected to be issued before June 30, 1997. The OMB intends to rescind OMB Circular A-128, *Audits of State and Local Governments*, which is the existing regulation governing audits of federal awards for states and local governments once OMB Circular A-133 is issued in final form.

.10 Once finalized, OMB Circular A-133 will establish audit requirements that apply to not-for-profit organizations (including hospitals and colleges and universities) and state, local, and Indian tribal govern-

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

ments, and will be effective for fiscal years beginning after June 30, 1996. Provisions of the revised Circular include the following:

- The threshold for audit is raised to $300,000 from $25,000.
- Auditors are required to identify major programs 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. Due to the timing of the issuance of the final Circular and related audit guidance, auditors may want to consider a provision in the Circular that allows auditors to determine major programs solely on the basis of federal expenditures for first-year audits. First-year audits are defined as the first year that an entity is audited under the new Circular or the first year of a change of auditors. As an example, if an auditor has a client with a June 30, 1997, fiscal year-end, the use of the risk-based approach to determine major programs is optional for that year because it would be the first audit under the new Circular.
- Major program coverage is required to be a minimum of 50 percent (or 25 percent for low-risk auditees) of the federal awards expended.
- The required level of testing of internal control over major programs is clarified as being based on auditors' planning for a low assessed level of control risk.
- Guidance is included for conducting program-specific audits covering those situations in which a federal grantor agency has not issued a program-specific audit guide, as well as those situations in which a program-specific audit guide has been issued by the grantor agency.
- Minimum requirements for the Schedule of Expenditures of Federal Awards are provided.
- Guidance is included concerning the following:
  1. Reporting audit findings in a single schedule of findings and questioned costs, which includes a summary of the auditor's results, and findings and questioned costs related to the financial statement audit as well as to federal awards.
  2. Thresholds for determining which audit findings should be included in the schedule of findings and questioned costs.
  3. Descriptions of what information auditors should include in an audit finding.
  4. Required follow-up on audit findings.
- Auditee management is required to provide a corrective action plan for current year audit findings and a summary schedule reporting the status of prior year audit findings.
- The definition of *nonprofit organization* is revised to include nonprofit hospitals.
- Restrictions are imposed on auditor selection whereby auditors who 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. This provision is not effective until audits of fiscal years beginning after June 30, 1998.
- The due date is shortened for submitting reports to nine months from thirteen months, after a two-year transition period. The transition period is for fiscal years beginning on or before June 30, 1998, during which auditees will have thirteen months after the end of the audit period to complete the audit and submit the reporting package. The provision for a cognizant or oversight agency to grant an extension is retained. Also the report submission process is streamlined, including incorporating a data collection form, and expanding the role of the federal clearinghouse.

Auditors should note that the November 1996 proposed revisions to OMB Circular A-133 included two significant changes from the earlier revision concerning the data collection form and audit coverage of indirect cost pools. In summary, the proposal would require auditors to prepare and sign the data collection

form, and test and report on the allowability of costs charged to cost pools. Because the final resolution of these issues is unknown at this time, auditors should carefully review the final Circular for any new requirements.

.11 As noted in the preceding paragraphs, the 1996 Amendments are effective for fiscal years beginning after June 30, 1996, and OMB expects to issue the revised OMB Circular A-133 before June 30, 1997. OMB will instruct federal agencies to adopt OMB Circular A-133 in codified regulations within six months after publication of the final OMB Circular A-133 in the *Federal Register* so that it will apply to audits of fiscal years beginning after June 30, 1996. Therefore, the revised OMB Circular A-133 should be followed for audits of years beginning after June 30, 1996. Until such time as OMB publishes the final revision of OMB Circular A-133, auditors are encouraged to use the November 5, 1996, proposed revision of OMB Circular A-133 for planning purposes.

.12 Last, as a result of the issuance of the 1996 Amendments and revisions to OMB Circular A-133, questions have arisen with regard to the status of position statements issued by the President's Council on Integrity and Efficiency (PCIE). These position statements were originally developed to address issues related to audits conducted under the Single Audit Act of 1984, OMB Circular A-128, and the March 1990 version of OMB Circular A-133. Therefore, with the exception of PCIE Statement No. 4, none of the remaining position statements is applicable to audits conducted under the 1996 Amendments or the new OMB Circular A-133 requirements. (See the section of this Audit Risk Alert entitled "PCIE Audit Committee Guidance" under "References for Additional Guidance" for a listing of all PCIE position statements.)

.13 Upon publication, a copy of the final revision to Circular A-133 may be obtained from the *Federal Register*; the OMB fax information line (202) 395-9068, document number 1133; the OMB home page on the Internet, which is currently located at http://www.whitehouse.gov/WH/EOP/OMB/html/ombhome.html; or by calling or writing the Office of Administration, Publications Office, Room 2200, New Executive Office Building, Washington, DC 20503, telephone (202) 395-7332.

.14 *Compliance Supplement.* A revised OMB Compliance Supplement which is currently under development will set forth the material compliance requirements that are to be included in an audit in accordance with OMB Circular A-133. It will cover states, local governments, and not-for-profit organizations. The OMB is expected to issue a Provisional Compliance Supplement before June 30, 1997, to replace the existing Compliance Supplements entitled *Compliance Supplement for Single Audits of State and Local Governments* (issued in September 1990) and *Compliance Supplement for Institutions of Higher Learning and Other Non-Profit Institutions* (issued in October 1991), which are no longer current. It is expected that a notice will be provided in the *Federal Register* of the Provisional Supplement's availability along with a request for public comment. Auditors should use the Provisional Supplement until the public comment process is completed and OMB issues a Final Supplement. OMB anticipates issuing a Final Supplement in 1998.

.15 The most significant changes to the revised Compliance Supplement will include the following:

- A compliance matrix, which provides an overview of the compliance requirements applicable to the programs listed in the supplement
- Replacement of the classifications of general requirements and specific requirements with the following fourteen types of compliance requirements, all of which are covered by the auditor's opinion on compliance:
  - — Activities Allowed or Unallowed
  - — Allowable Costs/Cost Principles
  - — Cash Management
  - — Davis–Bacon Act

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

  - — Eligibility
  - — Equipment and Real Property Management
  - — Matching, Level of Effort, Earmarking
  - — Period of Availability of Federal Funds
  - — Procurement and Suspension and Debarment
  - — Program Income
  - — Real Property Acquisition and Relocation Assistance
  - — Reporting
  - — Subrecipient Monitoring
  - — Special Tests and Provisions
- Audit objectives and suggested audit procedures for each type of compliance requirement
- Expanded guidance on allowable costs and cost principles, which includes a comparison of the requirements between the common rule, OMB Circular A-87, *Cost Principles Applicable for State, Local, and Indian Tribal Governments;* OMB Circular A-21, *Cost Principles for Educational Institutions;* and OMB Circular A-122, *Cost Principles for Non-Profit Organizations*
- Detailed guidance on how to determine applicable compliance requirements, control objectives, and audit objectives for programs not listed in the Compliance Supplement
- Characteristics of internal control over compliance presented in the format included in *Internal Control—Integrated Framework* (the COSO Report), published by the Committee of Sponsoring Organizations of the Treadway Commission

.16 Initially, the Provisional Supplement will include approximately twenty-five federal programs. This is far less than what was included in the Compliance Supplements that are being replaced. However, the OMB has made a commitment to continue working on the Provisional Supplement and to include additional programs in the Final Supplement. As noted above, the OMB will be adding guidance to the Compliance Supplement that instructs auditors on the appropriate steps to take when a program is not included. The Compliance Supplement will be available from the Government Printing Office (see the section of this Audit Risk Alert entitled "References for Additional Guidance" under the heading "PCIE Audit Committee Guidance" for information on how to contact the Government Printing Office) and the OMB home page on the Internet, which is currently located at http://www.whitehouse.gov/WH/EOP/OMB/html/ombhome.html. Once the Supplement has been issued, more detailed guidance on how to obtain copies will be included in the AICPA's *CPA Letter* and posted on the OMB and AICPA home pages.

.17 *AICPA Statement of Position.* With the changes described in the preceding three sections, Statement of Position (SOP) 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards,* and certain sections of the Audit and Accounting Guide *Audits of State and Local Governmental Units* (the Guide) have become outdated. In response, the AICPA is in the process of developing a new SOP that will supersede SOP 92-9 and the sections of the Guide that are outdated. The new SOP is expected to be issued during the summer of 1997 (assuming that the previously described OMB guidance is issued on the dates planned) and will provide auditors of states, local governments, and not-for-profit organizations with guidance on the work performed and the reports issued for audits under the 1996 Amendments, and OMB Circular A-133. It will also include revised simplified illustrative audit reports. The new illustrative simplified reports will include one report on the financial statements, one report that will meet the requirements for reporting on compliance and internal control under *Government Auditing Standards* (GAS; also known as the Yellow Book), and one report that will meet the requirements of the 1996 Amendments and OMB Circular A-133 for reporting on single audits of federal awards.

Status of Interim Compliance Supplements for Housing Agencies and Authorities and Certain Department of Education Programs

.18 Two federal agencies have issued interim guidance to address the unique requirements of certain agency programs. These two agencies are the U.S. Department of Housing and Urban Development (HUD) and the U.S. Department of Education. OMB ultimately plans to include the programs covered by this interim guidance in the OMB Compliance Supplement. However, these programs, with the exception of one HUD program (the Section 8 Program Cluster) and one Department of Education Program (84.010), will not be included in the upcoming issuance of the OMB Provisional Compliance Supplement (see the preceding discussion) and will be added at a later date. Additional details are discussed below.

.19 *Housing Authorities.* Interim guidance for agency program requirements (which would otherwise be listed in Part 4 of the OMB Provisional Compliance Supplement) for public and Indian housing (PIH) authorities is contained in the *Public and Indian Housing Compliance Supplement for Annual Audits of Public Housing Agencies and Indian Housing Authorities by Independent Auditors* (PIH Supplement). The PIH Supplement was developed by the HUD Office of Public and Indian Housing and the Office of Inspector General. It was originally issued in May 1995 and reissued in May 1996. The PIH Supplement is available on the HUD Office of Inspector General home page at: http://www.hud.gov/oig/oigguide.html, under the listing of "Audit Guides." A copy may be requested by sending a fax to (202) 401-3963.

.20 *U.S. Department of Education Programs.* In June 1996, the U.S. Department of Education published interim guidance that includes the agency program requirements (which would otherwise be listed in Part 4 of the OMB Provisional Compliance Supplement) for the following programs: (1) 84.010 Title I Grants to Local Education Agencies, (2) 84.011 Migrant Education—Basic State Grant Program, (3) 84.281 Eisenhower Professional Development State Grants, (4) 84.186 Safe and Drug-Free Schools—State Grants, (5) 84.298 Innovative Education Program Strategies, (6) 84.288, 84.291, and 84.290 Bilingual Educations, and (7) 84.041 Impact Aid. The Title I (84.010) program will also be included in the OMB Provisional Compliance Supplement (see the discussion of the Compliance Supplement above). Each of the other programs included in the Department of Education interim guidance will also ultimately be included in the OMB Compliance Supplement. In the interim, audits in accordance with OMB Circular A-133 should use the Department of Education interim guidance as agency program requirements in testing compliance with the requirements of the programs included therein. However, if Title I (84.010) is a major program and none of the other Department of Education programs listed above are major programs, the OMB Compliance Supplement should be used. This Department of Education guidance is currently available on the Internet at the ED/OIG Non-Federal Audit Team home page (http://home.gvi.net/~edoig/) under the listing for "Compliance Supplement for ESEA Programs ASCII text format or WP 5.2 format." A copy may also be requested by sending a fax to the ED/OIG Non-Federal Team at (202) 205-8238.

OMB Circular A-21

.21 Auditors involved with audits of federal awards 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), which are effective for fiscal years beginning after May 8, 1996. The revisions incorporate four cost accounting standards issued by the Cost Accounting Standards Board (CASB) applicable to all sponsored agreements subject to OMB Circular A-21 and extend the applicability of the CASB disclosure statement to universities that receive more than $25 million in federally funded sponsored agreements. It also amends the definition of equipment; eliminates the use of special cost studies to allocate utility, library, and student services costs (effective for fiscal years beginning on or after July 1, 1998); requires the use of fixed facilities and administrative cost rates for the life of sponsored agreements; establishes cost negotiation cognizant agency responsibilities; clarifies the policy for a change from use allowance to depreciation; adds criteria to interest allowability; and disallows tuition benefits for employee family members for fiscal years beginning on or after September 30, 1998. In performing audits in accordance with OMB Circular A-133, auditors should consider whether organizations subject to Circular A-21 have complied with the CASB Standards and disclosure requirements incorporated therein.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

U.S. Department of Education Issues New Drawdown Procedures for Grant Payments

.22 Auditors with clients that receive grants from the U.S. Department of Education should be aware of changes in the procedures for grant payments accounting and reporting. A letter was issued in July 1996, notifying program recipients of the new drawdown procedures to take effect in 1997 between July and September. The fundamental change is that recipients will have to request Department of Education dollars by individual program when drawdowns are made. In the past, recipients were allowed to pool their drawdowns into a single amount without identifying the specific programs being funded. The new procedure may require many recipients to change their internal processes and systems. Auditors should consider this change when testing cash management in conjunction with single audits. Contact Charles L. Coleman, Director of Cash Management, U.S. Department of Education, for further information at (202) 401-1776.

SEC Municipal Bond Disclosure Requirements

.23 In response to concerns about the municipal securities market, the Securities and Exchange Commission (SEC) issued a final rule entitled *Municipal Securities Disclosure* that 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. 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*, chapter 19, "Association With Financial Statements Included in Official Statements," 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.

.25 Further, the SEC's 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 issues in this area.

Recent IRS Activities

.26 *Internal Revenue Service Audits.* The Internal Revenue Service (IRS) continues to increase its enforcement activities regarding tax-exempt municipal bonds. Currently, the IRS is reportedly auditing about 150 to 200 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 prohibited in certain cases. The IRS is also beginning a random audit program to determine the overall level of compliance in municipal bond offerings. 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.

.27 One of the abuses that the IRS has recently been targeting is yield-burning. This is the purchase by a governmental issuer of securities for an advance refunding escrow at artificially inflated prices. If the price

of a security increases, the yield decreases—hence the term *yield-burning*. Yield burning may be done without the knowledge of the issuer by others involved in the transaction. Nonetheless, the issuer is the one responsible under current tax laws. Revenue Procedure 96-41, *Compliance With Tax-Exempt Bond Arbitrage Requirements*, was issued by the IRS in mid 1996 as a possible remedy for yield burning in advance refunding escrows. Recently, however, the IRS has stated that it is considering withdrawing the procedure because many issuers have indicated that it is doubtful that they would utilize this remedy. Because of the IRS interest in yield-burning, issuers should examine past advance refundings. If open market securities were used to fund an escrow (as opposed to state and local government securities), the yield on the escrow is slightly below the bond yield, and the securities were not purchased using a legitimate bidding process, yield-burning may have occurred. Auditors should consider suggesting that bond counsel be consulted in such cases.

.28 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. Because 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 in 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.

.29 With respect to compliance matters, paragraph 11.34 of the Guide states that auditors should consider obtaining evidence that governmental entities have complied with the 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.

.30 *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, 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, especially since the IRS has recently confirmed that it will be auditing governmental entities.

.31 The IRS's Tax-Sheltered Annuity Voluntary Correction (TVC) program, which began in 1995, gives plan sponsors of Section 403(b) annuity plans the opportunity to voluntarily correct any plan defects. The program was scheduled to conclude October 1996. However, the IRS has recently announced that the program has been extended until December 31, 1998. 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.

.32 *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 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. Further, the reclassification of a worker from an independent contractor to employee for federal purposes is likely to cause a similar reclassification

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

for state tax purposes. Auditors should be alert to such misclassifications by employers, which can result in compliance problems and potential tax liabilities.

.33 There were three significant developments in this area during 1996. First, the IRS issued guidance to its agents regarding worker classification. This guidance provides practical instruction to IRS agents to help resolve questions regarding who is an employee and who is an independent contractor. Auditors should encourage their clients to consider this IRS guidance when making worker classification decisions. Second, the Small Business Job Protection Act of 1996 (Public Law 104-188) modified Section 530 of the Revenue Act of 1978, a relief provision sometimes invoked to enable individuals who are really employees to continue to be treated as independent contractors without consequence to employers. The changes made to Section 530 were generally favorable. Last, the IRS introduced a Classification Settlement Program to provide a streamlined tax settlement for situations in which Section 530 relief is not available (meaning that its requirements are not met), but an employer has at least consistently reported the affected individuals as independent contractors. In such a case, a reduced tax assessment may be available. This program is currently scheduled to be open for two years, beginning March 5, 1996.

IRC Section 457 Deferred Compensation Plans

.34 Many state and local governments have established deferred compensation plans for their employees under the provisions of IRC Section 457. The recently passed Small Business Job Protection Act of 1996 includes a provision that will require these plans to hold all assets in trust for the exclusive benefit of participants and their beneficiaries. This new requirement generally is effective for assets and income held by IRC Section 457 plans on or after August 20, 1996. However, for plans in existence before August 20, 1996, a trust need not be established before January 1, 1999.

.35 Before this new legislation, the amounts deferred under an IRC Section 457 plan were legally the property of the governmental employer, subject only to the claims of the employer's creditors. Governmental Accounting Standards Board (GASB) Statement No. 2, *Financial Reporting of Deferred Compensation Plans Adopted Under Provisions of Internal Revenue Code Section 457*, is based on this premise and, therefore, it generally requires that IRC Section 457 plans be displayed in an agency fund. Because the guidance in GASB Statement No. 2 was based on the Internal Revenue Code in effect at that time, the GASB has added a project to its technical agenda to amend GASB Statement No. 2 to adapt it to the new legislation. Auditors should be alert for guidance from the GASB in this area. In the meantime, if a governmental employer establishes a new plan or decides to set up a trust for an existing plan that would be subject to the new law, auditors should refer to GASB Statement No. 2, paragraph 3, which states that GASB Statement No. 2 does not apply to plans in which the deferred amounts are not required to be considered assets of the employer government and are not subject to the claims of the employer's general creditors.

Financial Assurance Mechanisms for Local Government Landfills

.36 Auditors should note that the U.S. Environmental Protection Agency (EPA) recently issued final regulations on the financial assurance provisions for local government owners and operators of municipal solid waste landfill facilities (*Federal Register*, November 27, 1996). The EPA rule allows local government landfill owners and operators that meet certain financial, public notice, and record keeping and reporting requirements to use a financial test to demonstrate financial assurance for closure, postclosure, and corrective action cost up to a specified maximum limit. If a local government meets the financial test, it must also place in an operating record the following:

- A certification by the local government's chief financial officer that the local government satisfies the requirements of the financial test
- Independently audited year-end financial statements for the latest year prepared in conformity with generally accepted accounting principles (GAAP), including an unqualified opinion by the independent auditor

- A report by an independent CPA or appropriate state agency based on performing a agreed-upon procedures engagement relative to the local government's financial ratios required by the EPA rule

Airport Revenue Diversion

.37 Auditors of public airports should be aware that the Federal Aviation Administration (FAA) issued a notice of proposed policy entitled *Policy and Procedures Concerning the Use of Airport Revenue* (*Federal Register*, February 26, 1996). More recently, the FAA issued a supplemental notice of proposed policy under the same title (*Federal Register*, December 18, 1996) to address additional issues that were raised in the comments received on the February notice. The proposed policy relates to federal grants received by public airports under the Airport Improvement Program (AIP). Among other things, the 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 the term *airport revenue* and also in response to reports that certain airports have appeared to be diverting revenue in ways that are 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.

.38 The proposal indicates that the FAA will be amending the OMB Compliance Supplement to address the use of airport revenue. However, auditors should be aware that the proposal also states that even though the policy statement is not yet effective, public airports should assume that the FAA would act consistently with the views expressed in the documents in any enforcement action for revenue diversion.

Audit Issues and Developments

Investment Policy Compliance

.39 Investment activity for governmental entities is generally governed by legal or contractual provisions and, in many cases, governments are precluded from purchasing certain investments, including derivatives. 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 the highly publicized investment problems encountered at various governments, many state and local governments have recently passed legislation regarding investment policies and/or the kinds of investments that are allowable.

.40 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 purchasing certain investments, auditors should be alert to possible violations of laws and regulations in this area. The Audit and Accounting Guide *Audits of State and Local Governmental Units*, states in paragraph 7.25, 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

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, this is not always the case. Taxpayer initiatives and limitations due to the lack of taxpayer resources have placed limits on some governments' taxing power. In

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

addition, many special-purpose governments do not have the power to raise fees or taxes without the support of some other governmental body. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), and the Audit and Accounting Guide *Audits of State and Local Governmental Units*, paragraphs 17.08 through 17.13, provide guidance concerning the auditor's consideration of an entity's ability to continue as a going concern.

.42 A more frequent occurrence in a governmental environment is for an auditor to conclude that a government will likely continue as a going concern, even though the government is experiencing financial difficulties. In this situation, auditors should consider the need for disclosure of the financial difficulties in the government's financial statements.

Recent Auditing Pronouncements Issued

.43 *SAS No. 80.* In December 1996, the AICPA Auditing Standards Board (ASB) issued SAS No. 80, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter (AU section 326). The Statement (AU section 326) amends SAS No. 31, *Evidential Matter* (AU section 326), to recognize that evidential matter may exist only in electronic form. It also provides guidance to auditors engaged to audit the financial statements of entities for which significant information is transmitted, processed, maintained, or accessed electronically. SAS No. 80 (AU section 326) recognizes that, in certain entities, some of the accounting data and corroborating evidential matter are available only in electronic form. Source documents such as purchase orders, bills of lading, invoices, and checks might be replaced with electronic messages. In image-processing systems, source documents are scanned and converted into electronic images to facilitate storage and reference, and the source documents may not be retained after conversion. SAS No. 80 (AU section 326) also states that, in entities in which significant information is transmitted, processed, maintained, or accessed electronically, the auditor may determine that it is not practical or possible to reduce detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. For example, the potential for the improper initiation or alteration of information to occur and not be detected may be greater if information is produced, maintained, or accessed only in electronic form. In such circumstances, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk, or consider the effect on his or her report. SAS No. 80 (AU section 326) is effective for engagements beginning on or after January 1, 1997.

.44 *SAS No. 81.* In December 1996, the ASB issued SAS No. 81, *Auditing Investments* (AU section 332), which supersedes SAS No. 1, section 332, *Long Term Investments.* The Statement (AU section 332) revises the guidance on auditing assertions about the valuation of investments, including guidance on auditing investments carried at cost and fair value. This guidance will be particularly useful to auditors of governmental entities with the recent issuance of GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools,* that will require many investments to be carried at fair value (see the separate discussion of this Statement in the section of this Audit Risk Alert entitled "Accounting Issues and Developments"). SAS No. 81 (AU section 332) is effective for audits of financial statements for periods ending on or after December 15, 1997, with early application permitted.

.45 *SAS No. 82.* In February 1997, the ASB issued SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AU section 316). The new Statement (AU section 316) will supersede SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU section 316A). SAS No. 82 (AU section 316) provides auditors with expanded guidance on the consideration of fraud in conducting a financial statement audit. It strengthens the auditor's ability to fulfill his or her responsibility to plan and perform the audit in order to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.

.46 The new Statement (AU section 316) describes the types of fraud and requires auditors to specifically assess the risk of material fraud in every audit. It also provides separate categories of risk factors for fraudul-

ent financial reporting (management fraud) and misappropriation of assets (theft) that require auditor consideration.

.47 In addition, the new Statement (AU section 316) provides procedural guidance and examples of how auditors can respond to the presence of fraud risk factors. The new Statement (AU section 316) reaffirms the requirement that auditors communicate known instances of fraud to the appropriate levels of management and the audit committee and, under certain circumstances, appropriate regulators.

.48 The new Statement (AU section 316) is effective for audits of financial statements for periods ending on or after December 15, 1997.

.49 The AICPA is undertaking a major initiative to assist auditors in understanding and implementing SAS No. 82 (AU section 316). Implementation efforts include the following:

- A Practice Aid entitled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, walks auditors through issues likely to be encountered in applying the new SAS (AU section 316) to audits, with valuable tools, such as sample documentation. It also provides specific guidance on applying the concepts of the SAS (AU section 316) to various industries, including government. To obtain this publication (No. 008883) auditors should contact the AICPA Order Department at (800) 862-4272 or fax a request to (800) 362-5066.
- A self-study continuing professional education (CPE) course (No. 732045) entitled *Consideration of Fraud in a Financial Statement Audit: The Auditor's Responsibilities Under SAS No. 82* offers intermediate level information in text format and eight hours of recommended CPE. To obtain the CPE course auditors should contact the AICPA Order Department.
- Helpful guidance about the new SAS (AU section 316), including a press release, speech outline, and a comparison of SAS No. 82 (AU section 316) with SAS No. 53 (AU section 316A), are available on the AICPA's home page at: http://www.aicpa.org/members/div/auditstd/index.htm.

Audit Quality

.50 The AICPA and the President's Council on Integrity and Efficiency (PCIE) are involved in a cooperative effort in which Federal Inspectors General (IGs) of government agencies refer to the AICPA Professional Ethics Division audits of entities receiving federal awards that the IGs consider to be of a substandard nature. Also, the PCIE issues periodic reports on the results of IG desk reviews and quality control reviews of work performed by independent auditors. Information gathered during these investigations and reviews about the most common deficiencies can be useful to auditors when undertaking, planning, and conducting audit engagements of entities receiving federal awards. Some of the more common deficiencies include the following:

- Deficient audit reports (incorrect reports on internal control or compliance, not all required information included, incorrect presentation of financial information without proper qualification, improper or missing opinion, incorrect or missing findings, no disclosure of reportable conditions)
- Inadequate working papers (failure to adequately support opinion, no documentation of required procedures such as internal control evaluation, analytical procedures, or subsequent events review)
- Failure to perform all procedures required in agency audit guide or compliance supplement (no compliance testing, no study and evaluation of internal control)

The risks and ramifications to auditors of issuing deficient audit reports or performing inadequate audits are significant. AICPA-required corrective actions and sanctions can include mandatory CPE in specified subjects, mandatory work product preissuance reviews, preclusion from performing quality reviews, and suspension or expulsion from the AICPA and state CPA society. Substandard audit work can also result in actions by state boards of accountancy such as fines and loss of license or certification.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Financial Statements on the Internet

.51 It has become more common for governmental entities to make information available on the Internet or electronic bulletin boards (electronic sites). Information in electronic sites may include financial statements and other financial information, press releases, and other promotional material. Auditors should be aware that an Interpretation of SAS No. 8 (AU section 550) entitled "Other Information in Electronic Sites Containing Audited Financial Statements" (AU section 9550.16–.18) has been issued to address an auditor's responsibility with respect to other information included in an electronic site if the audited financial statements and the independent auditor's report thereon are also included. The Interpretation (AU section 9550.16–.18) appeared in the March 1997 *Journal of Accountancy* and was effective upon publication.

.52 The Interpretation (AU section 9550.16–.18) concludes that electronic sites are a means of distributing information and are not documents in the sense that the term *documents* is used in SAS No. 8 (AU section 550). Therefore, auditors are not required by SAS No. 8 (AU section 550) to consider the consistency of information in electronic sites with the original documents or to read other information contained in electronic sites. The Interpretation (AU section 9550.16–.18) also addresses the situation in which auditors are asked by their clients to consider information in electronic sites. It advises auditors that such consideration, which might take different forms, is not a service contemplated by SAS No. 8 (AU section 550). However, other auditing or attestation standards may apply, for example, agreed-upon procedures.

.53 Auditors should also note that the AICPA issued a nonauthoritative Practice Alert entitled *Financial Statements on the Internet*, which describes the distribution of audited financial statements and the related auditor's report on the Internet and speaks to several concerns for the auditor community. The Practice Alert is available on the AICPA's Fax Hotline at (201) 938-3787, document number 1566, and the AICPA's home page at: http://www.aicpa.org/pubs/cpaltr/jan97/suppl/prac.htm.

Modifying Computer Systems for the Year 2000

.54 Many computer systems process transactions based on storing two digits for the year of a transaction (for example, *97* for the year 1997), rather than a full four digits. A significant number of computer systems based on two-digit years are not programmed to consider the start of a new century, unless they have been recently modified. Systems that process year 2000 transactions with the year *00* may encounter significant processing inaccuracies and even inoperability. The potential impact of the year 2000 problem on governments is that date-sensitive calculations would be based on erroneous data or could cause a system failure. All forms of financial accounting, including interest computations, due dates, pensions, personnel benefits, investments, and legal commitments will be affected. It can also affect record keeping, such as inventory, maintenance, and file retention.

.55 Fixing this problem will likely be a very long, involved, and expensive process for many governments, requiring computer coding changes that will affect millions of lines of program code. Costs specifically associated with modifying software for the year 2000 should generally be charged to expenditure or expense as incurred. It may be advisable for auditors to consider discussing this matter with their clients to determine whether it is an issue and to determine whether the costs incurred to date have been accounted for properly.

Lawyers' Letters

.56 An interpretation of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU section 337), was issued in January 1997. The Interpretation, entitled "Use of Explanatory Language Concerning Unasserted Possible Claims or Assessments in Lawyers' Responses to Audit Inquiry Letters" (AU section 9337.31 and .32), addresses a concern that the inclusion of certain explanatory comments in responses by lawyers to audit inquiry letters may result in a limitation on the scope of the audit. The Interpretation (AU section 9337.31 and .32) appeared in the January 1997 issue of the *Journal of Accountancy* and was effective upon publication.

.57 A number of lawyers include explanatory comments in their responses to audit inquiry letters that are intended to emphasize the preservation of the attorney-client privilege with respect to unasserted possible claims or assessments. These comments might include the following: "It would be inappropriate for this firm to respond to a general inquiry relating to the existence of unasserted possible claims or assessments involving the organization." The Interpretation (AU section 9337.31 and .32) states that the inclusion of this or similar wording in a lawyer's response does not result in a limitation on the scope of the audit. The Interpretation (AU section 9337.31 and .32) also reminds auditors of the requirement pursuant to SAS No. 12 (AU section 337) to obtain the lawyer's acknowledgment of his or her responsibility to advise and consult with the client concerning financial statement disclosure obligations with respect to unasserted possible claims or assessments.

Pre-Award Surveys

.58 As part of the process of applying for a government grant or contract, state and local governments may be required to submit a written preaward assertion (survey) by management about the effectiveness of the design of an entity's internal control or a portion thereof, together with an auditor's report thereon. An interpretation of AICPA Statement on Standards for Attestation Engagements 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), entitled "Pre-Award Surveys" (AT section 9400.01–.08), was issued in February 1997. The Interpretation (AT section 9400.01–.08) appeared in the February 1997 *Journal of Accountancy* and was effective upon publication. This Interpretation (AT section 9400.01–.08) was issued to clarify that there are certain things that an auditor should not do in conjunction with a client's preaward survey. The Interpretation (AT section 9400.01–.08) states that the consideration of internal control in a financial statement audit does not provide a sufficient basis for auditors to issue a report expressing any assurance about the effectiveness of the design of internal control or any portion thereof. Other questions that are answered in the Interpretation (AT section 9400.01–.08) include how auditors can report on the design effectiveness of an entity's internal control or a portion thereof, what auditors' responsibilities are if they are requested to sign a form prescribed by a government agency in connection with a preaward survey, and whether auditors can issue reports on an entity's ability to establish suitably designed internal control.

Accounting Issues and Developments

.59 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 1997. Other standards will not be effective until after 1997; 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 1997[1]

.60 *Pension Accounting.* In November 1994, the GASB issued the following three pension-related Statements:

- GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*
- GASB Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*

[1] Note that GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, is not included in this Audit Risk Alert because it was effective in 1996. Auditors should refer to the Statement for further information or the summary that appeared in last year's Audit Risk Alert, *State and Local Governmental Developments—1996*.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- GASB Statement No. 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 the 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, with early implementation encouraged. The GASB is working on the development of an Implementation Guide that is expected to be issued by mid 1997.

.61 Also, the GASB issued Technical Bulletin 96-1, *Application of Certain Pension Disclosure Requirements for Employers Pending Implementation of GASB Statement No. 27*, in August 1996. The Technical Bulletin clarifies some implementation issues associated with the new pension-related Statements and is effective for years beginning after June 15, 1996 or when a defined benefit pension plan adopted GASB Statement No. 25, if earlier. The provisions terminate when GASB Statement No. 27 becomes effective or when an employer implements GASB Statement No. 27, if earlier.

.62 *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. 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.

.63 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. 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.

.64 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 required, as well as the carrying amount and market or fair values of underlying securities at the balance sheet date.

.65 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.*

.66 *Risk Financing Omnibus.* In February 1996, the GASB issued GASB Statement No. 30, *Risk Financing Omnibus*, an amendment of GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and*

Related Insurance Issues, that is effective for financial statements for periods beginning after June 15, 1996, with early application encouraged. 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.

.67 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 Statements Effective After 1997, With Early Application Encouraged

.68 *Investments.* In March 1997, the GASB issued GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, which is effective for financial statements for periods beginning after June 15, 1997, with early application encouraged. For most governmental entities, GASB Statement No. 31 establishes fair value standards for investments in the following:

1. Participating interest-earning investment contracts
2. External investment pools
3. Open-end mutual funds
4. Debt securities
5. Equity securities, option contracts, stock warrants, and stock rights that have readily determinable fair values

However, governmental entities other than external investment pools are permitted to report certain money market investments and *participating* interest earning investment contracts at amortized cost, provided that the investment has a remaining maturity of one year or less at the time of purchase. Also, *nonparticipating* investment contracts (which includes most certificates of deposit) should be reported using a cost-based measure.

.69 GASB Statement No. 31 also establishes fair value accounting and financial reporting standards for all investments held by governmental external investment pools. An exception, however, is that external investment pools are permitted to report short-term debt investments at amortized cost, provided that the fair value of those investments is not significantly affected by the impairment of the credit standing of the issuer or other factors. For that purpose, a pool's short-term investments are those with remaining maturities of up to 90 days.

.70 For defined benefit pension plans and IRC Section 457 deferred compensation plans, GASB Statement No. 31 provides guidance for applying fair value to certain investment transactions.

GASB Interpretations Effective in 1997

.71 *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. This Interpretation provides disclosure requirements for conduit debt obligations. Con-

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

duit 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. 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.

.72 *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. 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.

.73 *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 Nos. 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. 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 the 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.

.74 This Interpretation requires public entity risk pools with the 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 the transfer or pooling of risk should net capitalization contributions with other amounts and report assets or liabilities, as appropriate.

GASB Exposure Drafts Outstanding

.75 *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments.* Issued in January 1997, this exposure draft would make sweeping changes to the financial reporting standards for state and local governments. The GASB is expected to issue a final Statement by mid 1998.

.76 *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities.* Issued in April 1997, this exposure draft would make sweeping changes to the financial reporting standards for public colleges and universities. The GASB is expected to issue a final Statement by mid 1998.

.77 *Accounting and Financial Reporting for Nonexchange Transactions.* Issued in March 1997, this exposure draft would establish accounting and financial reporting standards for nonexchange transactions. Nonex-

change transactions are those in which a government gives (or receives) value without directly receiving (or giving) equal value in exchange. The GASB is expected to issue a final Statement by mid 1998.

.78 *The Financial Reporting Entity: Affiliated Organizations.* Issued in December 1994, this exposure draft 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 GASB is expected to issue a final Statement by late 1997.

Other Accounting Matters

.79 *Accounting for the Costs of Joint Activities.* In February 1997, a proposed SOP, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising,* was cleared for final issuance by the Financial Accounting Standards Board (FASB) and GASB, subject to certain revisions. 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 otherwise might be considered program or management and general costs if they had been incurred in a different activity, unless the criteria of purpose, audience, and content, as defined in the SOP, are met. If the criteria of purpose, audience, and content are met, the joint costs of those activities would be allocated and costs that are clearly identifiable with fund-raising, program, or management and general functions would be charged to that cost objective.

.80 The proposed SOP would be effective for years beginning on or after December 15, 1997. The AICPA is in the process of drafting those revisions and expects to issue the final SOP in the summer of 1997.

References for Additional Guidance

AICPA

.81 *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* (No. 012056)
- *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 (COSO) 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.

.82 *AICPA Continuing Professional Education Courses.* The AICPA offers continuing professional education (CPE) in the form of both group study and self-study courses. Group study courses include the following:

- Audits of HUD Regulated Lenders
- Audits of HUD-Assisted Projects
- Advanced Auditing of HUD-Assisted Projects
- Compliance Auditing
- Cost Principles for Nonprofit Organizations under OMB Circular A-133

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- Governmental Auditing and Accounting Update
- How to Perform an Audit of a State or Local Government
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations
- Single Audit Requirements for Nonprofit and Government Organizations
- Workpaper Preparation Techniques for Government and Nonprofit Organizations
- Yellow Book: *Government Auditing Standards*

.83 Self-study courses include the following:

- Introduction to Governmental Accounting
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations
- Single Audit Requirements for Nonprofit and Governmental Organizations
- How to Perform an Audit of a State and Local Government
- Understanding Federal Audit Policies and Procedures
- Working With the Revised Yellow Book on Government Auditing Standards
- HUD Audits: A Comprehensive Guide
- Governmental Auditing and Accounting Update
- Introduction to OMB Circular A-87
- Compliance Auditing
- Audits of Rural Development and Housing Programs
- Communicating Material Noncompliance and Internal Control Weaknesses

.84 The following video courses are also available:

- Effective Yellow Book Auditing
- 1997 Government Auditing and Accounting

.85 For more information about AICPA CPE courses, call the AICPA information hotline at (800) 862-4272.

.86 *AICPA Home Page.* The AICPA has established a home page on the World Wide Web. "AICPA Online," the AICPA's Web site (http://www.aicpa.org), offers members a unique opportunity to obtain AICPA and accounting-related material when they need it. CPAs can benefit tremendously by using online resources such as professional news, membership information, state and federal legislative updates, AICPA press releases, speeches, and exposure drafts, among other things. There is also a "Talk to Us" section for members who want to send E-mail messages directly to AICPA representatives or teams. Also, with a comprehensive list of links to other accounting- and finance-related sites, "AICPA Online" serves as a gateway to additional Internet resources.

.87 *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

.88 The GASB offers the following publications and services:

- *Codification of Governmental Accounting and Financial Reporting Standards*, as of June 30, 1996 (GCD96)—An edition as of June 30, 1997, is expected to be issued in late summer 1997.
- *GASB Original Pronouncements*, as of June 30, 1996 (GOP96)—An edition as of June 30, 1997, is expected to be issued in late summer 1997.
- *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. The GASB is also expected to issue implementation guidance on its Pension Statements (GASB Statement Nos. 25, 26, and 27) by mid 1997.
- *GASB Home Page*—Information about the GASB can be found on a World Wide Web home page site. The GASB address is http://www.financenet.gov/gasb.htm. Items that can be found include "Facts about GASB," summaries of all final GASB documents and of current due process documents, a list of publications, a list of Board members and staff with their E-mail addresses, and the technical plan for the current quarter.
- *Fax Information System*—The GASB has a twenty-four-hour fax system that enables interested persons to obtain information on upcoming meetings, the current technical plan, and "Facts about GASB." To access the system, dial (203) 847-0700, extension 14 from a fax machine, and follow the voice cues.
- 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 10.

Federal Agencies—Administrative Regulations

.89 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.*

.90 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.*

.91 Auditors should also be aware that many agencies have program-specific and other audit requirements that are not covered by OMB Circular A-133. Such requirements may relate to certain programs (such as student financial assistance or HUD-insured mortgage programs), as well as to contract audit requirements. Auditors may want to refer to the PCIE's *Revised Program Audit Guide Listing* for a summary of federal programs that have separate audit guides (see the section herein entitled "PCIE Audit Committee Guidance" for more details).

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

General Accounting Office

.92 General Accounting Office (GAO) publications include the following:

- *Government Auditing Standards, 1994 Revision*—These standards, also referred to as the Yellow Book, relate to audits of government organizations, programs, activities, and functions, and of government funds received by contractors, nonprofit organizations, and other nongovernment organizations. The standards incorporate the AICPA Statements on Auditing Standards for fieldwork and reporting, and prescribe the 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 (GPO), 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 GPO, Superintendent of Documents, Washington, DC 20401.

- *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).

- *Guide to Federal Agencies' Procurement of Audit Services from Independent Public Accountants*—This booklet provides a basic understanding of how independent public accountant (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).

- *Assessing Risks and Returns: A Guide for Evaluating Federal Agencies' IT Investment Decision-making*—This guide provides a structure for evaluating and assessing how well a federal agency is selecting and managing its information technology resources and to identify specific areas where improvements can be made (February 1997, GAO/AIMD-10.1.13).

- *Executive Guide: Improving Mission Performance Through Strategic Information Management and Technology*—This guide focuses on what agencies can do to improve performance by using new approaches to managing information and their related technologies (May 1994, GAO/AIMD-94-115).

- *Executive Guide: Effectively Implementing the Government Performance and Results Act*—This guide identifies key steps that agencies need to take towards the implementation of performance measurement, along with practices that can make implementation a success (June 1996, GAO/GGD-96-118).

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. Orders may also be placed by using the fax number (301) 258-4066. For copies of GAO reports and testimony, the status of GAO's open recommendations, and GAO's audit policy, check the GAO home page at: http://www.gao.gov. The GAO home page also contains the electronic version of *Government Auditing Standards*. For information on how to access GAO reports or other documents on the Internet, send an E-mail message to info@www.gao.gov.

Office of Management and Budget

.93 *Circulars.* OMB issues grants management circulars to establish uniform policies and rules to be observed by federal agencies for the administration of federal grants. Federal agencies then adopt these circulars in their regulations. The process for issuing grants management circulars includes due process with a notice of any proposed changes in the *Federal Register*, a comment period, and careful consideration of all

responses before issuance of final circulars. 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 Office of Administration, Publications Office, Room 2200, New Executive Office Building, Washington, DC 20503; telephone (202) 395-7332 or check the OMB home page at http://www.whitehouse.gov/WH/EOP/OMB/html/ombhome.html. An alternate address is http://www.sbaonline.sba.gov/ignet/.

OMB Circulars Relevant to Audits of State and Local Governments and Not-for-Profit Organizations

Circular Number	*Applicability*	*Issue Date*
A-21 (Revised)	Cost principles for educational institutions	May 1996
A-87 (Revised)	Cost principles for state, local, and Indian tribal governments	May 1995
A-102 (Revised)	Grants and cooperative agreements with state and local governments	October 1994
A-122 (Revised)	Cost principles for nonprofit organizations	October 1995
A-133 (Revised)	Audits of states, local governments, and nonprofit organizations	Revision expected before June 30, 1997

.94 *OMB Circular A-133 Compliance Supplement.* The OMB Compliance Supplement sets forth the major federal compliance requirements that should be considered in an audit of states, local governments, and nonprofit organizations that receive federal assistance. It supplements OMB Circular A-133. A revision to the Supplement is expected to be issued before June 30, 1997. For a separate discussion of the Compliance Supplement, see the section of this Audit Risk Alert entitled "Regulatory, Legislative, and Other Developments."

.95 *Other Guidance.* The *Catalog of Federal Domestic Assistance (CFDA)* 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. A searchable version of the CFDA is available on the GSA home page, which is currently located at http://www.gsa.gov/fdac.

.96 Program information provided by the catalog includes authorizing legislation and audit requirements. The GSA makes copies available to certain specified national, state, and local government offices. Catalog staff may be contacted at (202) 708-5126. The catalog may be purchased from the GPO by calling (202) 783-3238.

.97 Program information is also available on machine-readable magnetic tape. The tape may be purchased by writing the Federal Domestic Assistance Catalog Staff (WKU), General Services Administration, Ground Floor, Reporters Building, 300 Seventh Street, SW, Washington, DC 20407, or calling (202) 708-5126.

PCIE Audit Committee Guidance

.98 The PCIE Audit Committee publishes supplemental, nonauthoritative guidance for federal officials addressing issues arising from the implementation of the Single Audit Act and related OMB Circulars.

.99 The PCIE Audit Committee (or its predecessors) has issued the position statements listed in the following. These position statements were developed to address issues related to audits conducted under

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

the Single Audit Act of 1984, OMB Circular A-128, and the March 1990 version of OMB Circular A-133. With the exception of PCIE Statement No. 4, none of the position statements are applicable to audits conducted under the Single Audit Act Amendments of 1996 or the April 1996 OMB Circular A-133 (or subsequent versions).

- PCIE Statement No. 1 provides guidance on determining whether 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.

PCIE 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. PCIE Statement No. 6 (stock number 041-1-374-6) is available from the GPO, Superintendent of Documents, Mail Stop: SSOP, Washington, DC 20402-9328; telephone (202) 783-3238. All PCIE position statements are available on IGnet, the Inspectors General Internet site. The Internet address is http://www.sbaonline.sba.gov/ignet/. The position statements are located in the Single Audit Library.

.100 The PCIE has also issued the following:

- *Uniform Desk Review Guide of A-128 Single Audits* (last published in 1991) (PCIE-6-56)
- *Uniform Quality Control Review Guides for A-128 Single Audits* (last published in 1991) (PCIE-6-57)
- *Revised Program Audit Guide Listing* (July 1993) (stock number 065-0-585-9)
- *Study on Improving the Single Audit Process* (September 1993) (stock number 065-0-615-4)

Copies of the *Uniform Desk Review Guide* and the *Uniform Quality Control Guide* are available from the U.S. Department of Education, Office of Inspector General, at the preceding address and telefax number. The *Revised Program Audit Guide Listing* and the *Study on Improving the Single Audit* are available from the GPO at the above address. All of the above documents are also available for download from the Single Audit Library of IGnet, at the preceding Internet address.

Government Finance Officers Association

.101 The address, telephone number, and fax number of the Government Finance Officers Association (GFOA) are 180 N. Michigan Avenue, Suite 800, Chicago, IL 60601-7476; phone (312) 977-9700, fax (312) 977-4806, Internet address: http://www.financenet.gov/gfoa.htm. 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 to assist those wishing to use the GAAFR for instructional or self-study purposes.)
- *The GAAFR Review Guide to GASB Pronouncements*—This book presents edited articles from the GFOA newsletter *GAAFR Review* that cover all of the statements and interpretations issued by the GASB. It also includes relevant articles from the newsletter on the proper application of the provisions of GASB pronouncements.
- *A Preparer's Guide to Note Disclosures*—This guide compiles all current authoritative guidance on thirty-six key disclosure topics 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.
- *An Elected Official's Guide to Internal Control and Fraud Prevention*—This booklet explains the nature and purpose of internal controls and how those controls can be made more effective at all levels. It also presents examples of some of the types of fraud encountered in the public sector.
- *A Guide to Arbitrage Requirements for Governmental Bond Issues* and *1994 Supplement*—These two publications present a comprehensive overview of federal arbitrage requirements.
- *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 Statistical Sections of 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*

* * * *

.102 This Audit Risk Alert supersedes *State and Local Governmental Developments—1996.*

* * * *

.103 Auditors should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1996/97* [AAM section 8010].

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

References to Useful Web Sites

.104 The following listing summarizes the various web sites of many of the organizations referred to in this Audit Risk Alert.

Organization	*Web Site Address*
AICPA	http://www.aicpa.org
FinanceNet	http://www.financenet.gov
General Accounting Office	http://www.gao.gov
General Services Administration	http://www.gsa.gov
Governmental Accounting Standards Board	http://www.financenet.gov/gasb.htm
Government Finance Officers Association	http://www.gfoa.org
IGnet	http://www.sbaonline.sba.gov/ignet/
U.S. Department of Education Office of Inspector General Non-Federal Audit Team	http://www.gvi.net/~edoig/
U.S. Department of Housing and Urban Development Office of Inspector General	http://www.hud.gov/oig.html
U.S. Office of Management and Budget	http://www.whitehouse.gov/WH/EOP/OMB/html/ombhome.html

[*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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

- 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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

- 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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

(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].

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			

Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

.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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

- 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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

.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.

* * * *

.47 This Audit Risk Alert supersedes *Airline Industry Developments—1992.*

* * * *

.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].

.49

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		

Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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 environ-

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

ment, 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).

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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 organiza-

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

tions. 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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

.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.

* * * *

.45 This Audit Risk Alert supersedes *Common Interest Realty Associations Industry Developments—1993.*

* * * *

.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].

.47

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.]

Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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).

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

- 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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

- 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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

* * * *

.61 This Audit Risk Alert supersedes *Casino Industry Developments—1994.*

* * * *

.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].

Copyright © 1995, American Institute of Certified Public Accountants, Inc.

.63

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		

[The next page is 8247.]

AAM Section 8120

Construction Contractors Industry Developments—1996/97

Industry and Economic Developments

.01 Over the past several years, the construction industry has experienced increased levels of growth—thus reversing the steep declines of the early 1990s that resulted from speculative building during the previous decade. This trend toward steady, moderate growth appears to be continuing in the current year as evidenced by the industry's profitable first half.

.02 Residential building, led by single-family home construction, has had the most significant impact on the industry's continued resurgence. The level of activity in new home construction, as monitored by the United States Department of Commerce, increased by 1.3 percent during the month of June. This increase in housing starts represents a seasonally adjusted annual rate of 1.48 million—its highest level since April 1994.

.03 The housing sector of the construction industry is considered to be highly sensitive to interest rate changes. Housing starts typically increase when interest rates decline, and decrease when interest rates rise. But while this year's increase in housing starts is consistent with strong employment and other positive economic conditions, it also seems to be running counter to the current trend in interest rates. The yield on thirty-year United States Treasury bonds, which is considered a long-term interest rate benchmark, rose to over 7 percent at midyear, after ending 1995 at about 6 percent. This increase had driven up thirty-year mortgage rates from a low of 6.94 percent in February to 8.4 percent by July. Nevertheless, housing starts and new home sales have increased steadily this year. Industry observers suggest that these higher interest rates did not immediately affect demand because home buyers had the option to secure more affordable financing by obtaining adjustable-rate mortgages. Interest rates on these mortgages, which are tied to short-term market rates, have risen far less this year than those on fixed-rate mortgages. Additionally, although the rate increases priced some buyers out of the market, they may also have prompted a surge of purchases by previously hesitant buyers seeking to avoid further increases. However, industry economists believe that the effect of rising interest rates will ultimately depress the housing market, and therefore are predicting a slowdown in growth for housing starts in the second half of 1996. They also believe that the following factors reinforce the notion that home sales and new construction have hit their peak:

- Applications for building permits for single-family homes dropped 1.2 percent in June.
- Although mortgage applications in the second quarter matched first quarter volume, both were well below 1995 fourth-quarter activity.
- The recent growth in housing construction is likely to be viewed by the Federal Reserve Board as a reason to raise interest rates.
- A slowdown in the overall economy is expected for the second half of 1996.

.04 Current favorable economic conditions along with the prospect of a second-half slowdown have implications for audit risk that auditors may wish to consider. The following are examples—

- Auditors should be alert to the potential for management to use overly optimistic assumptions when developing estimates under favorable economic conditions. Also, in the event of a change in economic conditions during the second half, such assumptions, unless revised, may result in material misstatements.

- Auditors should note that business decisions (such as, undertaking new construction projects) made by construction contractors during periods of economic growth may not have an immediate positive impact on the contractor's results of operations due to the length of the start-up period and the contract term. As a result, such projects cannot always be expected to improve short-term results. Auditors may wish to consider this fact when developing independent expectations relating to client estimates or when applying analytical procedures to evaluate the reasonableness of financial statement assertions.

- Even under favorable economic conditions, a high level of inherent risk is 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. See the "Auditing Estimates" section of this Audit Risk Alert for further discussion of this issue.

- A change in economic conditions in the later half of 1996 may affect a large number of construction contractors' business decisions. For example, contractors may enter into high-risk contracts with uncreditworthy customers in the hope of maintaining the results achieved earlier in the year. In this circumstance, the auditor's assessment of the proper valuation of receivables from such customers may take on increased importance. Auditors may wish to consider applying such procedures as reviewing subsequent cash receipts, assessing customer financial viability and past payment performance, and evaluating the adequacy of allowances for doubtful accounts.

.05 Apartment construction should continue its pattern of growth from the previous year. Construction is expected to begin on 290,000 apartments in 1996, up from 274,000 units started in 1995.[1] This segment of the industry is typically volatile, though less sensitive than other forms of housing to interest-rate fluctuations. Evidence of this volatility can be seen in the 20 percent decrease in apartment construction for the month of June—after a 6 percent gain in May. Despite this isolated drop, construction of new apartments is expected to increase overall by 10 percent this year.

.06 Nonresidential construction tends to follow business cycles rather than other economic trends. In addition, unlike housing, which is a leading economic indicator, nonresidential construction generally lags behind the economy by about a year. Growth in this segment has remained relatively flat through the first half of 1996 and no significant change is expected for the remainder of the year. Within the nonresidential segment:

- Retail construction is closely tied to the consumer sector and therefore tends to mirror housing and employment trends. However, construction growth in this sector is expected to decline to perhaps as much as 10 percent less than last year's growth, given numerous consolidations and bankruptcies in the retail industry, along with expectations of lower retail sales revenues in the second half.[2] Growth from the aggressive expansion of some major retail chains will be largely offset by the contraction of smaller retailers.

- Office construction is expected to do well this year due in large part to the growth of companies in the high-technology sector.[3] As a result, office vacancy rates are expected to continue their decline throughout many parts of the country. The strength of the office market can be seen not only in the "build-to-suit" projects currently under way, but also in the rise of speculative office building construction where work begins with as little as 50 percent of the project preleased. Many expect this segment of the industry to perform better this year than it has in over a decade. Some markets however, such as the business districts of Los Angeles and downtown Dallas, will continue to struggle due to overcapacity. And all markets are likely to face competitive threats from improved and less expensive telecommunication capabilities which will, for some, obviate the need to maintain a business district location.

---

[1] By comparison, the number of apartment units started in 1985 was 670,000, so although the trend is upward, the increase does not compare favorably with past performance.

[2] See the Audit Risk Alert, *Retail Industry Developments—1996/97* [AAM section 8230].

[3] See the Audit Risk Alert, *High-Technology Industry Developments—1996/97* [AAM section 8200].

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.07 Nonbuilding construction, which includes public works and utilities, rose slightly by midyear but only modest growth is anticipated for the remainder of the year. This category of construction generally consists of long-term, publicly financed projects that are typically less sensitive to economic conditions than other segments of the industry.

.08 Regional variations in the performance of construction industry segments may differ significantly from national trends. See Exhibit 1, "Regional Analysis of Conditions in the Construction Industry."

Audit Issues and Developments

Impairment of Long-Lived Assets

.09 In March 1995, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08), which requires that long-lived assets and certain identifiable intangibles and goodwill related to those assets 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. 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 costs 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. The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. Accordingly, this is the first year that auditors will evaluate management's implementation of the Statement (AC I08).

.10 FASB Statement No. 121 (AC I08) is likely to have a significant impact on many construction contractors, given the inherently capital-intensive nature of the industry. Auditors may face issues relating to the recoverability of the carrying amount of certain long-lived assets if, as expected, a general economic slowdown occurs in the latter part of 1996. In evaluating a construction contractor's implementation of FASB Statement No. 121 (AC I08), major issues to be considered by auditors include the following:

- *The appropriate classification of long-lived assets as either those being held and used or those to be disposed of.* Auditors should obtain an understanding of the policies and procedures used by the contractor to classify long-lived assets pursuant to FASB Statement No. 121 (AC I08), as well as evaluating whether those classifications are proper.
- *The identification of events or circumstances indicating that the carrying amounts of assets to be held and used may not be recoverable.* Auditors should obtain an understanding of the policies and procedures used by the contractor to identify such events and circumstances. Examples of such events and circumstances could include the following:
  - — A dramatic change in the manner in which an asset is used
  - — A reduction in the extent to which an asset is used
  - — Forecasts showing lack of long-term profitability
  - — A change in the law or business environment
  - — A substantial drop in the market value of an asset
- *The assumptions used in the underlying calculation of estimated future cash flows when testing for asset impairment used in management's impairment test, and assumptions used in estimating the fair value of assets for which an impairment loss is to be recognized.* A contractor's estimate of future cash flows from asset use and the fair value of assets used in calculating impairment losses should be evaluated pursuant

to the guidelines set forth in AICPA Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates* (AU section 342). Procedures to be employed should include one or a combination of the following: (1) reviewing and testing the process used by management to develop the estimates, (2) developing an independent expectation to corroborate the reasonableness of the estimates, (3) reviewing subsequent events or transactions occurring before the completion of fieldwork.

- *The recording of assets to be disposed of at the lower of carrying amount or fair value less costs to sell.* Auditors should verify that the contractor has appropriately classified and valued long-lived assets to be disposed of.
- *The disclosure requirements of FASB Statement No. 121.* Auditors should verify that all disclosure requirements of FASB Statement No. 121 (AC I08) have been included in the contractor's financial statements.

Auditing Estimates

.11 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. A high level of audit risk associated with a contractor's estimates is likely, given the current economic environment. For example, estimates based on assumptions developed during the first half of the year may no longer be valid if a second-half economic slowdown occurs. In such circumstances, auditors should consider whether the contractor has made appropriate revisions.

.12 Proper implementation of the percentage-of-completion method (see the "Revenue Recognition" section of this Audit Risk Alert) 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.

.13 Auditors should consider the effect of current industry and economic conditions along with expected future trends on management's estimation process. The following are examples—

- With slower growth forecast for the housing sector, there is increased risk that some construction contractors may be inclined to offset lower revenue growth by underestimating costs to complete.
- Based on expectations of continued low inflation, management may underestimate future price escalations.
- Estimates of future financing costs may be understated by using current interest rates rather than projected rates, which are likely to be higher.

.14 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 internal control 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.

.15 Given the significant effect of the estimating process on the profit or loss associated with each contract, auditors should carefully evaluate evidence supporting all material estimates. SAS No. 57 (AU section 342)

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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).

.16 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. Auditors may wish to compare client-generated information with industry statistics to assess the reasonableness of financial statement assertions. The "Information Sources" section of this Audit Risk Alert contains the names of several industry associations that may be helpful in obtaining such statistics. Authoritative guidance on the use of analytical procedures by auditors is set forth in 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.

.17 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, for example, interpret complex contractual arrangements or evaluate a construction project's percentage of completion or estimates of costs to complete.

.18 Auditors should also carefully consider the effects of post-balance-sheet events on both the estimation process and 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.

Change Orders and Claims

.19 Change orders are modifications of an original contract that effectively alter the provisions of the contract without adding new provisions. They may be initiated by either the contractor or the customer, and they may include changes in specifications or design, method or manner of performance, facilities, equipment, materials, site, and period for completion of the work. Many change orders are unpriced; that is, the work to be performed is defined, but the adjustment to the contract price is to be negotiated later. For some change orders, both scope and price may be unapproved. In the current year, auditors are likely to see modifications to the contractual provisions of their client's construction projects in circumstances such as the following—

- In anticipation of a second-half economic slowdown in the housing industry, change orders might call for a reduction in the scope of a project in order to lower its overall cost.

- Change orders might expand existing construction plans due to the increased demand that may occur in the apartment sector given the growth rate of 10 percent that is expected for the current year.

In these circumstances, auditors should pay close attention to receivables arising from change orders. Auditors may wish to consider—

- Confirming the amounts of unapproved change orders with owners.
- Obtaining written representations from management and/or the client's legal counsel regarding change orders.
- Evaluating control procedures in place relating to unapproved change orders.
- Assessing the quality and extent of documentary evidence supporting the change order.
- Evaluating the impact of change orders on total contract revenue and costs calculated under the percentage of completion method.
- Assessing the propriety of underlying accumulated costs.
- Evaluating the existence and collectibility of revenues related to unapproved change orders.

.20 Claims are amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or others. These amounts may be attributable to customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs. Recognition of the amounts of additional contract revenue relating to claims is appropriate only if it is probable that the claim will result in additional contract revenue and if the amount can be reliably estimated. Those two requirements are satisfied by the existence of all the following conditions:

1. The contract or other evidence provides a legal basis for the claim; or a legal opinion has been obtained, stating that under the circumstances there is a reasonable basis to support the claim.
2. Additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance.
3. Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed.
4. The evidence supporting the claim is objective and verifiable, based on neither management's "feel" for the situation nor unsupported representations.

If the foregoing requirements are met, revenue from a claim should be recorded only to the extent that contract costs relating to the claim have been incurred. The amounts recorded, if material, should be disclosed in the notes to the financial statements. Costs attributable to claims should be treated as costs of contract performance as incurred. Auditors may wish to consider performing procedures similar to those cited previously for change orders.

Control Environment

.21 Many construction contractors are small, family-owned businesses operating as sole proprietorships. Internal control in these entities often includes unique characteristics that may affect an auditor's assessment of control risk. Characteristics that may increase control risk include the following:

- The entire accounting function of a small, closely-held construction contractor may be the responsibility of one or a few employees, with inadequate segregation of duties. Also, owners or managers often have the authority to override prescribed control activities.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- Owners and managers of construction entities frequently are entrepreneurs who may be more likely to give priority to the business of building over accounting systems and related control activities. As a result, internal control, accounting, and financial reporting functions may receive less support and attention than might be warranted.
- Owners and managers of small construction entities may not be well versed in matters of accounting, finance, and administration.
- The limited resources of some smaller contractors may engender informal accounting systems with inadequate internal control.

.22 If a construction contractor's internal control includes the preceding 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 as required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319).[4] 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.

.23 When assessing control risk, auditors may wish to consider whether the contractor has established control procedures to provide reasonable assurance of the following:

- Estimates of contract revenues and costs are updated periodically and reported to the appropriate levels of management.
- Revenue recognition is based on current estimates of progress in terms of cost incurred, physical completion of work, or another appropriate measure.
- Recorded contract revenues are periodically compared with contract terms for compliance.
- Change order and claim revenues are recognized in conformity with generally accepted accounting principles (GAAP).
- Adjustments to previously recognized contract profits resulting from management decisions are thoroughly documented.
- Revenues recognized on all contracts during the period are reconciled to the total revenues reflected in the financial statements.
- Management reporting of estimate updates provides sufficient information to allow for the determination of whether a contract loss reserve is required.

Job Site Visits

.24 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 conditions may increase the risk that construction contractors will be overly optimistic in establishing estimates. 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 below the maximum or when the

[4] SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AU section 319), revises the definition and description of internal control and makes conforming changes to relevant terminology. SAS No. 78 (AU section 319) was issued in December 1995 and is effective for audits of financial statements for periods beginning on or after January 1, 1997. See the "New Pronouncements" section for further discussion of this matter.

related accounts cannot be substantiated by other procedures. Yet another 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 the following:

- Identify uninstalled materials that should be excluded when measuring progress toward completion and noting physical security over such materials.
- Discuss with job site personnel the status of labor hours incurred to date and estimates to complete, including an evaluation of 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.
- Observe contractor-owned or rented material.
- Discuss with job site personnel issues that may affect the estimated total gross margin, such as problems encountered or operational inefficiencies.

Other Auditing Considerations

.25 *Retentions.* Contracts are sometimes structured so that the client may be permitted to withhold payment of a portion of the total contract price pending the completion of the contract or the occurrence of some specified event. In certain instances, these amounts may be retained for extended periods of time. Thus, auditors will need to assess the ultimate collectibility of such retentions. In doing so, auditors should understand the contractual provisions under which such amounts are withheld; the specified events or circumstances upon which these amounts are to be remitted; and the likelihood of such conditions being satisfied and the retentions being remitted.

.26 *Progress Payments.* Certain fixed-price contracts may be financed by way of progress payments made by the customer over the term of the contract. In examining this area auditors may wish to consider the following procedures:

- Conduct a review of subsequent cash receipts.
- Analyze activity in the progress payments accounts such as progress billings and progress payments received.
- Analyze the underlying costs incurred by the contractor.

New Pronouncements

Auditing Standards

.27 *SAS No. 75.* In September 1995, the Auditing Standards Board (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 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.

.28 *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 is effective for letters issued pursuant to paragraph 9 of SAS No. 72 (AU section 634.09) after April 30, 1996.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.29 *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, 544, 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 is effective for engagements beginning after December 15, 1995.

.30 *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 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. 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.

.31 *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 does not affect SAS No. 59 (AU section 342) 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.

.32 A table outlining the significant provisions aspects of the newly issued auditing standards is set forth in Exhibit 2, "Significant Provisions of Newly Issued SASs" of this Audit Risk Alert.

Attestation Standards

.33 *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 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.

.34 *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 provides guidance on the quantity, type, and content of working papers for attestation engagements and is effective for engagements beginning after December 15, 1995.

.35 *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 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 the discussion in the preceding section) and *Internal Control—Integrated Framework.* The amendment 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.

.36 *Quality Control Standards.* 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.

.37 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 201.01), and 202, *Compliance With Standards* (ET section 202.01), 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: (1) independence, integrity, and objectivity; (2) personnel management; (3) acceptance and continuance of clients and engagements; (4) engagement performance; and (5) 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.

Ethics Ruling—Indemnification of a Client

.38 Recently, the AICPA Professional Ethics Executive Committee issued Ethics Ruling No. 102, *Member's Indemnification of a Client* (ET section 191.204 and .205), as published in the January 1996 *Journal of Accountancy*. This ruling (ET section 191.204 and .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. In assessing their independence, auditors of construction contractors should consider the implication of indemnification arrangements requested by their clients, in light of this new ethics ruling (ET section 191.204 and .205).

AICPA Exposure Drafts: Proposed SASs

.39 *Consideration of Fraud in a Financial Statement Audit.* In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Consideration of Fraud in a Financial Statement Audit and Amendments to Statements on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures, *and No. 47,* Audit Risk and Materiality in Conducting and Audit. The proposed Statement would provide expanded operational guidance on the consideration of fraud in conducting a financial statement audit. The proposed changes in auditing standards also clarify the auditor's current responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud. In addition, the proposed changes provide added guidance on the standard of due professional care in the performance of work, including the need to exercise professional skepticism, and the concept of reasonable assurance. In addition to amending SAS Nos. 1 (AU sections 110 and 230) and 47 (AU section 312), the proposed Statement would—

- Describe fraud and its characteristics.
- Require the auditor to specifically assess the risk of material misstatement due to fraud and provide categories of fraud risk factors that should be considered in the auditor's assessment.
- Provide guidance on how the auditor should respond to the results of the assessment.
- Provide guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud.
- Describe related documentation requirements.
- Provide guidance regarding the auditor's communication about fraud to management, the audit committee, and others.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.40 *Amendment to SAS No. 31,* Evidential Matter. In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Amendment to SAS No. 31,* Evidential Matter. This proposed Statement would provide guidance for a practitioner who has been engaged to audit an entity's financial statements where significant information is transmitted, processed, maintained, or accessed electronically. The proposed Statement would include examples of evidential matter in electronic form and provide that an auditor should consider the time during which such evidential matter exists or is available in determining the nature, timing, and extent of substantive tests. In addition, the proposed Statement would indicate that an auditor may determine that, in certain engagement environments where evidential matter is in electronic form, it would not be practical or possible to reduce detection risk to an acceptable level by performing only substantive tests. The proposed Statement would provide that in such circumstances, an auditor should consider performing tests of controls to support an assessed level of control risk below the maximum for affected assertions.

.41 *Investments in Debt and Equity.* In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Investments in Debt and Equity.* This proposed Statement would revise the guidance on auditing investments to make that guidance consistent with recently issued accounting standards, particularly FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80).

Accounting Issues and Developments

Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities

.42 In June 1996, the FASB issued FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities.* This Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishment of liabilities. Those standards are based on consistent application of a financial-components approach that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. This Statement provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

.43 A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interest in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

1. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
2. Either (*a*) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right—to pledge or exchange the transferred assets or (*b*) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.
3. The transferor does not maintain effective control over the transferred assets through (*a*) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (*b*) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

.44 FASB Statement No. 125 requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interest in transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

.45 FASB Statement No. 125 requires that servicing assets and liabilities be subsequently measured by (*a*) amortization in proportion to and over the period of estimated net servicing income or loss and (*b*) assessment for asset impairment or increased obligation based on their fair values.

.46 FASB Statement No. 125 requires that debtors reclassify financial assets pledged as collateral and that secured parties recognize those assets and their obligation to return them in certain circumstances in which the secured party has taken control of those assets.

.47 FASB Statement No. 125 requires that a liability be derecognized if and only if either (*a*) the debtor pays the creditor and is relieved of its obligation for the liability or (*b*) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

.48 FASB Statement No. 125 provides implementation guidance for assessing isolation of transferred assets and for accounting for transfers of partial interest, servicing of financial assets, sercuritizations, transfers of sales-type and direct financial lease receivables, securities lending transactions, repurchase agreements including "dollars rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishment of liabilities.

.49 FASB Statement No. 125 supersedes FASB Statements No. 76, *Extinguishment of Debt*, and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. This Statement amends FASB Statement No. 115 (AC I80) to clarify that a debt security may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. This Statement amends and extends to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (AC Mo4), and supersedes FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*. This Statement also supersedes Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt*, No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)* and No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*.

.50 FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishment of liabilities occurring after December 31, 1996, and is to be applied prospectively. Earlier or retroactive application is not permitted.

Delayed Effective Dates—Accounting Pronouncements

.51 *Disclosures about Fair Value of Financial Instruments.* FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), issued in December 1991, was effective for financial statements issued for fiscal years ending after December 15, 1992. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995. In that a sizable portion of construction contractors may be smaller development-stage enterprises, financial statements for years ended during 1996 will be subject to the provisions contained therein. In such circumstances, auditors should consider whether management has made all disclosures required by FASB Statement No. 107 (AC F25).

.52 FASB Statement No. 107 (AC F25) requires disclosure of the fair 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 the disclosure of descriptive information pertinent to estimating the value of a financial instrument. Certain financial instruments (for example, lease contract, deferred-compensation arrangements, and insurance contracts) are excluded from the scope of the Statement (AC F25).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.53 *Disclosures about Derivative Financial Instruments.* FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), issued in October 1994, was effective for financial statements issued for fiscal years ending after December 15, 1994. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995.

.54 FASB Statement No. 119 (AC F25) requires disclosures about derivative financial instruments, such as 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), to require disaggregation of information about financial instruments with off-balance-sheet risk of accounting loss by class, business activity, risk, or other category that is consistent with the entity's management of those instruments. The Statement also amends FASB Statement No. 107 (AC F25) to require that fair value information be presented without combining, aggregating, or netting the fair value of derivative financial instruments with the fair value of nonderivative financial instruments and be presented together with the related carrying amounts in the body of the financial statements, a single footnote, or a summary table in a form that makes it clear whether the amounts represent assets or liabilities.

.55 Auditors should consider whether the provisions of FASB Statement No. 119 (AC F25) apply to their construction contractor clients, and if so, evaluate whether the client's financial statement disclosures are adequate and appropriate in view of the requirements set forth therein.

Revenue Recognition

.56 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 GAAP, 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.

.57 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.

Joint Ventures

.58 Contractors faced with limited financial resources and lack of access to new markets commonly overcome these 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.

.59 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.

.60 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.

.61 The FASB's Emerging Issues Task Force (EITF) has discussed several matters that may affect the appropriate accounting for investments in joint ventures. Those matters include the following:

- EITF Issue No. 95-6, *Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation*, sets forth criteria for determining whether significant influence exists. Although 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.
- EITF Issue No. 94-1, *Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects*, 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*, describes the discussion of the Securities and Exchange Commission (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.

.62 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* (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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

Exhibits

.63

Exhibit 1

Regional Analysis of Conditions in the Construction Industry[5]

Region	Economic Conditions
New England	• Solid gains in retail construction may slow as a result of bankruptcy filings by regional chains. • Office and industrial construction lags the rest of the nation due to corporate downsizing and consolidations.
Middle Atlantic	• Sharp declines in office construction are accompanied by excess office space. • Retail construction is saturated despite the relocation to the region of several large warehouse retailers. • Moderate growth is expected for industrial construction given declines in manufacturing.
South Atlantic	• Nonresidential construction in the region's northern states is depressed due to corporate downsizing and slower population growth. • Construction related to the 1996 Summer Olympics will boost growth in Atlanta and surrounding areas. • Southern states in the region contain some of the strongest office markets. • Retail construction is booming due to above-average employment growth. • Industrial construction is thriving given that the Carolinas are a prime location for manufacturing.
East North Central	• Industrial construction will continue to prosper given the high concentration of manufacturing firms and national distribution. • Office construction has seen scattered gains as vacancy rates continue to fall. • Retail construction has grown in many areas led by expansion in the industrial sector.
East South Central	• Industrial construction, which dominates this region is expected to continue growing due to the trend towards relocation to this region. • Retail construction is benefitting from growing tourism and the Mississippi casino boom.

[5] New England: CN, ME, MA, NH, RI, and VT.
Middle Atlantic: NJ, NY, and PA.
South Atlantic: DE, FL, GA, MD, NC, SC, VA, DC, and WV.
East North Central: IL, IN, MI, OH, and WI.
East South Central: AL, KY, MI, and TN.
West North Central: IA, KS, MN, MS, NE, ND, and SD.
West South Central: AK, LA, OK, and TX.
Mountain: AZ, CO, ID, MO, NV, NM, UT, and WY.
Pacific: AL, CA, HA, OR, and WA.

Region	Economic Conditions
West North Central	• The region's well-diversified economy is insulated from many cyclical variations. Accordingly, construction levels that have remained relatively constant over the past several years, should continue to do so.
West South Central	• Retail construction has shown significant growth, driven by an expanding labor market. • Gradual improvement in office construction is expected as the region rebounds from overbuilding. • Industrial construction is benefitting from growth in the high-technology field.
Mountain	• Commercial construction has grown significantly due to population increases. • Apartment construction may slow in some sections due to previous overbuilding, but will increase in the western states. • Retail construction is slowing as migration from more prosperous California decreases. • Industrial construction is expanding due to the influx of high-technology companies.
Pacific	• Excess office space in California will slow new office construction. • Industrial construction in the Northwest is expected to increase. • Retail construction is expected to strengthen along with the region's economy.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.64

Exhibit 2

Significant Provisions of Newly Issued SASs

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, 544, 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]).

AICPA Audit and Accounting Literature

Audit and Accounting Guide

.65 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

.66 The AICPA 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

.67 *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

.68 Further information on matters addressed in this Audit Risk Alert is available through various publications and services listed in the table entitled "Information Sources," of this document. Many non government and some government publications and services involve a charge or membership requirement.

.69 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.

.70 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.

.71 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.72 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.

* * * *

.73 This Audit Risk Alert supersedes *Construction Contractors Industry Developments—1995/96.*

* * * *

.74 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1996/97* [AAM section 8010] and *Compilation and Review Alert—1996/97* [AAM section 8015].

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.75

Information Sources

Organization	General Information	Fax/Phone 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. 1) 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)
United States Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4040 *SEC Public Reference Room* (202) 942-8090	*Information Line* (202) 942-8088 (ext. 3) (202) 942-7114 (tty)	SEC's Homepage www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)
United States Department of Commerce	Herbert C. Hoover Building 14th Street between Pennsylvania and Constitution Avenue Washington, DC 20230	*General Information* (202) 482-2000 Bureau of Economic Analysis 1441 L Street Washington, DC 20230 (202) 606-9600		
Associated General Contractors of Americas	1957 E Street, NW Washington, DC 20006	*General Information* (202) 393-2040		
Professional Construction Estimators Association of America	P.O. Box 11626 Charlotte, NC 28220-1626	*General Information* (704) 522-6376		
Construction Financial Management Association	Princeton Gateway Corporate Campus 707 State Rd., Ste. 223 Princeton, NJ 08540-1413	*General Information* (609) 683-5000		

[*The next page is 8263.*]

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.

Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

- 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:

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

> 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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1995, American Institute of Certified Public Accountants, Inc.

.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—

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

- 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.

* * * *

.93 This Audit Risk Alert supersedes *Federal Government Contractors Industry Developments—1994.*

* * * *

.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].

Copyright © 1995, American Institute of Certified Public Accountants, Inc.

.95 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.mil/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)

[The next page is 8285.]

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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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*

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

* * * *

.76 This Audit Risk Alert supersedes *Finance Companies Industry Developments—1994.*

* * * *

.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].

Copyright © 1995, American Institute of Certified Public Accountants, Inc.

.78 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 (1ly)		
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—1996/97

Industry and Economic Developments

.01 Investment companies continued their record growth during the first five months of 1996, led by mutual funds which averaged monthly cash inflows of more than $24 billion dollars. By historical standards, these inflows are enormous. Through the first half of 1996, investors put more money into mutual funds than they had in all of 1995 ($138.3 billion through June 1996 as opposed to $128.2 billion in 1995). As a result, total net assets in all types of mutual funds increased to $3.2 trillion by midyear, compared with $2.5 trillion in June 1995. Total net assets of stock funds increased to $1.5 trillion; bond and income fund assets increased to $830 billion; taxable money market fund assets decreased to $686 billion; and tax-exempt money market fund assets decreased to $132 billion.

.02 This pattern of growth, however, could not be sustained beyond May. Beginning in June, cash inflows into mutual funds dropped to $14.5 billion, a 38 percent decline from the previous month. The decline continued in July when the amount of cash invested in stock mutual funds dropped to $3.5 billion, its lowest level since November 1994. For some investment companies, the reduction in cash inflows was accompanied by a significant increase in fund redemptions. For example, within the span of one week during July, $112 million flowed out of emerging growth stock funds; $98 million was withdrawn from small stock technology funds; and $25 million was redeemed from aggressive small stock funds—the largest weekly outflows since January 1992. By August, stock mutual funds, following a market recovery, rebounded with inflows of approximately $17 billion, a significant increase over July but below both the 1996 monthly average and the January high of almost $30 billion. Bond mutual funds, which had outflows of more than $1 billion in July, continued their poor showing with inflows of only $1.7 million in August.

.03 In periods of sharply rising investor redemptions, auditors should be alert to the liquidity problems that may develop. Some investment companies have sought outside financing to satisfy redemption demands. Numerous investment companies have established contingent funding through financing arrangements such as lines of credit (by one newspaper account, a major bank reported a 50 percent increase in financing extended to mutual funds so far this year). In these circumstances, auditors should consider whether such financing arrangements have been properly disclosed in the notes to the financial statements. Auditors also should consider whether these loan agreements include restrictive covenants that raise reporting and disclosure issues.

.04 As an alternative means of financing redemption demands, some investment companies, with approval from the Securities and Exchange Commission (SEC), may lend money from one fund to another. In an approach that is generally considered more expedient and less expensive than other forms of financing, an investment company's equity fund might, for example, borrow cash from a bond fund affiliate on a temporary basis. Auditors should evaluate interfund loans such as these pursuant to auditing and accounting guidance on related-party transactions. The "Auditing Issues and Developments" section of this Audit Risk Alert gives further consideration to the issue of related-party transactions.

.05 For some investment companies, the sudden increase in outflows came on the heels of significant losses incurred due to sharp declines in market values during the summer months. Market value losses from equity holdings totaled more than $66 billion in the first two weeks of July. If such a trend continues beyond an investment company's year end, auditors may wish to consider whether subsequent events disclosure is

warranted. For example, although declines in the market value of security portfolios and the corresponding change in the net assets and net asset value per share are risks inherent to mutual fund investments, they have, in some instances, been accompanied by investor withdrawals that resulted in a significant decline in the value of an investment company's assets. If a sale of a substantial amount of securities is necessary to generate sufficient amounts of cash to satisfy investor withdrawals, disclosure may be warranted. In such circumstances, auditors should consider the guidance set forth in AICPA Statement on Auditing Standards (SAS) No.1, section 560, *Subsequent Events* (AU section 560).

.06 Sharp declines in market value, decreases in cash inflows, along with increases in investor redemptions, may cause portfolio managers to adopt more aggressive trading strategies (within the parameters of shareholder-approved investment objectives) as they attempt to improve shareholder returns, retain current investors, and attract new investors. Such strategies might include the use of derivatives—innovative financial instruments that often are very complex and involve a substantial risk of loss—as risk management tools, or as speculative investment vehicles. An investment company's use of derivatives may increase audit risk. As such, it is essential that auditors understand both the economics of derivatives used by the investment companies whose financial statements they audit and the nature and business purpose of their derivative activities. To the extent that derivatives qualify as financial instruments, as defined by Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards Nos. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (AC F25), 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), and 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), the disclosure requirements set forth in these pronouncements must be met. The AICPA publication, *Derivatives—Current Accounting and Auditing Literature*, summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations. The FASB has issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting for Derivative and Similar Financial Instruments and for Hedging Activities.*

.07 Additionally, auditors should consider the impact of the current industry environment that has fluctuated between significant growth, rising redemptions and sudden, sharp declines in the market value of investments on an investment company's internal controls. These circumstances could place burdens on internal controls that may affect an auditor's assessment of control risk.

Regulatory and Legislative Developments

Securities Regulation Bill

.08 Congress has undertaken an effort to reduce the role of state regulators in the review of mutual funds and stock sales, and to modernize mutual fund regulation. Legislation already passed by both Houses of Congress would create a national system of securities regulation. Federal rather than state regulations would govern mutual fund offerings and sales documents, sales of securities to professional investors, and securities of companies with more than $10 million in assets. If adopted, this bill will eliminate the burdens of duplicate regulations on investment companies. It would also codify previous exemptive orders which would provide a statutory exemption for certain types of mutual funds that offer new funds that invest only in the shares of other mutual funds, and exempt some investment companies from Federal law. As of this writing, the legislation passed by both Houses of Congress was to be reconciled in a House-Senate conference. The bill is likely to become law this year given its bipartisan nature along with the more than two-third's support needed to override a possible presidential veto. Auditors should be alert to the passage of this legislation to determine the effect, if any, on their audits of investment companies.

IRS Audits of Investment Companies

.09 The Internal Revenue Service (IRS) has conducted examinations of investment advisor firms of mutual funds with some regularity, however, mutual funds themselves have rarely been examined. To rem-

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

edy this shortcoming, the IRS has announced its intent to undertake an initiative to audit the tax returns of investment companies. The objectives of the IRS initiative are expected to include the identification of unreported income, the scrutiny of transactions with affiliates such as investment advisor firms, and the verification of Form 1099 information (focusing on the proper classification of ordinary income versus capital gain). If a revenue agent's examination is in process, and it concerns issues relevant to the financial statements for periods under audit, the auditor should consider the implications of any issues set forth therein. Adjustments resulting from the examination should be evaluated for their accounting and disclosure impact. If any assessments for tax deficiencies and related interest expense have been levied, consideration should be given to whether they have been properly reflected in the financial statements.

.10 Investment companies registered under the Investment Company Act of 1940 may elect to qualify for special Federal income tax treatment as regulated investment companies (RICs) under the Internal Revenue Code (IRC). Qualification as an RIC permits the investment company to avoid Federal and most state taxes on the investment income and capital gains it earns and distributes to its shareholders. Thus, an investment company distributing all of its income to its shareholders would have no taxable income and, therefore, would incur no tax liability. If an investment company fails to qualify as an RIC, it will be taxed as a corporation. Accordingly, when addressing the area of accounting for income taxes, auditors should consider whether the investment company has maintained its exempt status as an RIC.

.11 Tax regulations imposed upon investment companies are complex and varied. Auditors should consider an investment company's compliance with tax regulations that have a direct and material effect on the determination of financial statement amounts pursuant to SAS No. 54, *Illegal Acts by Clients* (AU section 317), which requires that audits be designed to provide reasonable assurance of detecting misstatements that result from illegal acts that have a direct and material effect on the determination of financial statement amounts.

SEC—Proposed Mutual Fund Disclosure Practice

.12 In a proposal to be issued some time this fall, the SEC is expected to set forth certain required disclosure practices for mutual funds. The proposal is expected to require improved risk disclosure and may include a graphic risk disclosure representation near the beginning of the prospectus. This would include a narrative description of the specific risks associated with the fund's investment approach, that is, the fund's risk profile. If this element of the proposal is adopted, auditors should consider their responsibilities pursuant to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550). SAS No. 8 (AU section 550) provides that, although an auditor's responsibility with respect to information in a document such as a prospectus does not extend beyond the financial information identified in the report, and although the auditor has no obligation to perform any procedures to corroborate other information contained therein, 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. If the auditor concludes that there is a material inconsistency, a determination should be made as to whether the financial statements, the report, or both require revision.

.13 The proposal may permit the sale of funds using *fund profiles* that are short summaries of key fund features. A full-length prospectus would be available upon request, at any time, and would be required to be delivered upon confirmation of the purchase.

1996 SEC Generic Comment Letter

.14 The SEC's Division of Investment Management has issued its generic comment letter for 1996, providing assistance to investment company registrants in preparing disclosure documents to be filed with the SEC. The letter includes discussions of the following topics:

- Prospectus improvement
- Disclosure comments for multiple class funds, registration statements filed on Form N-14, and closed-end funds' tender offers

- Proxy disclosure requirements relating to material factors discussions, compensation disclosure, as well as electronic proxy voting and voting results
- EDGAR implementation and filing procedures relating to Financial Data Schedules, Paper Copies, Cover Letters, and Extending Effectiveness of Rule 485(a) Filings
- Register additional shares under Rule 24f-2
- Deregistering funds

Private Securities Litigation Reform Act

.15 The Private Securities Litigation Reform Act of 1995 (the Act) became effective on December 22, 1995 (though not applicable to pending lawsuits) when Congress overrode a presidential veto. It offers significant relief to the accounting profession from class action securities lawsuits relating to publicly held entities. Such lawsuits will be more difficult to file through the imposition of tougher requirements on plaintiffs and their attorneys. Limitations are placed on accountants' liability and a safe harbor is created for certain projections of financial performance. The legislated reporting responsibility of auditors will be expanded to include a requirement for auditor notification to the SEC of illegalities not appropriately addressed by management.

.16 The Act requires that audits of financial statements by independent public accountants include the following:

- Procedures to identify illegal acts and related-party transactions that would have a direct and material effect on the determination of financial statement amounts
- An evaluation as to whether there is substantial doubt about the ability of the entity to continue as a going concern in the subsequent year

The Act also requires auditors who become aware that an illegal act has or may have occurred to determine the possible effect of fines and other factors on the financial statements. Auditors must then inform the entity's audit committee (or in the committee's absence, the board of directors) of their findings. If the auditor determines that there has been no timely and appropriate response to their notification, the auditor must forward that conclusion to the entity's board of directors. The board is then required to notify the SEC of that report within one business day, providing the auditor with a copy. If the auditor does not receive a copy, the auditor must forward the report of illegal acts to the SEC within the next business day.

SEC Proposal to Implement Private Securities Litigation Reform Act

.17 The SEC has released a proposed rule designed to implement the requirements of section 10A of the Securities Exchange Act of 1934 which was added by Title III to the Private Securities Litigation Reform Act of 1995, which is discussed above. The proposal will incorporate the statutory provisions of Section 10A into the Exchange Act Rules and Regulation S-X. The statutory provisions of Section 10A, which codifies certain professional auditing standards and expands the auditors reporting obligations, can be summarized as follows:

Section 10A(a)—Auditor Responsibilities. This section requires that audits of registrants' financial statements include the following:

- Procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts
- Procedures designed to identify related party transactions that are material or otherwise require disclosure
- An evaluation of whether there is substantial doubt about the registrant's ability to continue as a going concern during the ensuing fiscal year

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

These requirements appear to be consistent with generally accepted accounting principles. In fact, footnote 5 of the release specifically refers to the following for "standards addressing those procedures mandated by section 10A":

- SAS No. 54, *Illegal Acts by Clients* (AU section 317)
- SAS No. 45, Omnibus Statement on Auditing Standards—1983, "Related Parties" (AU section 334)
- SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341)
- SAS No. 64, *Omnibus Statement on Auditing Standards—1990* (AU section 341)
- 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 341)
- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU section 316)

In addition, the definition of "illegal acts" is consistent with that used in SAS No. 54 (AU section 317).

.18 *Section 10A(b)—Auditor Reporting of Illegal Acts.* This section contains provisions that would require the auditor to report certain illegal acts directly to the SEC if the registrant fails to do so. If the auditor becomes aware of information indicating that an illegal act (whether or not material) has occurred or may have occurred, then the auditor would be required "in accordance with GAAS" to determine whether it is likely that an illegal act has occurred and, if so, it's possible effect on the financial statements. The auditor would be required to inform the registrant's management of the illegal act "as soon as practicable." In addition, the auditor must gain assurance that the registrant's board of directors was adequately informed of any detected illegal act. Generally accepted auditing standards (GAAS) already contains similar notification requirements; Section 10A(b) contains the additional requirement that these notifications occur "as soon as practicable."

.19 The auditor would be required to then notify the board of directors directly if the following three conclusions are met:

1. The illegal act has a material effect on the financial statements;
2. Senior management has not taken timely and appropriate remedial action;
3. The failure to take remedial action is reasonably expected to warrant either a departure from the auditor's standard report or the auditor's resignation from the audit engagement.

After receiving such a report, the board of directors has one business day to notify the SEC that it received such a report. If the auditor does not receive a copy of the board's notice to the SEC within that one business day period, then by the end of the next business day the auditor is required to furnish directly to the SEC a copy of the report given to the board.

.20 *Section 10A(c)—Private Rights of Action.* This provision states that there is no private right of action against auditors based on any findings, conclusions, or statements expressed in their reports to the SEC.

.21 *Section 10A(d)—Civil Money Penalties.* This section subjects auditors to civil money penalties if the SEC finds in a cease-and-desist proceeding that the auditor willfully failed to comply with the direct reporting provisions in Section 10A.

.22 *Definition of an Audit.* The proposed amendment would conform the definition of *audit* in Regulation S-X with Section 10A by noting that the audit of the financial statements of SEC registrants should be performed in accordance with GAAS as may be modified or supplemented by the SEC.

.23 *Report Confidentiality.* Reports filed under Section 10A would be confidential and exempt from disclosure under the Freedom of Information Act.

Audit Issues and Developments

Related-Party Transactions

.24 The expected scrutiny of transactions with affiliates by the IRS, along with such issues as interfund loans, should serve as a reminder to auditors of the significance of the examination of related-party transactions and transactions with affiliates (including advisory and 12b-1 fees, sales load commissions, and purchases and sales of investments through an affiliate) in their audits of investment companies.

.25 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."

.26 In a mutual fund environment, the investment manager, distributor, custodian, and transfer agent are generally considered to be related parties. Transactions occurring between the fund and such parties are common. FASB Statement No. 57 (AC R36) sets forth the requirements for the disclosure of related-party transactions. 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 GAAS. Auditors should satisfy themselves concerning the required financial statement disclosures.

Valuation of Securities

.27 In that the purchase and redemption prices of fund shares are based almost exclusively on the value of a fund's investment portfolio, the area of securities valuation is a prime concern for auditors of investment companies. Investment securities whose disposition is restricted under Federal law and securities for which active markets do not exist require additional auditor scrutiny to ensure that carrying amounts approximate fair value. If security values are determined by the investment company's board of directors, auditors should review and evaluate relevant evidential matter underlying the basis for the valuation. Security investments may also include securities of companies that are in default on the payment of dividends and interest, or that have filed for protection under bankruptcy laws. Such investments may also include floating- or variable-rate senior loans to corporations, partnerships, and other entities issued as part of leveraged buyouts, acquisitions, or recapitalizations. The AICPA Audit and Accounting Guide *Audits of Investment Companies* includes guidance on testing portfolio valuations. As discussed in the Guide, the audit focus should include such procedures as a review of the fund's pricing methods, consideration of the board's oversight (that is, through a valuation committee), etc. These considerations are especially important in emerging market environments. Auditors of financial statements of investment companies registered with the SEC should consider whether management has addressed the guidance set forth in Accounting Series Releases (ASRs) 113 and 118 as well as the 1994 Dear CFO letter.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

Tax Qualification

.28 Investment companies that qualify under the special provisions of subchapter M of the IRC are not taxed on earnings that are distributed to shareholders. Auditors should exercise special care when verifying that funds have met the quarterly and annual tests imposed by the IRC.

.29 Auditors should also be alert to the tax consequences of investing in complex financial instruments. Such investments may cause differences between book and tax income and generate income that may not be eligible for the 90-percent-gross income test or may constitute short-short gains subject to the 30-percent-short-short limit specified in the IRC. Investment companies also must meet certain quarterly diversification requirements with respect to total assets.

.30 When evaluating whether investment companies meet those requirements, auditors of single-state municipal bond funds that have multiple issues guaranteed by a single agency or municipality should consider aggregating such agency's or municipality's issues into one issue solely for the purpose of measuring diversification. Investments in limited partnerships and securities denominated in foreign currencies also pose special tax qualification and valuation risks.

Service Auditor's Reports

.31 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 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 influence custodian and transfer agent third-party internal control reports, as well as multiple-class fund design and operation reporting on expense allocation and the calculation of net asset value per share and distributions.

.32 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319), requires an auditor to obtain an understanding of an entity's internal control sufficient to plan the audit. If an investment company uses a service organization, control activities 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 control activities performed by a service organization. If an investment company relies on a service organization's control activities over the processing of transactions that are material to the investment company's financial statements, these control activities should be considered by the auditor.

.33 One method of obtaining information about these control activities is to obtain a service auditor's report as described in SAS No. 70 (AU section 324). Auditors assessing whether there is a need to obtain a service auditor's report if their clients use service organizations should note that 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 activities 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.

.34 Some additional factors that may be considered in determining whether to obtain a service auditor's report are the following—

- Whether the transactions or accounts processed 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.)

.35 The AICPA Auditing Procedure Study, *Implementing SAS No. 70,* Reports on the Processing of Transactions by Service Organizations, can provide auditors with guidance in this area.

New Pronouncements

Auditing Standards

.36 *SAS No. 75.* In September 1995, the Auditing Standards Board (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 certain circumstances, as discussed in the Statement (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 Statement on Auditing Standards No. 72,* Letters for Underwriters and Certain Other Requesting Parties (AU section 634). The Statement (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 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, 544, 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. Such reports frequently are prepared in connection with an underwriting of a closed-end fund. SAS No. 77 is effective for engagements beginning after December 15, 1995.

.39 *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 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. 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. Such uncertainties may include the valuation of illiquid investments or those investments for which a readily

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

ascertainable market value does not exist. This Statement (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.

.41 A table outlining the significant provisions of the newly issued auditing standards is set forth in the Exhibits section of this Audit Risk Alert.

Attestation Standards

.42 *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. Reporting on security counts performed pursuant to Rules 17f-1 and 17f-2 of the 1940 Act should follow SSAE No. 4 (AT section 600). The SEC staff notes that SSAE No. 4 (AT section 600) is not accepted for 17f-1 or 2 reports.

.43 *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 provides guidance on the quantity, type, and content of working papers for attestation engagements and is effective for engagements beginning after December 15, 1995.

.44 *SSAE No. 6.* In December 1995, 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 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 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.

.45 *Quality Control Standards.* 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.

.46 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 201.01), and 202, *Compliance With Standards* (ET section 202.01), 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 (QC section 20) 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.

New Independence Standards

.47 The second general auditing standard, "Independence" (AU section 220.07) provides that in all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors. The precepts established to guard against the presumption of loss of independence are contained in the AICPA's *Code of Professional Conduct*. Recently issued standards relating to independence are enumerated in the following sections:

Ethics Ruling—Indemnification of a Client. The AICPA Professional Ethics Executive Committee issued Ethics Ruling No. 102, *Member's Indemnification of a Client* (ET section 191.204 and .205), as published in the January 1996 *Journal of Accountancy*. This ruling 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. In assessing their independence, auditors of investment companies should consider the implication of indemnification arrangements requested by their clients, in light of this new ethics ruling.

Extended Audit Services. The AICPA Professional Ethics Executive Committee issued the following independence standards relating to providing extended audit services:

- Ethics Interpretation 101-13, *Extended Audit Services* (ET section 101.15)
- Ethics Ruling No. 97, *Performance of Certain Extended Audit Services* (ET section 191.194 and .195)
- Ethics Ruling No. 103, *Member Providing Attest Report on Internal Controls* (ET section 191.206 and .207)
- Ethics Ruling No. 104, *Member Providing Operational Auditing Services* (ET section 191.208 and .209)
- Ethics Ruling No. 105, *Frequency of Performance of Extended Audit Procedures* (ET section 191.210 and .211)

The complete text of the standards shown above were published in the August 1996 edition of the AICPA's *Journal of Accountancy* and became effective upon publication.

AICPA Exposure Drafts: Proposed SASs

.48 *Consideration of Fraud in a Financial Statement Audit.* In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Consideration of Fraud in a Financial Statement Audit and Amendments to Statements on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures, *and No. 47,* Audit Risk and Materiality in Conducting and Audit Proposed Statement on Auditing Standards. The proposed Statement would provide expanded operational guidance on the consideration of fraud in conducting a financial statement audit. The proposed changes in auditing standards also clarify the auditor's present responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud. In addition, the proposed changes provide added guidance on the standard of due professional care in the performance of work, including the need to exercise professional skepticism, and the concept of reasonable assurance. In addition to amending SAS Nos. 1 (AU sections 110 and 230) and 47 (AU section 312), the proposed Statement would:

- Describe fraud and its characteristics.
- Require the auditor to specifically assess the risk of material misstatement due to fraud and provide categories of fraud risk factors that should be considered in the auditor's assessment.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- Provide guidance on how the auditor should respond to the results of the assessment.
- Provide guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud.
- Describe related documentation requirements.
- Provide guidance regarding the auditor's communication about fraud to management, the audit committee, and others.

.49 *Amendment to SAS No. 31, Evidential Matter.* In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter. This proposed Statement would provide guidance for a practitioner who has been engaged to audit an entity's financial statements where significant information is transmitted, processed, maintained, or accessed electronically. The proposed Statement would include examples of evidential matter in electronic form and provide that an auditor should consider the time during which such evidential matter exists or is available in determining the nature, timing, and extent of substantive tests. In addition, the proposed Statement would indicate that an auditor may determine that, in certain engagement environments where evidential matter is in electronic form, it would not be practical or possible to reduce detection risk to an acceptable level by performing only substantive tests. The proposed Statement would provide that in such circumstances, an auditor should consider performing tests of controls to support an assessed level of control risk below the maximum for affected assertions.

Accounting Issues and Developments

Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities

.50 In June 1996, the FASB issued FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities.* This Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishment of liabilities. Those standards are based on consistent application of a financial-components approach that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. This Statement provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

.51 A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interest in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

1. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
2. Either (*a*) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right—to pledge or exchange the transferred assets or (*b*) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.
3. The transferor does not maintain effective control over the transferred assets through (*a*) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (*b*) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

.52 FASB Statement No. 125 requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interest in transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

.53 FASB Statement No. 125 requires that servicing assets and liabilities be subsequently measured by (*a*) amortization in proportion to and over the period of estimated net servicing income or loss and (*b*) assessment for asset impairment or increased obligation based on their fair values.

.54 FASB Statement No. 125 requires that debtors reclassify financial assets pledged as collateral and that secured parties recognize those assets and their obligation to return them in certain circumstances in which the secured party has taken control of those assets.

.55 FASB Statement No. 125 requires that a liability be derecognized if and only if either (*a*) the debtor pays the creditor and is relieved of its obligation for the liability or (*b*) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

.56 FASB Statement No. 125 provides implementation guidance for assessing isolation of transferred assets and for accounting for transfers of partial interest, servicing of financial assets, securitizations, transfers of sales-type and direct financial lease receivables, securities lending transactions, repurchase agreements including "dollars rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishment of liabilities.

.57 FASB Statement No. 125 supersedes FASB Statements No. 76, *Extinguishment of Debt*, and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. This Statement amends FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), to clarify that a debt security may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. This Statement amends and extends to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (AC Mo4), and supersedes FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*. This Statement also supersedes Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt*, No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*, and No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*.

.58 FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishment of liabilities occurring after December 31, 1996, and is to be applied prospectively. Earlier or retroactive application is not permitted.

Disclosures About Derivative Financial Instruments

.59 FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), issued in October 1994, was effective for financial statements issued for fiscal years ending after December 15, 1994. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995.

.60 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), to require disaggregation of information about financial instruments with off-balance-sheet risk of accounting loss by

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

class, business activity, risk, or other category that is consistent with the entity's management of those instruments. The Statement (AC F25) also amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), to require that fair value information be presented without combining, aggregating, or netting the fair value of derivative financial instruments with the fair value of nonderivative financial instruments and that it be presented together with the related carrying amounts in the body of the financial statements, a single note, or a summary table in a form that makes clear whether the amounts represent assets or liabilities.

.61 Auditors should consider whether the provisions of FASB Statement No. 119 (AC F25) apply to their investment company clients and, if so, evaluate whether the client's financial statement disclosures are adequate and appropriate in view of the requirements set forth therein.

.62

Exhibit

Significant Provisions of Newly Issued SASs

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, 544, 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]).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

Information Sources

.63 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.

.64 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.

.65 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.

.66 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.67 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.

* * * *

.68 This Audit Risk Alert supersedes *Investment Companies Industry Developments—1995/96.*

* * * *

.69 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1996/97* [AAM section 8010] and *Compilation and Review Alert—1996/97* [AAM section 8015].

.70

Information Sources

Organization	General Information	Fax/Phone 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. 1) 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) 942-4040 *SEC Public Reference Room* (202) 942-8090	*Information Line* (202) 942-8088 (ext. 3)	SEC's Homepage www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)
Investment Company Institute	1401 H Street, NW Washington, DC 20005	*General Information* (202) 326-8305 *Conferences* (202) 326-5968 *Publications* (202) 326-8305		

[*The next page is 8343.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1995, American Institute of Certified Public Accountants, Inc.

- 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.

Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

* * * *

.64 This Audit Risk Alert supersedes *Oil and Gas Producers Industry Developments—1994.*

* * * *

.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].

.66

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		

Copyright © 1995, American Institute of Certified Public Accountants, Inc.

AAM Section 8170

Securities Industry Developments—1996/97

Industry and Economic Developments

.01 Strength in the major financial markets, along with effective cost controls, led the brokerage industry to a strong first half in 1996. Revenues from all lines of business—principal transactions (meaning, firms trading on their own account), commissions, investment banking, and asset management—rose sharply during this period. As a result, net income for many brokerage firms reached levels not seen since 1993. The factors that have contributed to the industry's success, along with the possible audit implications, include the following:

- *Trading volume.* The average daily volume of stock trading was almost double that of 1990 levels, and continues to trend upwards. Eight out of ten of the highest trading days took place during 1996. In fact, the busiest day on record occurred in July when a combined volume of more than 1.5 billion shares traded on the New York and the National Association of Security Dealers and Quotation Analysts (NASDAQ) exchanges. Accordingly, there was a significant increase in broker commissions derived from buy and sell transactions on the sales of domestic stocks and bonds totaling $476.8 billion, a 47 percent increase over the first half of last year. When documenting their understanding of a broker-dealer's internal control and assessing control risk, as required by AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319A),[1] auditors may wish to consider the impact of sudden and significant increases in trading activity whether they are isolated events or sustained conditions. Auditors may also wish to consider the effect of such circumstances on the potential for an increased risk of material errors and irregularities, and whether reportable conditions, as defined in SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU section 325), may exist. Auditors should also be aware of their responsibilities with respect to material inadequacies in internal control pursuant to the Securities and Exchange Commission's (SEC) rule 17a-5(h)(2), and, where appropriate, the Commodity Futures Trading Commission's (CFTC) regulation 1.16(c)(5).

- *Underwriting activities.* Many brokerage entities have benefitted from the stock underwriting boom that began in the second quarter. Stock underwriting volumes are running at a near record pace and are expected to eclipse strong 1995 totals. Though rising interest rates may put a damper on some debt offerings, overall stock and bond issuance climbed 31 percent in the second quarter to $237 billion, pushing disclosed fees for underwriting debt and equity deals to a record $2.9 billion (up 70 percent from the same period last year). Some of the audit implications germane to the area of underwriting are discussed in the "Audit Issues and Developments" section of this Audit Risk Alert under "Underwriting Activities." It should be noted that the increase in underwriting activity is likely to result in a greater number of engagements to provide underwriters with *comfort letters.* Though not directly related to the audits of broker-dealers, auditors involved in such engagements should be aware of recently issued SAS No. 76, *Amendments to SAS No. 72,* Letters for Underwriters and Certain Other Requesting Parties (AU section 622), the provisions of which are discussed in the "New Pronouncements" section of this Audit Risk Alert.

---

[1] SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AU section 319), revises the definition and description of internal control and makes conforming changes to relevant terminology. SAS No. 78 (AU section 319) was issued in December 1995 and is effective for audits of financial statements for periods beginning on or after January 1, 1997. See "New Pronouncements" in the "Audit Issues and Developments" section for further discussion of this matter.

One of the most lucrative segments of the underwriting business relates to initial public offerings (IPOs). Sales of IPOs nearly tripled in the second quarter of 1996 to $18.6 billion (compared to $6.7 billion for the same period last year), breaking the record of $12.2 billion set in the fourth quarter of 1995. However, a tumultuous stock market in July had a dampening effect on IPOs, particularly for companies without a track record of earnings. Given the sharp decline in stock prices, it became extremely difficult to proceed with new issues and a number of IPOs were postponed. A subsequent market turnaround did improve the outlook for many IPOs, but for others the delay lingered. For such IPOs, auditors should consider examining relevant underwriting agreements to which the broker-dealer is party in order to determine whether provisions for losses arising from unfulfilled underwriting commitments are necessary, and if so, whether they have been appropriately reflected in the financial statements by management.

- *Mergers and acquisitions.* A high level of corporate merger and acquisition activity during the first half of 1996 drove up investment banking revenues for many brokerage firms. Mergers and acquisitions have also increased within the securities industry itself. Restructuring often accompanies such activities as redundant functions are eliminated and existing areas streamlined. Further consideration of this matter is discussed in the "Accounting Issues and Developments" section of this Audit Risk Alert under "Restructurings." Additionally, auditors who are called upon to perform agreed-upon procedures in due diligence engagements relating to mergers and acquisitions should be aware of the following recently issued pronouncements, the provisions of which are discussed in the "New Pronouncements" section of this Audit Risk Alert: SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AU section 622), and AICPA Statement on Standards for Attestation Engagements (SSAE) No. 4, *Agreed-Upon Procedures Engagements* (AT section 600).

- *Continued bull market.* As the Dow Jones Industrial Average continued to climb through the early part of the year, brokerage firms generated higher revenues from their own trading activities. However, the dramatic market decline during the summer months may have caused some broker-dealers to implement riskier hedging strategies to offset future market downturns. Those strategies may include the use of complex financial instruments including derivatives. It is essential that auditors understand both the economics of the derivatives used and the nature and business purpose of the broker-dealer's derivatives activities. If derivatives are accounted for as hedges of recorded assets or liabilities or of anticipated transactions, auditors should review the appropriateness of the use of hedge accounting, based on the criteria set forth in relevant accounting literature.

.02 Some industry observers expect the strong revenue growth to continue through year end given the upward trends in underwriting, and mergers and acquisition activity, along with continued active trading by both individual and institutional investors. However, the industry is cyclical in nature, with profits largely a function of the market environment and the direction of interest rates, and vulnerable to any severe retreat in the stock market.

Regulatory and Legislative Developments

Justice Department Action

.03 After a two-year probe into alleged price fixing on the NASDAQ exchange, the United States Justice Department and two dozen securities firms agreed to settle the government's civil complaint charging antitrust violations. Specifically, these securities firms were accused of keeping the spread between buy and sell prices for NASDAQ stocks artificially high while, at the same time, intimidating rival brokerage firms that did not follow this practice. The settlement, which some analysts predict may cost the industry more than $50 million in the first year alone, calls for the following:

- The random taping of conversations on over the counter trading desks
- Stepped up monitoring of NASDAQ traders' conversations by internal compliance officers

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- Future legal sanctions for firms that engage in collusive behavior
- Semiannual briefings for traders by securities firms on the restrictions set forth under the settlement
- The filing of detailed reports certifying compliance with the terms of the settlement agreement

Further discussion of this matter is undertaken in the "Audit Issues and Developments" section of this Audit Risk Alert under "Illegal Acts by Clients."

Commodities Futures Trading Commission—Issuance of Final Rules

.04 Broker-dealers that are also commodities brokers must consider the rules and regulations of the 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 United States futures exchanges. Since 1982, the CFTC has also regulated operations on futures contracts and options on physical commodities trading on commodity markets. On May 1, 1996, the CFTC issued its final rules, which became effective on May 31, 1996, addressing early warning reporting requirements; minimum financial requirements; prepayment of subordinated debt; gross collection of exchange-set margin for omnibus accounts; and capital charge on receivables from foreign brokers. Specifically, the CFTC adopted amendments to the following:

- Rule 1.12, sets forth the financial early warning repurchase agreement requirements for futures commission merchants (FCMs) and introducing brokers (IBs), that are intended to provide the CFTC and industry self-regulating organizations (SROs) with sufficient advance notice of a firm's financial or operational problems and to take necessary protective or remedial action to ensure the safety of customer investments and the integrity of the marketplace. The amendments to this rule, which would be applicable to FCMs only, will—
  - — Require the reporting of a decrease in net capital of 20 percent or more within two business days and a planned reduction in excess adjusted net capital of 30 percent or more two business days prior thereto, and to make that provision applicable to all FCMs, rather than just those FCMs subject to the risk assessment reporting requirements of CFTC Rule 1.15
  - — Require the reporting of a margin call that exceeds an FCM's excess adjusted net capital that remains unanswered by the close of business on the day following the issuance of the call
  - — Require reporting by an FCM whenever its excess adjusted net capital is less than 6 percent of the maintenance margin required to support positions of noncustomers carried by the FCM, unless the noncustomer is itself subject to the CFTC's minimum financial requirements for an FCM or the SEC's minimum financial requirements for a securities broker-dealer
- Rules 1.17(a)(1)(i) and (ii) were amended in order to—
  - — Increase the minimum required dollar amount of adjusted net capital for FCMs from $50,000 to $250,000
  - — Increase the minimum required dollar amount of adjusted net capital for IBs from $20,000 to $30,000
  - — Make the amount of adjusted net capital required by a registered futures association for its member FCMs and IBs an element of the CFTC's minimum financial requirements for FCMs and IBs
- Rule 1.17(h)(2)(vii) was amended with respect to the procedure to obtain approval for prepayment of subordinated debt.
- Rule 1.58, which governs gross collection of exchange-set margins for omnibus accounts carried by FCMs for foreign brokers was also amended.

According to the CFTC, the 5 percent capital charge for unsecured receivables from a foreign broker will not apply in the following instances.

1. The receivables represent deposits required to maintain futures or options positions
2. The foreign broker has been granted comparability relief under CFTC Rule 30.10
3. The asset is held in accordance with the relevant grant of relief under Rule 30.10 at the foreign broker, with another foreign broker that has been granted comparability relief under Rule 30.10, or a depository in the same jurisdiction as either foreign broker in accordance with Rule 30.7

Private Securities Litigation Reform Act

.05 The Private Securities Litigation Reform Act of 1995 (the Act) became effective on December 22, 1995 (though not applicable to pending lawsuits), when Congress overrode a presidential veto. It offers significant relief to the accounting profession from class action securities lawsuits relating to publicly held entities. Such lawsuits will be more difficult to file through the imposition of tougher requirements on plaintiffs and their attorneys. Limitations are placed on accountants' liability and a safe harbor is created for certain projections of financial performance. The legislated reporting responsibility of auditors will be expanded to include a requirement for auditor notification to the SEC of illegalities not appropriately addressed by management.

.06 The Act requires that audits of financial statements by independent public accountants include the following:

- Procedures to identify illegal acts and related-party transactions that would have a direct and material effect on the determination of financial statement amounts
- An evaluation as to whether there is substantial doubt about the ability of the entity to continue as a going concern in the subsequent year

.07 The Act also requires auditors who become aware that an illegal act has or may have occurred to determine the possible effect of fines and other factors on the financial statements. Auditors must then inform the entity's audit committee (or in the committee's absence, the board of directors) of their findings. If the auditor determines that there has been no timely and appropriate response to their notification, the auditor must forward that conclusion to the entity's board of directors. The board is then required to notify the SEC of that report within one business day, providing the auditor with a copy. If the auditor does not receive a copy, the auditor must forward the report of illegal acts to the SEC within the next business day.

Securities and Exchange Commission Proposal to Implement Private Securities Litigation Reform Act

.08 The SEC has released a proposed rule designed to implement the requirements of Section 10A of the Securities Exchange Act of 1934 which was added by Title III to the Private Securities Litigation Reform Act of 1995, which is discussed above. The proposal will incorporate the statutory provisions of Section 10A into the Exchange Act Rules and Regulation S-X. The statutory provisions of Section 10A, which codifies certain professional auditing standards and expands the auditors reporting obligations, can be summarized as follows:

Section 10A(a)—Auditor Responsibilities. This section requires that audits of registrants' financial statements include the following:

- Procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts
- Procedures designed to identify related party transactions that are material or otherwise require disclosure

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- An evaluation of whether there is substantial doubt about the registrant's ability to continue as a going concern during the ensuing fiscal year

These requirements appear to be consistent with generally accepted accounting principles. In fact, footnote 5 of the release specifically refers to the following for "standards addressing those procedures mandated by Section 10A":

- SAS No. 54, *Illegal Acts by Clients* (AU section 317)
- SAS No. 45, Omnibus Statement on Auditing Standards—1983, "Related Parties" (AU section 334)
- SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341)
- SAS No. 64, *Omnibus Statement on Auditing Standards—1990* (AU section 341)
- 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 341)
- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU section 316)

In addition, the definition of "illegal acts" is consistent with that used in SAS No. 54 (AU section 317).

.09 *Section 10A(b)—Auditor Reporting of Illegal Acts.* This section contains provisions that would require the auditor to report certain illegal acts directly to the SEC if the registrant fails to do so. If the auditor becomes aware of information indicating that an illegal act (whether or not material) has occurred or may have occurred, then the auditor would be required "in accordance with GAAS" to determine whether it is likely that an illegal act has occurred and, if so, it's possible effect on the financial statements. The auditor would be required to inform the registrant's management of the illegal act "as soon as practicable." In addition, the auditor must gain assurance that the registrant's board of directors was adequately informed of any detected illegal act. Generally accepted auditing standards (GAAS) already contains similar notification requirements; Section 10A(b) contains the additional requirement that these notifications occur "as soon as practicable."

.10 The auditor would be required to then notify the board of directors directly if the following three conclusions are met:

1. The illegal act has a material effect on the financial statements;
2. Senior management has not taken timely and appropriate remedial action;
3. The failure to take remedial action is reasonably expected to warrant either a departure from the auditor's standard report or the auditor's resignation from the audit engagement.

After receiving such a report, the board of directors has one business day to notify the SEC that it received such a report. If the auditor does not receive a copy of the board's notice to the SEC within that one business day period, then by the end of the next business day the auditor is required to furnish directly to the SEC a copy of the report given to the board.

.11 *Section 10A(c)—Private Rights of Action.* This provision states that there is no private right of action against auditors based on any findings, conclusions, or statements expressed in their reports to the SEC.

.12 *Section 10A(d)—Civil Money Penalties.* This section subjects auditors to civil money penalties if the SEC finds in a cease-and-desist proceeding that the auditor willfully failed to comply with the direct reporting provisions in Section 10A.

.13 *Definition of an Audit.* The proposed amendment would conform the definition of *audit* in Regulation S-X with Section 10A by noting that the audit of the financial statements of SEC registrants should be performed in accordance with GAAS as may be modified or supplemented by the SEC.

.14 *Report Confidentiality.* Reports filed under Section 10A would be confidential and exempt from disclosure under the Freedom of Information Act.

Securities and Exchange Commission Amendments

.15 In May 1996, the SEC amended its Rules 12g-1, 12g-4, and 12h-3 under the Securities Exchange Act of 1934 (the Exchange Act) to increase the total assets threshold for registration and reporting requirements from $5 million to $10 million. The rule amendments, which became effective immediately, will increase the number of issuers not subject to the Act's registration and reporting requirements (for example, Forms 10-K, 10Q, and 8-K). The rule amendments will revise:

- Rule 12g-1 so that an issuer will not be required to register under section 12(g) until it has 500 or more record holders of a class of equity securities and total assets of $10 million or more. The revision does not change the existing requirements that securities traded on national securities exchanges or on the National Association of Securities Dealers, Inc. (NASD) automated quotation system (NASDAQ system) be registered pursuant to section 12 of the Act.
- Rules 12g-4 and 12h-3 to raise the asset threshold from $5 million to $10 million for termination of section 12(g) registration and for the suspension of section 15(d) reporting. The rule amendments do not change the other tests for the termination of registration and for the suspension of reporting. An issuer that conducts a public offering registered under the Securities Act of 1933 will continue to be subject to reporting pursuant to section 15(d) of the Exchange Act unless the issuer otherwise becomes eligible to suspend such reporting.

FOCUS Reports

.16 In February 1996, the SEC approved an NASD requested rule change that will—

- Eliminate the requirement for all NASD member firms to file monthly FOCUS Part I reports.
- Require monthly filings of a modified FOCUS Part II report only for those firms that carry customer accounts and that are subject to the reserve computation requirement of SEC Rule 15c3-3 or are classified as brokers or dealers under the net capital rule. The modified FOCUS Part II report would consist of a balance sheet, net capital computation, reserve formula computation, a one-line profit and loss figure for the month, and certain financial and operational data.
- Require all firms to file a quarterly FOCUS Part II or IIA report, as currently required.

.17 According to the NASD under the rule change, approximately two thousand firms that operate on a fully disclosed basis will no longer have to file a monthly FOCUS Part I report. In addition, those firms that must continue to file monthly will have a simplified filing requirement.

Audit Issues and Developments

Illegal Acts by Clients

.18 During 1996, the United States Justice Department filed a civil complaint in Federal court alleging that two dozen securities firms violated antitrust laws by engaging in anticompetitive behavior (price fixing) on the NASDAQ exchange. 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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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). In May 1996, the AICPA issued an exposure draft of a proposed Statement on Auditing Standards—*Consideration of Fraud in a Financial Statement Audit and Amendments to Statements on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures, *and No. 47,* Audit Risk and Materiality in Conducting and Audit. The exposure draft is discussed in the "Audit Issues and Developments" section of this Audit Risk Alert.

Underwriting Activities

.19 Issuers of securities often engage broker-dealers to underwrite their public or private offerings. In such arrangements, the underwriter (or a syndicate of underwriters) either agree to buy the securities issued and in turn sell them to the public (commonly referred to as a firm commitment), or agree to sell as much of the security issue as possible, normally with a minimum requirement to complete the underwriting (best efforts approach). Given the high volume of underwriting activity during the current year, along with the postponement of some IPOs during the summer months, this area may present a higher than usual level of audit risk. In auditing a broker-dealer's underwriting cycle, some of the procedures to be considered by auditors include the following:

- Auditors should consider reviewing underwriting contracts to which the broker-dealer is party in order to assess the accounting and disclosure implications of the terms and conditions contained therein. Additionally, auditors may wish to confirm amounts of open contractual commitments as well as assessing management's treatment of its underwriting liability for unsold positions. Auditors should give consideration to subsequent events relating to such transactions—as set forth under SAS No. 1, section 560, *Subsequent Events* (AU section 560), and to assess whether a provision for losses arising from unfulfilled commitments is necessary, and if so, whether it has been properly reflected in the broker-dealer's financial statements.

- Purchase transactions for newly issued securities may involve the payment of a good-faith deposit to the managing underwriter. As part of the audit of a broker-dealer acting in this capacity, auditors may wish to confirm the client's liability with the participants in the offering. Auditors may be confronted with a circumstance in which the broker-dealer, as a participant in an offering, has made a good-faith payment to a managing underwriter. In such cases, the auditor may wish to confirm the client's asset with the managing underwriter.

- In assessing the completeness and accuracy of a client's recorded underwriting commitments, it may be beneficial for auditors to monitor announcements in financial periodicals of securities offerings (commonly referred to as *tombstones*). In those cases in which the offering has been advertised, the auditor can determine whether the broker-dealer has recorded the commitments pertaining to the offerings in which its name appears as manager or participant.

- Underwriters are common targets in shareholder lawsuits. As such, in the evaluation of litigation, claims, and assessments, auditors should ascertain the existence of any current or pending legal action against the broker-dealer. Auditors should pay particular attention to whether the underwriters are jointly or severally liable for legal claims arising in connection with the underwriting. Although the liability of participants who are severally liable is limited to those claims relating to their portion of the securities underwritten, those participants who are jointly liable will be responsible for all claims to the extent that those claims are not satisfied by other participants to the underwriting. Auditors should be aware of their responsibilities in this area pursuant to SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU section 337).

Valuation of Securities

.20 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. Chap-

ter 4, *Auditing Considerations*, of the AICPA's Audit and Accounting Guide *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, consider internal control related to the estimation process, and read relevant minutes. Auditors should refer to SAS No. 57, *Auditing Accounting Estimates* (AU section 342), which provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit. 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 a specialist used. Auditing the valuation of such securities is an area that requires a high degree of professional judgment and scrutiny to ensure that the carrying amounts approximate fair value.

On-Line Trading

.21 On-line trading initiated from personal computers continues to increase, advanced predominantly by discount brokers. Although on-line trading has been available for several years to investors who trade shares using their broker's in-house software, investors are increasingly being given the option to buy and sell shares by dialing a computer system using a modem on a home computer. One of the nation's largest discount brokerage firms is expected to offer investors the option of trading certain load and no-load mutual funds on its Internet web site. Many other discount brokers are expected to follow suit by year end. These technological changes are likely to redefine the industry as well as increasing audit risk given that electronic evidence obtained from the client's computer system may not provide the same level of assurance as to authenticity and occurrence as do externally generated documents. Auditors should consider carefully internal control related to on-line and Internet trading along with the nature and sufficiency of available evidential matter underlying on-line trading transactions. The AICPA's Auditing Procedure Study, *Audit Implications of EDI* (product no. 021060), provides auditors with guidance on engagements in an electronic data interchange environment and may be helpful in these circumstances. Additionally, the AICPA recently issued an exposure draft of a proposed SAS, *Amendment to SAS No. 31*, Evidential Matter. The proposed SAS addresses certain issues related to evidential matter in electronic form as discussed in the "AICPA Exposure Drafts: Proposed SASs" section of this Audit Risk Alert.

Service Auditor's Reports

.22 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 and assessing control risk, auditors should carefully consider the functions and 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 broker-dealers, that use service organizations. SAS No. 70 (AU section 324) may specifically impact custodian and transfer agent third-party internal control reports, as well as multiple-class fund design and operation reporting on expense allocation and the calculation of net asset value per share and distributions.

.23 SAS No. 55 (AU section 319) requires an auditor to obtain an understanding of an entity's internal control sufficient to plan the audit. If a broker-dealer uses a service organization, control activities 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 control activities performed by a service organization. If a broker-dealer relies on a service organization's control activities over the processing of transactions that are material to the broker-dealer's financial statements, these control activities should be considered by the auditor.

.24 One method of obtaining information about these control activities is to get a service auditor's report as described in SAS No. 70 (AU section 324). Auditors frequently ask whether it is necessary to obtain a

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

service auditor's report if 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 broker-dealer may implement control activities that will obviate the need for a service auditor's report. In such circumstances, the broker-dealer is not relying on the service organization's controls.

.25 Some additional factors that may be considered in determining whether to obtain a service auditor's report are the following:

- Whether the transactions or accounts affected by the service organization are material to the broker-dealer'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 broker-dealer (Such information may provide the auditor with sufficient information to plan the audit.)

The AICPA Auditing Procedure Study, *Implementing SAS No. 70,* Reports on the Processing of Transactions by Service Organizations (product no. 021056) can provide auditors with additional guidance in this area.

New Pronouncements

Auditing Standards

.26 *SAS No. 75.* In September 1995, the Auditing Standards Board (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 certain circumstances, as discussed in the Statement. 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.

.27 *SAS No. 76.* In September 1995, the ASB issued SAS No. 76, *Amendments to Statement on Auditing Standards No. 72,* Letters for Underwriters and Certain Other Requesting Parties (AU section 634). The Statement (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 is effective for letters issued pursuant to paragraph 9 of SAS No. 72 (AU section 634.09) after April 30, 1996.

.28 *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, 544, 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. Such reports frequently are prepared in connection with an underwriting of a closed-end fund. SAS No. 77 is effective for engagements beginning after December 15, 1995.

.29 *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 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. 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.

.30 *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. Such uncertainties may include the valuation of illiquid investments or those investments for which a readily ascertainable market value does not exist. This Statement 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.

.31 A table outlining the significant provisions of the newly issued auditing standards is set forth in the Exhibits section of this Audit Risk Alert.

Attestation Standards

.32 *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. Reporting on security counts performed pursuant to Rules 17f-1 and 17f-2 of the 1940 Act should follow SSAE No. 4 (AT section 600). The SEC staff notes that SSAE No. 4 (AT section 600) is not accepted for 17f-1 or 2 reports.

.33 *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 provides guidance on the quantity, type, and content of working papers for attestation engagements and is effective for engagements beginning after December 15, 1995.

.34 *SSAE No. 6.* In December 1995, 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 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 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) is permitted.

.35 *Quality Control Standards.* 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.

.36 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 20158.01), and 202, *Compliance With Standards* (ET section 202.01), of the AICPA Code of Professional Conduct. The definition of a firm's accounting and auditing practice has been revised to include engagements

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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 (QC section 20) 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.

New Independence Standards

.37 The second general auditing standard, "Independence" (AU section 220.07) provides that in all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors. The precepts established to guard against the presumption of loss of independence are contained in the AICPA's *Code of Professional Conduct*. Recently issued standards relating to independence are enumerated in the following sections:

Ethics Ruling—Indemnification of a Client. The AICPA Professional Ethics Executive Committee issued Ethics Ruling No. 102, *Member's Indemnification of a Client* (ET section 191.204 and .205), as published in the January 1996 *Journal of Accountancy*. This ruling 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. In assessing their independence, auditors of investment companies should consider the implication of indemnification arrangements requested by their clients, in light of this new ethics ruling.

Extended Audit Services. The AICPA Professional Ethics Executive Committee issued the following independence standards relating to providing extended audit services:

- Ethics Interpretation 101-13, *Extended Audit Services* (ET section 101.15)
- Ethics Ruling No. 97, *Performance of Certain Extended Audit Services* (ET section 191.194 and .195)
- Ethics Ruling No. 103, *Member Providing Attest Report on Internal Controls* (ET section 191.206 and .207)
- Ethics Ruling No. 104, *Member Providing Operational Auditing Services* (ET section 191.208 and .209)
- Ethics Ruling No. 105, *Frequency of Performance of Extended Audit Procedures* (ET section 191.210 and .211)

The complete text of the standards shown above were published in the August 1996 edition of the AICPA's *Journal of Accountancy* and became effective upon publication.

AICPA Exposure Drafts: Proposed SASs

.38 *Consideration of Fraud in a Financial Statement Audit.* In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Consideration of Fraud in a Financial Statement Audit and Amendments to Statements on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures, *and No. 47,* Audit Risk and Materiality in Conducting and Audit Proposed Statement on Auditing Standards. The proposed Statement would provide expanded operational guidance on the consideration of fraud in conducting a financial statement audit. The proposed changes in auditing standards also clarify the auditor's present responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud. In addition, the proposed changes provide added guidance on the standard of due professional care in the performance of work, including the need to exercise professional skepticism, and the concept of reasonable assurance. In addition to amending SAS Nos. 1 (AU sections 110 and 230) and 47 (AU section 312), the proposed Statement would:

- Describe fraud and its characteristics.
- Require the auditor to specifically assess the risk of material misstatement due to fraud and provide categories of fraud risk factors that should be considered in the auditor's assessment.
- Provide guidance on how the auditor should respond to the results of the assessment.
- Provide guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud.
- Describe related documentation requirements.
- Provide guidance regarding the auditor's communication about fraud to management, the audit committee, and others.

.39 *Amendment to SAS No. 31, Evidential Matter.* In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter. This proposed Statement would provide guidance for a practitioner who has been engaged to audit an entity's financial statements where significant information is transmitted, processed, maintained, or accessed electronically. The proposed Statement would include examples of evidential matter in electronic form and provide that an auditor should consider the time during which such evidential matter exists or is available in determining the nature, timing, and extent of substantive tests. In addition, the proposed Statement would indicate that an auditor may determine that, in certain engagement environments where evidential matter is in electronic form, it would not be practical or possible to reduce detection risk to an acceptable level by performing only substantive tests. The proposed Statement would provide that in such circumstances, an auditor should consider performing tests of controls to support an assessed level of control risk below the maximum for affected assertions.

Accounting Issues and Developments

Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities

.40 In June 1996, the FASB issued FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities.* This Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishment of liabilities. Those standards are based on consistent application of a financial-components approach that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. This Statement provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

.41 A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interest in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

1. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
2. Either (*a*) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right—to pledge or exchange the transferred assets or (*b*) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

3. The transferor does not maintain effective control over the transferred assets through (*a*) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (*b*) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

.42 FASB Statement No. 125 requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interest in transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

.43 FASB Statement No. 125 requires that servicing assets and liabilities be subsequently measured by (*a*) amortization in proportion to and over the period of estimated net servicing income or loss and (*b*) assessment for asset impairment or increased obligation based on their fair values.

.44 FASB Statement No. 125 requires that debtors reclassify financial assets pledged as collateral and that secured parties recognize those assets and their obligation to return them in certain circumstances in which the secured party has taken control of those assets.

.45 FASB Statement No. 125 requires that a liability be derecognized if and only if either (*a*) the debtor pays the creditor and is relieved of its obligation for the liability or (*b*) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

.46 FASB Statement No. 125 provides implementation guidance for assessing isolation of transferred assets and for accounting for transfers of partial interest, servicing of financial assets, securitizations, transfers of sales-type and direct financial lease receivables, securities lending transactions, repurchase agreements including "dollars rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishment of liabilities.

.47 FASB Statement No. 125 supersedes FASB Statements No. 76, *Extinguishment of Debt*, and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. This Statement amends FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), to clarify that a debt security may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. This Statement amends and extends to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (AC Mo4), and supersedes FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*. This Statement also supersedes Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt*, No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*, and No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*.

.48 FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishment of liabilities occurring after December 31, 1996, and is to be applied prospectively. Earlier or retroactive application is not permitted.

Delayed Effective Dates—Accounting Pronouncements

.49 *Disclosures about Fair Value of Financial Instruments.* FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), issued in December 1991, was effective for financial statements issued for fiscal years ending after December 15, 1992. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995. In that

a sizable portion of broker-dealers may be smaller enterprises, financial statements for years ended during 1996 will be subject to the provisions contained therein. In such circumstances, auditors should consider whether management has made all disclosures required by FASB Statement No. 107 (AC F25). In September 1996, the FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Elimination of Certain Disclosures about Financial Instruments by Small Nonpublic Entities*, which, if adopted, would exempt certain small entities from the requirements of Statement No. 107 (AC F25).

.50 FASB Statement No. 107 (AC F25) requires disclosure of the fair 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 requires disclosure of descriptive information pertinent to estimating the value of a financial instrument. Certain financial instruments (for example, lease contract, deferred-compensation arrangements, and insurance contracts) are excluded from the scope of the Statement (AC F25).

.51 *Disclosures about Derivative Financial Instruments.* FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), issued in October 1994, was effective for financial statements issued for fiscal years ending after December 15, 1994. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995.

.52 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), to require disaggregation of information about financial instruments with off-balance-sheet risk of accounting loss by class, business activity, risk, or other category that is consistent with the entity's management of those instruments. The Statement (AC F25) also amends FASB Statement No. 107 (AC F25) to require that fair value information be presented without combining, aggregating, or netting the fair value of derivative financial instruments with the fair value of nonderivative financial instruments and be presented together with the related carrying amounts in the body of the financial statements, a single footnote, or a summary table in a form that makes it clear whether the amounts represent assets or liabilities.

.53 Auditors should consider whether the provisions of FASB Statement No. 119 (AC F25) apply to their broker-dealer clients, and if so, evaluate whether the client's financial statement disclosures are adequate and appropriate in view of the requirements set forth therein.

Restructurings

.54 During the current year, the securities industry has continued its efforts to trim the costs of operations and has seen an increase in the number of mergers and acquisitions. Restructuring often accompanies these activities as redundant functions are eliminated and existing areas streamlined. Restructuring charges typically include employee-related costs, costs associated with the elimination and reduction of product lines, and costs related to the consolidation of operations. Restructuring charges also include asset writedowns and losses on the disposal of assets. If broker-dealers implement restructuring programs, auditors should consider the impact of the reductions in personnel on operations and on the entity's internal control, the appropriateness and completeness of recorded liabilities relating to current restructuring plans, and the appropriate period for reporting the costs associated with restructurings.

.55 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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

that should be accrued and the timing of recognition of restructuring charges. It also prescribes disclosures that should be included in the financial statements.

.56 For publicly held entities, 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.

FASB Exposure Draft

.57 The FASB has issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting for Derivative and Similar Financial Instruments and for Hedging Activities*, which if adopted would establish accounting and reporting standards for derivative financial instruments and other similar financial instruments and for hedging activities. The proposed Statement would be effective for fiscal years beginning after December 15, 1997, with earlier application permitted only as of the beginning of a fiscal year that begins after the issuance of the final Statement. The comment deadline is October 11, 1996.

.58

Exhibit

Significant Provisions of Newly Issued SASs

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, 544, 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]).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

Information Sources

.59 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.

.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.

* * * *

.64 This Audit Risk Alert supersedes *Securities Industry Developments—1995/96.*

* * * *

.65 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1996/97* [AAM section 8010] and *Compilation and Review Alert—1996/97* [AAM section 8015].

.66

Information Sources

Organization	General Information	Fax/Phone 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. 1) 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) 942-4040 *SEC Public Reference Room* (202) 942-8090	*Information Line* (202) 942-8088 (ext. 3)	SEC's Homepage www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)
Securities Industry Association	120 Broadway New York, NY 10271-0080 (212) 608-1500	Fax (212) 608-1604 E-mail: info@sia.com	Internet: http://www.sia.com	
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			
Public Securities Association	40 Broad Street New York, NY 10004-2373 (212) 809-7000	Fax (212) 440-5260	Internet: http://www.psa.com	

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

Organization	General Information	Fax/Phone Services	Electronic Bulletin Board Services	Recorded Announcements
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		

[*The next page is 8375.*]

AAM Section 8180

Not-for-Profit Organizations Industry Developments—1997

Industry and Economic Developments

.01 Overall, the effects of growth on the not-for-profit sector continue to lag behind those on the economy as a whole. Funding that not-for-profit organizations receive from private foundations has increased. Funding from the federal government has remained relatively steady. However, the use of block grants rather than specific program grants for government funding for social service programs is likely to increase. This will result in states having more discretion in the kinds of services that are ultimately funded. Interest rates remained steady, resulting in not-for-profit organizations receiving steady 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. Exhibit 1 summarizes the changes in key economic factors from last year.

Exhibit 1

Economic Factor	*Change from Last Year*
Private Contributions	Information not available. (Increases are expected to outpace inflation.)
Interest Rates	Steady
Corporate Contributions	Increase (5 percent to 7.5 percent)
Equity Markets	Significant Increase
Funding from Foundations	Significant increase (Some surveys say as high as 16 percent)
Government Funding	Steady

.02 The use of gifts, such as annuities, charitable remainder annuity trusts and unittrusts, pooled income funds, and lead trusts, that provide donors with tax deductions while retaining beneficial interests in property continues to increase. 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. The recently issued AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, which is discussed in the "AICPA Guide Project" section of this Audit Risk Alert, provides new guidance concerning accounting for those gifts. 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
- Conflicts of interest arising from transactions with members of the board of trustees and other insiders
- Lobbying activities

- The perception that expenditures for program services are too low as a percentage of total expenditures
- Fraud and abuse
- The amounts of assets held by not-for-profit organizations
- The portion of revenue earned from fees for goods or services
- Whether activities undertaken by the organization are consistent with its exempt purpose
- Contractual compliance and excess revenues related to government sponsored or funded programs

The adverse publicity concerning such issues continues to adversely affect the amounts some donors are willing to contribute. Furthermore, the excess benefits of executives may have the following consequences:

- The imposition of fines on the organization by the Internal Revenue Service (IRS) under recently enacted intermediate sanctions, which are discussed in the "IRS Activities" section of this Audit Risk Alert
- Jeopardizing 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) potentially high-risk investments, such as certain derivatives and equity instruments.

.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 generally accepted accounting principles (GAAP).

Regulatory and Legislative Developments

Major Changes to Single Audits of Federal Awards

.06 The promise of major change in single audit policy became a reality during 1996. These changes continue to be finalized during the first half of 1997. Auditors performing audits of federal awards should follow developments in this area closely to ensure that the appropriate guidance is followed. The sections below summarize four key pieces of guidance which have been or are currently being revised for single audits and program-specific audits of federal awards. The latter three, U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* the *Compliance Supplement,* and the AICPA Statement of Position, were not completed at the time of publication of this Audit Risk Alert. Information on the status of these documents will be published in the *Journal of Accountancy* and *The CPA Letter* and will be made available on the AICPA Fax Hotline and home page (http://www.aicpa.org).

.07 *Single Audit Act Amendments of 1996 (1996 Amendments).* On July 5, 1996, President Clinton signed into law legislation amending the Single Audit Act of 1984 (Public Law 104-156), which is effective for fiscal years beginning after June 30, 1996. The 1996 Amendments extend the act's jurisdiction to not-for-profit organizations, raise the dollar threshold for audit coverage to $300,000 from $25,000, implement a risk-based approach to identify the major federal programs to be audited, and shorten the audit report due date to nine months after a transition period of two years. The 1996 Amendments are discussed further in a November 1996 *Journal of Accountancy* article entitled "Auditing Federal Awards, A New Approach." A copy of the 1996 Amendments is also available on the AICPA Fax Hotline; dial (201)-938-3787 from a fax machine and select document number 402. The full text of the amendments is located on IGnet at http://www.sbaonline.sba.gov/ignet/under the listing "Single Audit."

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.08 *OMB Circular A-133*, Audits of States, Local Governments, and Non-Profit Organizations. A revised OMB Circular A-133, applicable only to not-for-profit organizations, was issued on April 22, 1996. Once the 1996 Amendments were passed (see above), it became necessary for the OMB to propose another revision to OMB Circular A-133 to add states and local governments to the scope of the Circular and to comply with certain other aspects of the 1996 Amendments. This proposed revision was issued in the November 5, 1996, *Federal Register* (61 FR 57231), and a final document is expected to be issued before June 30, 1997. The OMB intends to rescind Circular A-128, *Audits of State and Local Governments*, which is the existing regulation governing audits of federal awards for states and local governments once OMB Circular A-133 is issued in final form.

.09 Once finalized, OMB Circular A-133 will establish audit requirements that apply to not-for-profit organizations (including hospitals and colleges and universities) and state, local, and Indian tribal governments, and will be effective for fiscal years beginning after June 30, 1996. Provisions of the revised Circular include the following:

- The threshold for audit is raised to $300,000 from $25,000.
- Auditors are required to identify major programs 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. Due to the timing of the issuance of the final Circular and related audit guidance, auditors may want to consider a provision in the Circular that allows auditors to determine major programs solely on the basis of federal expenditures for first year audits. First year audits are defined as the first year that an entity is audited under the new Circular or the first year of a change of auditors. As an example, if an auditor has a client with a June 30, 1997, fiscal year end, the use of the risk-based approach to determine major programs would be optional for that year because it would be the first audit under the new Circular.
- Major program coverage is required to be a minimum of 50 percent (or 25 percent for low-risk auditees) of the federal awards expended.
- The required level of testing of internal control over major programs is clarified as being based on auditors' planning for a low assessed level of control risk.
- Guidance is included for conducting program-specific audits covering those situations in which a federal grantor agency has not issued a program-related audit guide, as well as those situations in which a program-specific audit guide has been issued by the grantor agency.
- Minimum requirements for the Schedule of Expenditures of Federal Awards are provided.
- Guidance is included concerning the following:
  1. Reporting audit findings in a single schedule of findings and questioned costs which includes a summary of the audit results, and findings and questioned costs related to the financial statement audit as well as to federal awards
  2. Thresholds for determining which audit findings should be included in the schedule of findings and questioned costs
  3. Descriptions of what information auditors should include in an audit finding
  4. Required follow-up on audit findings
- Auditee management is required to provide a corrective action plan for current year audit findings and a summary schedule reporting the status of prior year audit findings.
- The definition of *non-profit organization* is revised to include non-profit hospitals.
- Restrictions are 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. This provision is not effective until audits of fiscal years beginning after June 30, 1998.

- The due date is shortened for submitting reports to nine months from thirteen months, after a two-year transition period. The transition period is for fiscal years beginning on or before June 30, 1998, during which auditees will have thirteen months after the end of the audit period to complete the audit and submit the reporting package. The provision for a cognizant or oversight agency to grant an extension is retained. Also the report submission process is streamlined, including incorporating a data collection form, and expanding the role of the federal clearinghouse.

Auditors should note that the November 1996 proposed revisions to OMB Circular A-133 included two significant changes from the earlier revision concerning the data collection form and audit coverage of indirect cost pools. In summary, the proposal would require auditors to prepare and sign the data collection form, and test and report on the allowability of costs charged to cost pools. Because the final resolution of these issues is unknown at this time, auditors should carefully review the final Circular for any new requirements.

.10 As noted in the preceding paragraphs, the 1996 Amendments are effective for fiscal years beginning after June 30, 1996, and OMB expects to issue the revised OMB Circular A-133 before June 30, 1997. OMB will instruct federal agencies to adopt OMB Circular A-133 in codified regulations within six months after publication of the final OMB Circular A-133 in the *Federal Register* so that it will apply to audits of fiscal years beginning after June 30, 1996. Therefore, the revised OMB Circular A-133 should be followed for audits of years beginning after June 30, 1996. Until such time as OMB publishes the final revision of OMB Circular A-133, auditors are encouraged to use the revision of OMB Circular A-133 published in the November 5, 1996 *Federal Register* for planning purposes.

.11 Last, as a result of the issuance of the 1996 Amendments and revisions to OMB Circular A-133, questions have arisen with regard to the status of position statements issued by the President's Council on Integrity and Efficiency (PCIE). These position statements were originally developed to address issues related to audits conducted under the Single Audit Act of 1984, OMB Circular A-128, and the March 1990 version of OMB Circular A-133. Therefore, with the exception of PCIE Statement No. 4, none of the remaining position statements is applicable to audits conducted under the 1996 Amendments or the new OMB Circular A-133 requirements.

.12 Upon publication, a copy of the final revision to OMB Circular A-133 may be obtained from the *Federal Register*; the OMB fax information line (202) 395-9068, document number 1133; the OMB home page on the Internet, which is currently located at http://www.whitehouse.gov/WH/EOP/OMB/html/ombhome.html; or by calling or writing the Office of Administration, Publications Office, Room 2200, New Executive Office Building, Washington, DC 20503, telephone (202) 395-7332.

.13 *Compliance Supplement.* A revised OMB Compliance Supplement which is currently under development will set forth the material compliance requirements that are to be included in an audit in accordance with OMB Circular A-133. It will cover states, local governments, and not-for-profit organizations. The OMB is expected to issue a Provisional Compliance Supplement before June 30, 1997, to replace the existing Compliance Supplements entitled *Compliance Supplement for Single Audits of State and Local Governments* (issued in September 1990) and *Compliance Supplement for Institutions of Higher Learning and Other Non-Profit Institutions* (issued in October 1991), which are no longer current. It is expected that a notice will be provided in the *Federal Register* of the Provisional Supplement's availability along with a request for public comment. Auditors should use the Provisional Supplement until the public comment process is completed and OMB issues a Final Supplement. OMB anticipates issuing a Final Supplement in 1998.

.14 The most significant changes to the revised Compliance Supplement will include the following:

- A compliance matrix, which provides an overview of the compliance requirements applicable to the programs listed in the supplement
- Replacement of the classifications of general requirements and specific requirements with the following fourteen types of compliance requirements, all of which are covered by the auditor's opinion on compliance:

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

  - — Activities Allowed or Unallowed
  - — Allowable Costs/Cost Principles
  - — Cash Management
  - — Davis-Bacon Act
  - — Eligibility
  - — Equipment and Real Property Management
  - — Matching, Level of Effort, Earmarking
  - — Period of Availability of Federal Funds
  - — Procurement and Suspension and Debarment
  - — Program Income
  - — Real Property Acquisition and Relocation Assistance
  - — Reporting
  - — Subrecipient Monitoring
  - — Special Tests and Provisions
- Audit objectives and suggested audit procedures for each type of compliance requirement
- Expanded guidance on allowable costs and cost principles, which includes a comparison of the requirements between the common rule, OMB Circular A-21, *Cost Principles for Educational Institutions;* and OMB Circular A-122, *Cost Principles for Non-Profit Organizations*
- Detailed guidance on how to determine applicable compliance requirements, control objectives, and audit objectives for programs not listed in the Compliance Supplement
- Characteristics of internal control over compliance are presented in the format included in *Internal Control—Integrated Framework* (the COSO Report), published by the Committee of Sponsoring Organizations of the Treadway Commission

.15 Initially, the Provisional Supplement will include approximately twenty-five federal programs. This is far less than what was included in the Compliance Supplements that are being replaced. However, the OMB has made a commitment to continue working on the Provisional Supplement and to include additional programs in the Final Supplement. As noted above, the OMB will be adding guidance to the Compliance Supplement that instructs auditors on the appropriate steps to take when a program is not included. The Compliance Supplement will be available from the Government Printing Office (See the table under the section of this Audit Risk Alert entitled "Information Sources" for information on how to contact the Government Printing Office) and the OMB home page on the Internet, which is currently located at http://www.whitehouse.gov/WH/EOP/OMB/html/ombhome.html. Once the supplement has been issued, more detailed guidance on how to obtain copies will be included in the AICPA's *CPA Letter* and posted on the OMB and AICPA home pages.

.16 *AICPA Statement of Position.* With the changes described in the preceding three sections, Statement of Position (SOP) 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards,* and certain sections of the Audit and Accounting Guide *Audits of State and Local Governmental Units* (the Guide) have become outdated. In response, the AICPA is in the process of developing a new SOP that will supersede SOP 92-9 and the sections of the Guide that are outdated. The new SOP is expected to be issued during the summer of 1997 (assuming that the previously described OMB guidance is issued on the dates planned) and will provide auditors of states, local governments, and not-for-profit organizations with guidance on the work performed and the reports issued for audits under the 1996 Amendments, and OMB Circular A-133. It will also include revised simplified illustrative audit reports. The new illustrative simplified reports will include one report on the financial statements, one report that will meet the requirements for reporting on compliance

and internal control under *Government Auditing Standards* (GAS, also known as the Yellow Book), and one report that will meet the requirements of the 1996 Amendments and OMB Circular A-133 for reporting on single audits of federal awards.

OMB Circulars A-21 and A-122

.17 Auditors involved with audits of federal awards for colleges and universities should be aware that the OMB issued revisions to OMB Circular A-21 in May 1996 (*Federal Register*, May 8, 1996) which are effective for fiscal years beginning after May 8, 1996. The revisions incorporate four cost accounting standards issued by the Cost Accounting Standards Board (CASB) applicable to all sponsored agreements subject to OMB Circular A-21 and extend the applicability of the CASB disclosure statement to universities that receive more than $25 million in federally funded sponsored agreements. It also amends the definition of equipment; eliminates the use of special cost studies to allocate utility, library, and student services costs (effective for fiscal years beginning on or after July 1, 1998); requires the use of fixed facilities and administrative cost rates for the life of sponsored agreements; establishes cost negotiation cognizant agency responsibilities; clarifies the policy for a change from use allowance to depreciation; adds criteria to interest allowability; and disallows tuition benefits for employee family members for fiscal years beginning on or after September 30, 1998. In performing audits in accordance with OMB Circular A-133, auditors should consider whether organizations subject to OMB Circular A-21 have complied with the CASB standards and disclosure requirements incorporated therein.

.18 In October 1995, OMB published proposed revisions to OMB Circular A-122. The proposed revisions would change 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. The period for commenting on the proposal has expired and the final revision is expected to be issued in October 1997.

U.S. Department of Education Issues New Drawdown Procedures for Grant Payments

.19 Auditors with clients that receive grants from the U.S. Department of Education should be aware of changes in the procedures for grant payments accounting and reporting. A letter was issued in July 1996, notifying program recipients of the new drawdown procedures to take effect in 1997 between July and September. The fundamental change is that recipients will have to request Department of Education dollars by individual program when drawdowns are made. In the past, recipients were allowed to pool their drawdowns into a single amount without identifying the specific programs being funded. The new procedure may require many recipients to change their internal processes and systems. Auditors should consider this change when testing cash management in conjunction with single audits. Contact Charles L. Coleman, Director of Cash Management, U.S. Department of Education, for further information at (202) 401-1776.

Audit Quality

.20 The AICPA and the President's Council on Integrity and Efficiency (PCIE) are involved in a cooperative effort in which Federal Inspectors General (IGs) of government agencies refer to the AICPA Professional Ethics Division audits of entities receiving federal awards that the IGs consider to be of a substandard nature. Also, the PCIE issues periodic reports on the results of IG desk reviews and quality control reviews of work performed by independent auditors. 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 awards. Some of the more common deficiencies cited by reviewers include—

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- Deficient audit reports (incorrect reports on internal control or compliance, not all required information included, incorrect presentation of financial information without proper qualification, improper or missing opinion, incorrect or missing findings, no disclosure of reportable conditions)
- Inadequate working papers (failure to adequately support opinion, no documentation of required procedures such as internal control evaluation, analytical procedures, or subsequent events review)
- Failure to perform all procedures required in agency audit guide or compliance supplement (no compliance testing, no study and evaluation of internal control)

The risks and ramifications to auditors of issuing deficient audit reports or performing inadequate audits are significant. AICPA-required corrective actions and sanctions can include mandatory CPE in specified subjects, mandatory work product preissuance reviews, preclusion from performing quality reviews, and suspension or expulsion from the AICPA and state CPA society. Substandard audit work can also result in actions by state boards of accountancy such as fines and loss of license or certification.

Other Federal Issues

.21 *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.

.22 *Work Opportunity Reconciliation Act and Health Care Reform Issues.* In August 1996, the federal government passed the Personal Responsibility and Work Opportunity Reconciliation Act (Public Law 104-193) to overhaul the welfare system. Beginning October 1, 1996, states gained broad authority over their own welfare programs, and the form of federal funding was changed to block grants, giving the states flexibility in determining who is eligible for the funds. On an overall basis, the law is expected to reduce the amount of government funds expended for welfare per person. As a result, not-for-profit organizations that provide programs to serve the homeless, immigrants, the poor, and others who may be adversely affected by the overhaul may receive pressure to increase their levels of service. Some are responding to that pressure by changing the ways in which they raise funds, and operate and deliver services.

.23 Similarly, continued state wide initiatives to move health care services (physical care as well as behavioral care) to managed care arrangements are creating opportunities as well as challenges to some organizations. These organizations must assess changes to their service delivery systems and funding mechanisms but are also identifying opportunities to provide new services or to serve new populations.

.24 Auditors should consider the effects of these changes on their consideration of internal control and on the organization's compliance with applicable laws and regulations.

.25 Also, some organizations may be motivated to increase their lobbying activities at the state level as they compete for funds. Auditors should consider whether those activities are in accordance with IRS restrictions on lobbying activities.

.26 In addition, the act eases restrictions that religious organizations may face in establishing eligibility for federal funds. As a result, some religious organizations may receive increased government funds and may also be subjected to increased audit and compliance requirements. For example, the organization may be required to have an audit performed in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States or in accordance with OMB Circular A-133. Auditors should consider whether the organization has complied with applicable laws and regulations. Paragraphs 21 through 23 of Statement on Auditing Standards (SAS) No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AU section 801.21–.23), provide

guidance on the auditor's responsibilities if he or she becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement. SAS No. 74 (AU section 801) provides that, in that situation, "the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with generally accepted auditing standards may not satisfy the relevant legal, regulatory, or contractual requirements." SAS No. 74 (AU section 801) also notes that "the auditor should consider how the client's actions in response to such communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in SAS No. 54 [*Illegal Acts by Clients* (AU section 317)]."

.27 *Philanthropy Protection Act of 1995.* The Philanthropy Protection Act of 1995, which took effect March 6, 1996, exempts charitable gift annuities, charitable remainder unittrusts, charitable remainder annuity trusts, and other kinds of split-interest agreements that will be commingled for investment purposes from the Investment Company Act and other securities laws. Also, it requires organizations to make certain written disclosures about the terms of the operations of the fund to potential contributors. Auditors should consider whether organizations have made the disclosures required by the act.

.28 *New Postal Rates.* In October 1996, the U.S. Postal Service changed its rate structure for not-for-profit organizations. The Postal Service estimates that the changes will save organizations an average of 6.4 percent for each piece of mail they send, though rates will increase for certain kinds of mail, such as mail that is neither sorted according to certain specifications, delivered to local postal facilities, nor bar coded. Auditors should consider the effects of such changes when performing their analytical procedures and other substantive tests of expenses.

State and Local Issues

.29 State and local laws concerning not-for-profit organizations continue to change. Some states have enacted or are revising existing laws concerning not-for-profit registration or licensing requirements; annual reporting requirements; charitable solicitation, registration, and disclosure requirements; charitable gift annuity registrations; and limitations on fund-raising expenses. Also, some states have increased efforts to have not-for-profit organizations pay property taxes, collect and remit sales and use 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

.30 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. Examples include the result of an incorrect accrual for taxes on unrelated business income (UBI) or a material indirect effect on the financial statements that would require disclosures, such as the result of a potential loss of tax-exempt status. 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.

.31 *Intermediate Sanctions and Other Matters.* On July 30, 1996, the Taxpayer Bill of Rights (HR 2337) was enacted into law. This law allows the IRS to impose harsh penalties on insiders and managers of section

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

501(c)(3) and section 501(c)(4) organizations in certain circumstances related to excess benefit transactions. Under the new law, disqualified persons who unjustly benefit from an organization are subject to a first-tier penalty excise tax of 25 percent of the excess benefit amount. Also, organization managers who knowingly participate in an excess benefit transaction are subject to an excise tax of 10 percent. Further, taxes may be imposed on disqualified persons who do not correct the transaction by undoing the excess benefit to the extent possible.

.32 An *excess benefit transaction* is a transaction in which an economic benefit is provided to or for the use of any disqualified person if the value of the economic benefit provided directly by the organization exceeds the value of the consideration received by the organization. Also included is any transaction in which the amount of any economic benefit provided to any disqualified person is determined by the revenues of the organization, provided the transaction constitutes prohibited inurement under the present law. A *disqualified person* is any individual who is in a position to exercise substantial influence over the affairs of the organization, whether by being an organization manager or otherwise. Also included are certain family members and 35-percent-owned entities of a disqualified person, as well as anyone who was a disqualified person at any time during the five-year period prior to the transaction at issue. An *organization manager* is an officer, director, trustee or anyone who has the power or authority of an officer, director, or trustee.

.33 In general, intermediate sanctions are effective for excess benefit transactions occurring on or after September 14, 1995. However, they do not apply to transactions occurring pursuant to a written contract that was binding on September 13, 1995, and at all times thereafter before such benefits arose, and the terms of which have not materially changed. The Treasury Department and the IRS will likely issue regulations and provide guidance for interpretations of these provisions.

.34 Congress is considering expanding the provisions concerning excess benefit transactions to other tax-exempt organizations, such as those under section 501(c)(5) (for example, labor unions) and those exempt under section 501(c)(6) (for example, business leagues), but further action is not imminent.

.35 Also, under this law, all tax-exempt organizations must provide copies of their three most recent annual information returns and application for exemption from tax to the general public. Specifically, if the request is made in person, a copy must be made available immediately, with certain exceptions, such as if the requested documents have been made widely available to the public. If not made in person, a copy must be provided within 30 days. The organization may charge a reasonable fee for copying and mailing costs. The penalty for failure to furnish a requested information return or exemption application is $10 for each day during which such failure continues, with a $5000 limit on the return penalty and no limit on the exemption application penalty.

.36 The rules concerning the annual information return and application for exemption from tax to the general public will not go into effect until 60 days after regulations to implement them have been issued.

.37 On September 12, 1996, the IRS issued a notice in which they requested comments in drafting future guidance. In particular, comments were requested concerning ways in which the organization can make relevant documents widely available.

.38 *Eligibility as an S Corporation Shareholder.* For tax years beginning after 1997, qualified charities and certain retirement plans will be eligible to be S corporation shareholders. Currently, and until 1998, the contribution of voting or nonvoting S corporation stock to either of these entities would have terminated the S election for the business.

.39 The not-for-profit organization must treat the shares of the S corporation as an interest in an unrelated trade or business. Therefore, the items of income, loss, deduction, or credit that flow through to the tax-exempt shareholder and gain or loss on the sale of the stock will be treated as UBI. This characterization

of the income and loss as UBI applies regardless of the nature of the income actually passed through. Therefore, interest income (ordinarily excluded from UBI due to its passive nature) will be treated as UBI.

.40 *Increased Penalties for Failure to File Form 990.* The penalty for failure to file timely or complete returns for small tax-exempt organizations has been increased from $10 to $20 per day, with a maximum fine of the lesser of $10,000 or five percent of the organization's gross receipts. Large organizations (those having gross receipts exceeding $1 million) are subject to a penalty of $100 per day, with a maximum of $50,000. No penalty will be imposed if an organization can show that the failure to file a complete return was due to reasonable cause. This provision applies to returns for taxable years ending on or after July 30, 1996.

.41 *Establishing 401(K) Plans.* Since 1986, tax-exempt organizations have been prohibited from establishing 401(k) plans. Therefore, many section 501(c)(3) and governmental education organizations established 403(b) plans that provide employees with the ability to defer wage income into annuity investments. Under the recent tax bill, all tax-exempt organizations are once again permitted to establish 401(k) plans. This provision is effective for plan years beginning after December 31, 1996.

.42 *Unrelated Business Income Taxes.* If UBI taxes are material to the financial statements, they must be accrued. Auditors should consider the following developments in determining whether liabilities for taxes are properly reported:

- *Taxability of affinity and rental revenue from mailing lists.* The 9th Circuit Court of Appeals ruled that income from the rental of the Sierra Club's mailing list, which was used in connection with an affinity program, is nontaxable royalty income because the revenue represents payments for the right to use intangible property. The Sierra Club did not actively participate in the rental of its list but instead engaged an unrelated mailing list broker, who paid royalties to the club.

  However, the Court refused to agree that all of the club's income from the affinity program constituted exempt royalties. As a result, the issue of whether the club's affinity program income is fully nontaxable has been remanded to the Tax Court for additional tax finding. The IRS will continue to pursue this issue.

- *Administrative services.* The IRS recently issued two identical rulings concerning fees earned by an exempt fraternal organization in exchange for its performance of administrative services for closely related exempt organizations. The fraternal organization charged the lower of its cost or market for its services, and expense allocations were reviewed by the related exempt organization's board of directors. The IRS ruled that due to the close control relationship between the entities, the services should be considered to contribute to the fraternal organization's exempt purpose. Accordingly, the charge for administrative services will not be subject to UBIT.

- *Instant bingo.* In an appeal from the Tax Court, the 5th Circuit Court of Appeals recently confirmed that what is commonly called *instant bingo* (or *pull tab bingo*) is not bingo for tax purposes. Thus, at least in the 5th Circuit, income from instant bingo cannot avoid UBI tax using the statutory exception for bingo. However, the organization involved in the case would have avoided tax on the income if it ether had used volunteers to run the activity or had conducted it on an irregular basis.

- *Museum activities.* A recently released Technical Advice Memorandum (TAM 9550003) focuses on the taxability of various activities undertaken by museums. It provides insight concerning the current thinking of the IRS on a number of UBI issues regularly faced by museums.

.43 *Taxable Subsidiaries.* The IRS recently issued Private Letter Ruling (PLR) number 9542045, which discusses several issues concerning taxable subsidiaries of tax-exempt entities, such as potential taxation on formation, the requirement to maintain operations that are separate from the operations of the tax-exempt entity, and factors to consider concerning section 512(b)(13) in order to avoid unrelated business income on royalty payments. Also, the Treasury has released proposed regulation 1.337(d)-4 under section 337(d). Under the proposed regulations, if a taxable corporation transfers all or substantially all of its assets to one or more tax-exempt entities, the taxable corporation must recognize gain or loss as if the assets transferred

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

were sold at fair market value. This can also apply if the taxable corporation changes its status to tax-exempt. Proposed regulations are effective thirty days after publication as final regulations. Similar treatment applies under section 337 (b)(1) on a liquidation of a taxable corporation into an exempt parent organization.

.44 *Tax-Sheltered Annuity Voluntary Correction (TVC) Program Extended.* The IRS's TVC program, which began in 1995, gives plan sponsors of section 403(b) annuity plans the opportunity to voluntarily correct any plan defects. The program was scheduled to conclude October 1996. However, the IRS has recently announced that the program has been extended until December 31, 1998. 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.

.45 Based on past IRS audit experience, thousands of exempt organizations are believed to have defective plans. But, as of July 15, 1996 only 31 had taken advantage of the TVC program. The IRS has speculated that employers are awaiting to see how harshly the penalties are being applied. The IRS proposed examination guidelines were included in Announcement 96-25, 1996-17 Internal Revenue Bulletin No. 1.

.46 *Lobbying Disclosure Act of 1995.* The Lobbying Disclosure Act of 1995 requires organizations that lobby to register and report their federal lobbying activities. The act includes definitions of lobbying activities, including exemptions for organizations spending less than $20,000 on lobbying activities during a semiannual reporting period, and for religious organizations exempt from filing tax returns. Organizations meeting certain requirements must register with the U.S. Congress and file semiannual reports no later than February 14 and August 14 of each year. Failure to comply with the provisions of the act may result in civil penalties up to $50,000.

Audit Issues and Developments

Internal Control

.47 Changes in financial accounting standards, increased attention to the requirements to properly bill overhead costs to government agencies, restructuring, increased participation in affinity programs or similar arrangements, 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. In addition, as the overall economy improves, competition for qualified staff increases and not-for-profit organizations, which tend to pay lower salaries than for-profit entities, may have difficulty retaining well qualified staff, which may result in changes in internal control. 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 the "Auditing Pronouncements" section 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.

.48 *Affinity Programs and Other Affiliations.* Some entities, including some operating on the Internet, offer not-for-profit organizations fund-raising opportunities through various arrangements, such as affinity programs and investment networks. Some of those arrangements may be fraudulent, such as those that are actually investment pyramids, and organizations associated with them may be committing illegal acts. SAS No. 54 (AU section 317) discusses the nature and extent of the consideration that auditors should give to the possibility of illegal acts and provides guidance on the auditor's responsibilities if a possible illegal act is detected.

.49 Some affinity programs or other arrangements offer organizations royalties or other income in exchange for using the organization's name or logo. Auditors should consider internal controls over revenue earned and received under such arrangements.

Auditing Pronouncements

.50 Exhibit 2 summarizes six new Statements on Auditing Standards that have been recently issued.

Exhibit 2

Pronouncement	Pronouncements Affected	Key Provisions	Effective Date
SAS No. 77, *Amendments to Statement 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 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	The Statement (AU sections 311, 341, and 623) is effective for engagements beginning after December 15, 1995.
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	The Statement (AU section 319) is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application encouraged.
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])	The Statement (AU section 508) is effective for reports issued on or after February 29, 1996, with earlier application permitted.
SAS No. 80, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter (AU section 326)	SAS No. 31	Provides guidance for audits in which significant information is transmitted, processed, maintained, or accessed electronically	The Statement (AU section 326) is effective for engagements beginning on or after January 1, 1997.
SAS No. 81, *Auditing Investments,* (AU section 332)	SAS No. 1	Revises the guidance on auditing investments to make that guidance consistent with recently issued accounting standards, particularly FASB Statement Nos. 115 (AC I80) and 124 (AC No5)	The Statement (AU section 332) is effective for audits of financial statements for periods ending on or after December 15, 1997.
SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AU section 316)	SAS No. 53	Provides expanded guidance on the consideration of fraud in conducting a financial statement audit	The Statement (AU section 316) is effective for audits of financial statements for periods ending on or after December 15, 1997.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.51 *SAS No 77.* In November 1995, the ASB issued SAS No. 77, *Amendments to Statement 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 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.

.52 *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 the COSO Report. 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.

.53 *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, if 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, *Reports on Audited Financial Statements* (AU section 508), concerning emphasis paragraphs, matters involving uncertainties, and disclaimers of opinion. This SAS (AU section 508) neither affects SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), nor precludes 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.

.54 *SAS No. 80.* In December 1996, the ASB issued SAS No. 80, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter (AU section 326). This Statement (AU section 326) amends SAS No. 31, *Evidential Matter* (AU section 326), to recognize that evidential matter may exist only in electronic form. It also provides guidance to auditors engaged to audit the financial statements of entities for which significant information is transmitted, processed, maintained or accessed electronically.

.55 SAS No. 80 (AU section 326) recognizes that, in certain entities, some of the accounting data and corroborating evidential matter are available only in electronic form. Source documents such as purchase orders, bills of lading, invoices, and checks might be replaced with electronic messages. In image processing systems, source documents are scanned and converted into electronic images to facilitate storage and reference, and the source documents may not be retained after conversion. SAS No. 80 (AU section 326) also states that, in entities in which significant information is transmitted, processed, maintained, or accessed electronically, the auditor may determine that it is not practical or possible to reduce detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. For example, the potential for the improper initiation or alteration of information to occur and not be detected may be greater if information is produced, maintained, or accessed only in electronic form. In such circumstances, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk, or consider the effect on his or her report. SAS No. 80 (AU section 326) is effective for engagements beginning on or after January 1, 1997.

.56 *SAS No. 81.* In December 1996, the ASB issued SAS No. 81, *Auditing Investments* (AU section 332), which supersedes SAS No. 1, section 332, *Long Term Investments.* The Statement (AU section 332) revises the guidance on auditing investments to make that guidance consistent with recently issued accounting standards, particularly Financial Accounting Standards Board (FASB) Statement Nos. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), and 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations* (AC No5). The Statement (AU section 332) includes guidance on auditing asser-

tions about the valuation of investments, including guidance on auditing investments carried at cost and fair value. The guidance in SAS No. 81 (AU section 332) regarding investments accounted for using the equity method of accounting is generally unchanged from the guidance contained in the previous standard. SAS No. 81 (AU section 332) is effective for audits of financial statements for periods ending on or after December 15, 1997, with early application permitted.

.57 *SAS No. 82.* In February 1997, the ASB issued SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AU section 316). The new Statement (AU section 316) will supersede SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU section 316A). SAS No. 82 (AU section 316) provides auditors with expanded guidance on the consideration of fraud in conducting a financial statement audit. It strengthens the auditor's ability to fulfill his or her responsibility to plan and perform the audit in order to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.

.58 The new Statement (AU section 316) describes the types of fraud and requires auditors to specifically assess the risk of material fraud in every audit. It also provides separate categories of risk factors for fraudulent financial reporting (management fraud) and misappropriation of assets (theft) that require consideration.

.59 In addition, the new Statement (AU section 316) provides procedural guidance and examples of how auditors can respond to the presence of fraud risk factors. The new Statement (AU section 316) reaffirms the requirement that auditors communicate known instances of fraud to appropriate levels of management and the audit committee and, under certain circumstances, appropriate regulators.

.60 The new Statement (AU section 316) is effective for audits of financial statements for periods ending on or after December 15, 1997.

.61 The AICPA is undertaking a major initiative to assist auditors in understanding and implementing SAS No. 82 (AU section 316). Implementation efforts include the following:

- A Practice Aid entitled, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, walks auditors through issues likely to be encountered in applying the new SAS (AU section 316) to audits, with valuable tools, such as sample documentation. It also provides specific guidance on applying the concepts of the SAS (AU section 316) to various industries, including not-for-profit organizations. To obtain this publication (No. 008883) auditors should contact the AICPA Order Department at (800) 862-4272 or fax a request to (800) 362-5066.
- A self-study continuing professional education (CPE) course (No. 732045) entitled, *Consideration of Fraud in a Financial Statement Audit: The Auditor's Responsibilities Under SAS No. 82*, offers intermediate level information in test format and eight hours of recommended CPE. To obtain the CPE course auditors should contact the AICPA Order Department.
- Helpful guidance about the new SAS (AU section 316), including a press release, speech outline, and a comparison of SAS No. 82 (AU section 316) with SAS No. 53 (AU section 316A), are available on the AICPA's home page.

Financial Statements on the Internet

.62 It has become more common for not-for-profit organizations to make information available on the Internet or electronic bulletin boards (electronic sites). Information in electronic sites may include financial statements and other financial information, press releases, and other promotional material. Auditors should be aware that an interpretation of SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550) entitled "Other Information in Electronic Sites Containing Audited Financial

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Statements" (AU section 9550.16–.18) has been issued to address an auditor's responsibility with respect to other information included in an electronic site if the audited financial statements and the independent auditor's report thereon are also included. The Interpretation (AU section 9550.16–.18) appeared in the March 1997 *Journal of Accountancy* and was effective upon publication.

.63 The Interpretation (AU section 9550.16–.18) concludes that electronic sites are a means of distributing information and are not documents in the sense that the term *documents* is used in SAS No. 8 (AU section 550). Therefore, auditors are not required by SAS No. 8 (AU section 550) to consider the consistency of information in electronic sites with the original documents or to read other information contained in electronic sites. The Interpretation (AU section 9550.16–.18) also addresses the situation in which auditors are asked by their clients to consider information in electronic sites. It advises auditors that such consideration, which might take different forms, is not a service contemplated by SAS No. 8 (AU section 550). However, other auditing or attestation standards may apply, for example, agreed-upon procedures.

.64 Auditors should also note that the AICPA issued a nonauthoritative Practice Alert entitled, *Financial Statements on the Internet*, which describes distribution of audited financial statements and the related auditor's report on the Internet and speaks to several concerns for the auditor community. The Practice Alert is available on the AICPA's Fax Hotline at (201) 938-3787, document number 1566, and the AICPA's home page at http://www.aicpa.org/pubs/cpaltr/jan97/suppl/prac.htm.

Modifying Computer Systems for the Year 2000

.65 Many computer systems process transactions based on storing two digits for the year of a transaction (for example *97* for the year 1997), rather than a full four digits. A significant number of computer systems based on two-digit years are not programmed to consider the start of a new century, unless they have been recently modified. Systems that process year 2000 transactions with the year *00* may encounter significant processing inaccuracies and even inoperability. The potential impact of the year 2000 problem on not-for-profit organizations is that date sensitive calculations would be based on erroneous data or could cause a system failure. All forms of financial accounting, including interest computations, due dates, pensions, personnel benefits, investments, and legal commitments will be affected. It can also affect record keeping, such as inventory, maintenance, and file retention.

.66 Fixing this problem will likely be a very long, involved, and expensive process for many organizations, requiring computer coding changes that will affect millions of lines of program code. Auditors should consider the consensus reached by the Emerging Issues Task Force (EITF) of the FASB in its discussion of Issue No. 96-14, *The Accounting for Costs Associated with Modifying Computer Software for the Year 2000*, which provides that costs specifically associated with modifying software for the year 2000 should be expensed as incurred. It may be advisable for auditors to consider discussing this matter with their clients to determine whether it is an issue and to determine whether the costs incurred to date have been accounted for properly.

Lawyers' Letters

.67 An interpretation of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU section 337), was issued in January 1997. The Interpretation, entitled "Use of Explanatory Language Concerning Unasserted Possible Claims or Assessments in Lawyers' Responses to Audit Inquiry Letters" (AU section 9337.31 and .32) addresses a concern that the inclusion of certain explanatory comments in responses by lawyers to audit inquiry letters may result in a limitation on the scope of the audit. The Interpretation (AU section 9337.31 and .32) appeared in the January 1997 issue of the *Journal of Accountancy* and was effective upon publication.

.68 A number of lawyers include explanatory comments in their responses to audit inquiry letters that are intended to emphasize the preservation of the attorney-client privilege with respect to unasserted pos-

sible claims or assessments. These comments might include the following: "It would be inappropriate for this firm to respond to a general inquiry relating to the existence of unasserted possible claims or assessments involving the organization." The Interpretation (AU section 9337.31 and .32) states that the inclusion of this or similar wording in a lawyer's response does not result in a limitation on the scope of the audit. The Interpretation (AU section 9337.31 and .32) also reminds auditors of the requirement pursuant to SAS No. 12 (AU section 337) to obtain the lawyer's acknowledgment of his or her responsibility to advise and consult with the client concerning financial statement disclosure obligations with respect to unasserted possible claims or assessments.

Pre-Award Surveys

.69 As part of the process of applying for a government grant or contract, not-for-profit organizations may be required to submit a written pre-award assertion (survey) by management about the effectiveness of the design of an entity's internal control or a portion thereof, together with an auditor's report thereon. An interpretation of AICPA Statement on Standards for Attestation Engagements 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), entitled "Pre-Award Surveys" (AT section 9400.01–.08), was issued in February 1997. The Interpretation (AT section 9400.01–.08) appeared in the February 1997 *Journal of Accountancy* and was effective upon publication. The Interpretation (AT section 9400.01–.08) was issued to clarify that there are certain things that an auditor should not do in conjunction with a client's pre-award survey. The Interpretation (AT section 9400.01–.08) states that the consideration of internal control in a financial statement audit does not provide a sufficient basis for auditors to issue a report expressing any assurance about the effectiveness of the design of internal control or any portion thereof. Other questions that are answered in the Interpretation (AT section 9400.01–.08) include how auditors can report on the design effectiveness of an entity's internal control or a portion thereof, what auditors' responsibilities are if they are requested to sign a form prescribed by a government agency in connection with a pre-award survey, and whether auditors can issue reports on an entity's ability to establish suitably designed internal control.

Accounting Issues and Developments

Joint Costs

.70 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 bona-fide program or management and general activities 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.

.71 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 conformity with SOP 87-2.

.72 Some state attorneys general continue to criticize the manner in which some organizations allocate joint costs. They believe that some organizations have been too liberal in their allocation of costs to program expenses, especially those costs incurred to educate the public.

.73 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. An AICPA proposed SOP on this subject is discussed in the "Accounting for the Costs of Joint Activities" section of this Audit Risk Alert.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Religious Organizations

.74 Some religious organizations are structured and operate under principles and practices based on their beliefs, including doctrines concerning control and authority, rather than corporate law or other structures. Accordingly, the relationships between and among such organizations, as well as the appropriate reporting for transactions they enter into, may be unclear. That lack of clarity may result in the following reporting issues:

- In some circumstances, control or authority is vested in another body or entity, either voluntarily or in accordance with principles followed by the organizations. In those circumstances, it may be unclear whether certain entities should be included in the consolidated financial statements of the reporting entity in conformity with the guidance in SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations.*
- Assets may be owned by the reporting entity but held or perhaps even titled to another entity. (This circumstance is more likely to occur in situations in which one of the entities operates outside of the United States.) It may be unclear whether those assets should be reported as assets in the reporting entity's financial statements.
- In some circumstances, pension benefits and other employee benefits, including post-employment benefits, such as food, housing, life insurance, and medical benefits, may be administered by the either (1) a religious entity, (2) a separate corporate entity that is not in trust form, or (3) a separate corporate entity that is in trust form. It may be unclear which entity(ies) should report liabilities for unfunded obligations under either FASB Statement No. 87, *Employers' Accounting for Pensions* (AC P16), or FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (AC P40).

Auditors should consider whether the financial statements represent the entity that they purport to represent and whether the accounting for benefit plans and related liabilities, if any, is appropriate and consistently applied.

.75 As part of that consideration, auditors may wish to request the organization to obtain a specific opinion from legal counsel concerning the interpretation of principles, practices, canon laws, or other arrangements and related legal implications. SAS No. 73, *Using the Work of a Specialist* (AU section 336) provides guidance concerning circumstances in which auditors rely on the representations or work of an attorney for other than litigation, claims, and assessments as addressed in SAS No. 12 (AU section 337).

Restructuring and Reengineering

.76 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 EITF of the FASB in its discussion of EITF 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. Also, auditors should consider the effects of such restructuring and reengineering, including the outsourcing of significant functions, on the organization's internal controls, and on the auditor's audit planning and testing.

Accounting Pronouncements and Projects

.77 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 [AC C67] 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 FASB 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 [AC F25] is effective for financial statements issued for fiscal years ending after December 15, 1995.)
FASB Statement No. 121, *Accounting for the 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
FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (AC F38)	Transfers and servicing of financial assets and extinguishment of liabilities occurring after December 31, 1996
FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities* (AC F38)	Financial statements issued for fiscal years ending after December 15, 1996
FASB Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power, (An Interpretation of FASB Statement No. 116)* (AC C67)	Financial statement issued for years ending after September 15, 1996

.78 *FASB Not-for-Profit Organizations Project.* The FASB is continuing its consideration of the specialized accounting principles and practices 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). 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). The portion of the project addressing investments was completed in November 1995 and resulted in FASB Statement No. 124 (AC No5).

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.79 *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).* After considering the comments received on the exposure draft, the FASB has decided to split this project into two separate pieces. One part of the project addresses situations in which the recipient organization has the unilateral power to redirect the use of the assets away from the specified beneficiary. FASB Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power (An Interpretation of FASB Statement No. 116)* (AC C67), issued in September 1996, addresses this. The other part of the project addresses other situations in which a donor specifies a third-party beneficiary, including accounting by that beneficiary for the contribution received. FASB Interpretation No. 42 (AC C67) provides that an organization that receives assets acts as a donee and a donor, rather than an agent, trustee, or intermediary, if a resource provider specifies a third-party beneficiary or beneficiaries and explicitly grants the recipient organization the unilateral power to redirect the use of the assets away from the specified beneficiary or beneficiaries (variance power).

.80 Auditors should consider the wording used in the 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.

.81 The balance of the issues covered in the exposure draft will be addressed in the second piece of the project. The period for commenting on the proposal has expired.

.82 *Extinguishment of Liabilities.* In June 1996, the FASB issued FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (AC F38). Among other things, the Statement (AC F38) requires that a liability be derecognized if and only if either (1) the debtor pays the creditor and is relieved of its obligation for the liability or (2) the debtor is legally released from being the primary obligator under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance. (The Statement [AC F38] supersedes FASB Statement No. 76, *Extinguishment of Debt.*)

.83 *Disclosures About Fair Value of Financial Instruments.* In December 1996, the FASB issued Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities* (AC F38). The Statement (AC F38) amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 (AC F25) optional for entities that meet all of the following criteria:

1. The entity is a nonpublic entity.
2. The entity's total assets are less than $100 million on the date of the financial statements.
3. The entity has not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), other than loan commitments, during the reporting period.

The Statement (AC F25) is effective for fiscal years ending on or after December 15, 1996. Earlier application is permitted in financial statements that have not been issued previously.

.84 *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 the 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.

.85 Not-for-profit organizations are currently required to follow SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations.* If, however, the FASB Statement resulting from the exposure draft were issued and required to be applied by not-for-profit organizations, it would supersede SOP 94-3 to the extent that it is inconsistent with the FASB Statement resulting from the exposure draft.

.86 The exposure draft would require the 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 kinds 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.)

.87 The period for commenting on the proposal has expired, and the FASB expects to conduct a sunset review of the project in June 1997.

.88 *AICPA Guide Project.* In August 1996, the AICPA Not-for-Profit Organizations Committee issued the Audit and Accounting Guide *Not-for-Profit Organizations* (the Guide). The Guide incorporates certain provisions of FASB Statement Nos. 116 (AC C67) and 117 (AC C25) and is directed at not-for-profit organizations in general, and not at specific kinds of organizations, such as voluntary health and welfare organizations or private colleges and universities.

.89 The Guide supersedes 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*

.90 It also supersedes 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*
- 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*

.91 Some of the Guide's provisions are as follows:

- 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 were covered by the pronouncements that were superseded by the Guide.
- If the financial statements include prior-year 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 C25) and the 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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 (1) clearly include wording such as "information to be used for budget purposes only" or that (2) 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). Although contributions receivable are not required to be confirmed, auditors may nevertheless decide to request confirmation of contributions receivable. If auditors confirm promises to give, they 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 should recognize contribution revenue and an asset representing its right to receive future cash flows. In all cases, all changes in the value of assets held under split-interest agreements are recognized in the financial statements.

- Contributions of an irrevocable right to receive income from a perpetual trust held by third parties should be reported as permanently restricted support, with distributions reported as unrestricted or temporarily restricted investment income.

- 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 items received should not be recognized.

- If collection items are not capitalized, auditors 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 auditors' 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 auditors understand the organization's control environment, which is a component of its internal control.

- FASB Statement No. 124 (AC No5) 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 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 Guide retains the measurement guidance for accounting for other investments included in the AICPA publications that will be superseded by the 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 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 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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 (AU section 336) provides guidance concerning circumstances in which auditors rely on the representations or work of an attorney for other than litigation, claims, and assessments as addressed in SAS No. 12 (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.

.92 In addition, the Guide includes 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

.93 The provisions of the Guide are effective for financial statements for periods ending on or after December 31, 1996.

.94 *Accounting for the Costs of Joint Activities.* In February 1997, a proposed SOP, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, was cleared for final issuance by the FASB and Governmental Accounting Standards Board (GASB), subject to certain revisions. 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 otherwise might be considered program or management and general costs if they had been incurred in a different activity, unless the criteria of purpose, audience, and content, as defined in the SOP, are met. If the criteria of purpose, audience, and content are met, the joint costs of those activities would be allocated and costs that are clearly identifiable with fund-raising, program, or management and general functions would be charged to that cost objective.

.95 The proposed SOP would be effective for years beginning on or after December 15, 1997. The AICPA is in the process of drafting those revisions and expects to issue the final SOP in the summer of 1997.

.96 *GASB—Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities.* Issued in April 1997, this exposure draft would make sweeping changes to the financial reporting standards for public colleges and universities. The GASB is expected to issue a final Statement by mid 1998.

.97 *GASB—The Financial Reporting Entity: Affiliated Organizations.* Issued in December 1994, this exposure draft 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 GASB is expected to issue a final Statement by late 1997.

Nonauthoritative AICPA Audit and Accounting Literature

Continuing Professional Education Courses

.98 The AICPA offers group-study and self-study courses. Group-study courses include the following:

- — Audits of HUD-Assisted Projects
- — Advanced Auditing of HUD-Assisted Projects

- The AICPA Survival Guide for the Not-for-Profit Auditor
  - — Compliance Auditing
  - — Cost Principles for Nonprofit Organizations Under OMB Circular A-133

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- Getting Started With Nonprofit Organization Tax Issues
  - — Implementing SFAS Nos. 116 and 117 in Financial Statements of Nonprofit Organizations
  - — Nonprofit Accounting and Auditing Update
- Single Audit Requirements for Nonprofit and Governmental Organizations
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations
  - — Tackling Tough Tax Topics in Nonprofit Organizations
- Using the AICPA Not-for-Profit Organizations Audit and Accounting Guide
- Workpaper Preparation Techniques for Government and Nonprofit Organizations
  - — Yellow Book: Government Auditing Standards

.99 Self-study courses include the following:

- — Accounting for Nonprofits: Contributions and Financial Statements
- Audit Requirements of OMB Circular A-133
- Audits of Rural Development and Housing Programs
- Communicating Material Noncompliance and Internal Control Weaknesses
  - — Compliance Auditing
  - — HUD Audits: A Comprehensive Guide
- Nonprofit Accounting and Auditing Update
- Not-for-Profit Organizations: Using the New AICPA Audit and Accounting Guide
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations
  - — Understanding Federal Audit and Administrative Requirements
  - — Working with the Revised Yellow Book on Government Auditing Standards

.100 Videocourses include the following:

- Effective Yellow Book Auditing Videocourse
- 1997 Nonprofit Auditing and Accounting Videocourse

.101 For more information about AICPA CPE courses, call the AICPA information hotline at (800) 862-4272.

Not-for-Profit Organizations Checklists

.102 The AICPA's Technical 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,* product number 008681, is a nonauthoritative Practice Aid designed to help those preparing reports and financial statements of not-for-profit organizations.

Technical Practice Aids

.103 *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.

Industry Conference

.104 The AICPA will hold its Fifth Annual Not-for-Profit Organizations Industry Conference on June 12 to 13, 1997 in Washington DC. The conference is designed for both practitioners and financial executives, and to provide technical information for those decision makers. An additional four CPE credit optional session entitled "OMB A-133 In-Depth 97," will be offered on the evening of June 11, 1997. For further information, call the AICPA CPE Conference Hotline at (800) 862-4272.

References for Additional Guidance

Federal Agencies—Administrative Regulations

.105 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.*

.106 Auditors should also be aware that many agencies have program-specific and other audit requirements that are not covered by OMB Circular A-133. Such requirements may relate to certain programs (such as student financial assistance or HUD-insured mortgage programs), as well as to contract audit requirements. Auditors may want to refer to the PCIE's *Revised Program Audit Guide Listing* for a summary of federal programs that have separate audit guides.

General Accounting Office

.107 General Accounting Office (GAO) publications include the following:

- *Government Auditing Standards, 1994 Revision*—These standards, also referred to as the Yellow Book, relate to audits of government organizations, programs, activities, and functions, and of government funds received by contractors, nonprofit organizations, and other nongovernment organizations. The standards incorporate the AICPA Statements on Auditing Standards for fieldwork and reporting, and prescribe the 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 (GPO), 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 GPO, Superintendent of Documents, Washington, DC 20401.

- *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).

- *Guide to Federal Agencies' Procurement of Audit Services from Independent Public Accountants*—This booklet provides a basic understanding of how independent public accountant (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).

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. Orders may also be placed by using the fax number (301) 258-4066. For copies of GAO reports and testimony, the status of GAO's open recommendations, and GAO's audit policy, check the GAO home page at: http://www.gao.gov. The GAO home page also contains the electronic version of *Government Auditing Standards.* For information on how to access GAO reports or other documents on the Internet, send an e-mail message with "info" in the body to: info@www.gao.gov.

Office of Management and Budget

.108 *Circulars.* OMB issues grant management circulars to establish uniform policies and rules to be observed by federal agencies for the administration of federal grants. Federal agencies then adopt these circulars in their regulations. The process for issuing grants management circulars includes due process with a notice of any proposed changes in the *Federal Register,* a comment period, and careful consideration of all responses before issuance of final circulars. Circulars and other documents relevant to audits of not-for-profit organizations are listed below. For copies of circulars and bulletins, write or call the Office of Administration, Publications Office, Room 2200, New Executive Office Building, Washington, DC 20503; telephone (202) 395-7332 or check the OMB home page at: http://www.whitehouse.gov/wh/EOP/OMB/html/ombhome.html. An alternate address is http://www.sbaonline.sba.gov/ignet.

OMB Circulars Relevant to Audits of Not-for-Profit Organizations

Circular Number	*Applicability*	*Issue Date*
A-21 (Revised)	Cost principles for educational institutions	May 1996
A-110	Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations	November 1993
A-122 (Revised)	Cost principles for non-profit organizations	October 1995
A-133 (Revised)	Audits of states, local governments, and nonprofit organizations	Revision expected before June 30, 1997

.109 *OMB Circular A-133 Compliance Supplement.* The OMB Compliance Supplement sets forth the major federal compliance requirements that should be considered in an audit of states, local governments, and nonprofit organizations that receive federal assistance. It supplements OMB Circular A-133. A revision to the supplement is expected to be issued before June 30, 1997. For a separate discussion of the Compliance Supplement, see the section of this Audit Risk Alert entitled "Regulatory and Legislative Developments."

.110 *Other Guidance.* The *Catalog of Federal Domestic Assistance* (CFDA) 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. A searchable version of the CFDA is available on the GSA home page, which is currently located at http://www.gsa.gov/fdac.

.111 Program information provided by the catalog includes authorizing legislation and audit requirements. The GSA makes copies available to certain specified national, state, and local government offices. Catalog staff may be contacted at (202) 708-5126. The catalog may be purchased from the GPO by calling (202) 783-3238.

.112 Program information is also available on machine-readable magnetic tape. The tape may be purchased by writing the Federal Domestic Assistance Catalog Staff (WKU), General Services Administration, Ground Floor, Reporters Building, 300 Seventh Street, SW, Washington, DC 20407, or calling (202) 708-5126.

Information Sources

.113 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.

.114 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.

.115 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.

.116 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.117 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bands per second (bps), are listed data lines.

* * * *

.118 This Audit Risk Alert supersedes *Not-for-Profit Organizations Industry Developments—1996.*

* * * *

.119 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1996/97* [AAM section 8010].

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.120

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 by calling (800) 862-4272	*24 Hour Fax Hotline* (201) 938-3787	*AICPA Home Page* The AICPA has a home page on the World Wide Web. It can be accessed at http://www.aicpa.org.
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		The FASB has a home page on the World Wide Web. It can be accessed at either http://www.fasb.org or http://www.rutgers.edu/accounting/raw/fasb
U.S. Department of Education	Office of Inspector General U.S. Department of Education, Switzer Building, Room 4200 Washington DC 20202 (202) 205-5497		The U.S. Department of Education, Non-Federal Audit Team home page is currently located at http://www.gvi.net/~edoig
U.S. Office of Management and Budget	Office of Administration Publications Office Room 2200 New Executive Office Building Washington DC 20503 (202) 395-7332	*Twenty Four Hour Fax Hotline* (202) 395-9068 for certain Circulars and Standards (202) 395-9088 for speeches and press releases	OMB has a home page on the World Wide Web. The address is http://www.whitehouse.gov/WH/EOP/OMB/html/ombhome.html. For information concerning publications, standards, and exposure drafts released for comments by Inspectors General refer to IGnet at: http://www.sbaonline.sba.gov/ignet/
National Association of College and University Business Offices	One Dupont Circle Suite 500 Washington DC 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 The service can also be accessed through the IGnet (see above).

Information Sources *(cont'd)*

Organization	General Information	Fax Services	Electronic Bulletin Board Services
National Health Council	1730 M Street, NW Suite 500 Washington DC 20036 (202) 785-3910 (202) 785-5923 (f)		The National Health Council has a home page on the World Wide Web. The address is http://www.healthanswer.com
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.
U.S. General Accounting Office	U.S. Government Printing Office *Superintendent of Documents* Washington, DC 20401 (202) 783-3238 (202) 512-2250 (f) or U.S. GAO P.O. Box 6015 Gaithersburg, MD 20884 (202) 512-6000 (202) 258-4066 (f)		The GAO has a home page on the World Wide Web. The address is http://www.gao.gov.

[*The next page is 8401.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

 Copyright © 1994, American Institute of Certified Public Accountants, Inc.

- 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.

 Copyright © 1994, American Institute of Certified Public Accountants, Inc.

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.

 Copyright © 1994, American Institute of Certified Public Accountants, Inc.

- 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.

.52

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	*Guidelines*	*Commentary*
(ii) more than $5 billion, but less than $9 billion, and a composite CAMEL (or MACRO, or equivalent) rating of 1 or 2.	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.	● 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**		
(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.	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.	

Copyright © 1994, American Institute of Certified Public Accountants, Inc.

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*
	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]	● There are projects underway at various banking industry associations to provide guidance on management reporting ● 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).

Copyright © 1994, American Institute of Certified Public Accountants, Inc.

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	

Copyright © 1994, American Institute of Certified Public Accountants, Inc.

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. 16. Filing Peer Review Reports. 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.	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. ● 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.

Copyright © 1994, American Institute of Certified Public Accountants, Inc.

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. Procedures for Determining Compliance with Designated Laws. 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 20. Reviews with Audit Committee and Management 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.	● 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
(c) Notice by accountant of termination of services. 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. Notice of Termination. 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.	

Copyright © 1994, American Institute of Certified Public Accountants, Inc.

Regulation	*Guidelines*	*Commentary*
	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 financial 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

Copyright © 1994, American Institute of Certified Public Accountants, Inc.

Regulation	*Guidelines*	*Commentary*
(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.	● "Other report" refers to the reports required by 12 CFR § 363. ● 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;

Copyright © 1994, American Institute of Certified Public Accountants, Inc.

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.	

Copyright © 1994, American Institute of Certified Public Accountants, Inc.

.53

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.

 Copyright © 1994, American Institute of Certified Public Accountants, Inc.

(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.

 Copyright © 1994, American Institute of Certified Public Accountants, Inc.

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

 Copyright © 1994, American Institute of Certified Public Accountants, Inc.

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.

[The next page is 8433.]

.54

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.

[The next page is 8461.]

 Copyright © 1994, American Institute of Certified Public Accountants, Inc.

AAM Section 8200

High-Technology Industry Developments—1996/97

Industry and Economic Developments

.01 After several consecutive years of high growth rates in both earnings and stock price, high-technology enterprises are showing signs of more moderate patterns of earnings growth along with increased stock price volatility. To begin the year, investors sold off stocks in certain high-technology sectors, such as Internet-related entities and semiconductor manufacturers, that were perceived as being overpriced. However, soon after January's sell-off, high-technology stocks began to rebound, showing a gain of 21 percent by midyear. Then, in July, following lower-than-expected earnings reports from two major high-technology companies—both considered industry bellwethers—a key high-technology stock index dropped almost 20 percent from its high point in June. Although some suggest that these events presage fundamental changes in the economics of the industry, the consensus is that the industry's performance this year does not necessarily signal an end to the technology boom.

.02 This year's earnings decline has generally been attributed to—

1. The aftermath of last year's "over-enthusiasm" for anything related to high technology (evidence of this could be found in the significant initial public-offering activity of high-technology startups). In some cases those optimistic expectations of continued high-earnings growth led production to outpace demand, thus bloating inventories and reducing profit margins. As such, in planning this year's engagements, auditors should consider the increased level of audit risk associated with inventory valuation and revenue recognition. These matters are addressed in the "Audit Issues and Developments" section of this Audit Risk Alert.
2. A ripple effect attributable in large part to a decline in demand for personal computers in the corporate, small business, and home markets. This decline has had a pervasive impact throughout the industry on entities whose operations relate to components (for example, semiconductors), peripherals (for example, CD-ROM players), and software (systems and applications programs) for personal computers.
3. Excess capacity. After several years of cautious plant expansion, semiconductor manufacturers put into operation more than forty new production facilities in the fourth quarter of 1995. The resulting overproduction is expected to drive down current revenues by 9 percent—after a 42 percent increase in the prior year. Excess capacity and downward revenue trends may call into question the recoverability of the carrying amount of certain long-lived assets. The "Impairment of Long-Lived Assets" section of this Audit Risk Alert addresses this issue from the auditor's perspective.

Despite these circumstances, continued revenue growth is expected for 1996, but at a more moderate pace. This projection is based on the premise that although certain market segments of the industry (for example, personal computers and cellular communications) appear to be maturing and consequently profit growth, while still generally healthy, will slow from rapid to incremental, new areas of high growth are emerging. Examples include computer hardware and software for linking networks as well as electronic commerce on the Internet.

.03 The Internet is expected to be the next major medium of communication and will likely have a significant impact on many segments of the high-technology industry. Internet usage currently is expanding

at a rate of approximately 15 percent to 20 percent a month and is expected to grow rapidly for the rest of the decade. And, while Internet-related software (that is, programs that provide access to the Internet, allow users to browse the world-wide-web, or create firewalls that protect corporate data) currently accounts for less than 1 percent of the $100 billion global software market industry, analysts see an enormous potential for growth. Some predict annual growth as high as 100 percent, with $4 billion in projected software sales revenues by the year 2000. This expansion will offset slow growth in other software categories such as mainframe software.[1] The rush to cater to potential Internet customers is expected to serve as a catalyst for reorganization and internal as well as external expansion by high-technology enterprises. Some of the concerns related to these activities are discussed in the "Accounting Issues and Developments" section of this Audit Risk Alert under "Restructurings."

.04 The demand for Internet-related services has generated an increase in the number of start-up enterprises involved in the development of software to gain access to, or browse, the Internet. In these circumstances, auditors should consider whether the guidance set forth in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 7, *Accounting and Reporting by Development Stage Enterprises* (AC De4), is being properly applied by the client. Development-stage enterprises also 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.

.05 The industry's competitive environment has intensified during 1996, posing a particularly serious threat to a variety of industry segments such as those relating to personal computers, certain components and peripherals, and cellular phones. Widespread "price wars" in these markets have had a significant impact on profit given that margins, which are generally very small, leave little or no room to absorb sustained price reductions. A formidable competitive threat is expected from Japanese consumer electronics giants who are mounting an effort to break into the U.S. personal computer market, after failing to do so a decade ago. A Japanese push into the desktop field will almost certainly escalate the already fierce price cutting wars. As a result, these industry segments are likely to experience a higher rate of business failure than in prior years. 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. Additionally, to counter rampant competition and diminishing profit margins, high-technology enterprises are likely to place greater emphasis on the need to rapidly identify, and move into, new market segments. In such circumstances auditors should consider the audit risks implicit in any such expansion (that is, the impact on internal control, accounting systems, and organizational structure).

Legislative Developments

Telecommunications Act

.06 On February 8, the Telecommunications Act of 1996 became law. This legislation ended government mandates that established and maintained regulatory barriers between local and long-distance calling, cable

[1] The mainframe software market is expected to grow at less than 2 percent annually through the end of the century as corporations downsize their computer operations from main frames to network servers.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

television, broadcasting, and wireless services. The intent of this legislation is to increase competition, thereby encouraging both low rates for consumers and innovative approaches to telecommunications. The bill will permit long-distance carriers, local telephone companies, and cable-tv operators to enter each other's markets. It is anticipated that the short-term effect of the legislation will be to set off a high level of activity in restructurings, mergers, acquisitions, and joint ventures by, among others, local and long-distance phone companies, broadcasters, cable television operators, publishing companies, movie studios, and information technology firms. It is expected that the Telecommunications Act will transform the industry, generating intense competition, fierce price wars, and new technologies. Accordingly, auditors should be aware of their responsibilities pursuant to SAS No. 22, *Planning and Supervision* (AU section 311), which provides that auditors should consider matters affecting the industry in which an entity operates, such as economic conditions, government regulations, and changes in technology, as they relate to the audit.

Litigation Reform

.07 Expectations of quick profits have lured many investors into the high-technology industry. However, the associated investment risks have been formidable. Lower- than-projected earnings, intense competition, slowing demand, and, in some cases, Chapter 11 bankruptcy filings have led to sharp declines in the value of some high-technology stocks. In the past, disappointed investors have often sought to recoup their losses through litigation. Auditors of publicly held high-technology entities (particularly young, highly touted start-ups) have been disproportionately involved in such class action shareholder lawsuits. The accounting profession, which has been active in seeking legislation to place limits on such legal actions, has achieved its objective in the form of the Private Securities Litigation Reform Act of 1995 (the Act).

.08 The Act became effective (though not applicable to pending lawsuits) on December 22, 1995, when Congress overrode a presidential veto. It offers significant relief to the accounting profession from class action securities lawsuits relating to publicly held entities. Such lawsuits will be more difficult to file because of the imposition of tougher requirements on plaintiffs and their attorneys. Limitations are placed on an accountant's liability and a "safe harbor" is created for certain projections of financial performance. The reporting responsibility of auditors is expanded by the Act to include a requirement for auditor notification to the Securities and Exchange Commission (SEC) of illegalities not appropriately addressed by management.

.09 The Act requires that audits of financial statements by independent public accountants include—

- Procedures to identify illegal acts and related-party transactions that would have a direct and material effect on the determination of financial statement amounts.
- An evaluation as to whether there is substantial doubt about the ability of the entity to continue as a going concern in the subsequent year.

The Act also requires auditors who become aware that an illegal act has or may have occurred to determine the possible effect of fines and other factors on the financial statements. Auditors must then inform the entity's audit committee (or, in the committee's absence, the board of directors) of their findings. If the auditor determines that there has been no timely and appropriate response to his or her notification, the auditor must forward that conclusion to the entity's board of directors. The board is then required to notify the SEC of that report within one business day, providing the auditor with a copy. If the auditor does not receive a copy, the auditor must forward the report of illegal acts to the SEC within the next business day.

Audit Issues and Developments

Inventory Valuation

.10 Inventory valuation is always a concern in high-technology enterprises. The following are some of the factors that make it even more important this year.

- Rapid changes in a product's design may have an adverse impact on some entities. For example, business news reports disclosed an instance in which a small semiconductor manufacturer was unable to sell a significant portion of its inventory of a Pentium chip clone, *at any price*, because of a new, faster version released by a competitor.
- The Telecommunications Act is expected to increase the need for rapid product innovation.
- The slowdown in sales of personal computers has had an impact on many component and peripheral manufacturers. Since these products are built before the personal computers are sold, the slowdown has caused production levels to outpace consumer demand.
- Given the highly competitive nature of the industry, some entities may be unable to conduct adequate market research studies and thus may release new products prematurely.

Given the speed of technological advances and the highly competitive environment of the high-technology industry, rapid inventory obsolescence, such as that occurring in the circumstances described above, is commonplace. Products are typically susceptible to frequent changes intended to upgrade their performance. Product life cycles may be short and competitive products with superior price and performance can quickly enter the marketplace. In this 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 determine whether inventory amounts and trends seem plausible given a particular set of circumstances. Factors that should be considered include expected future demand for the product and anticipated technological advancements that render existing inventories obsolete or significantly diminish their value. In making inventory obsolescence evaluations auditors may consider reviewing sales forecasts prepared by management and comparing them to industry association statistics to assess their reasonableness. The "Information Sources" section at the end of this Audit Risk Alert contains the names of several such industry associations.

Loan Covenants

.11 During 1995, a significant number of initial public offerings involved small, start-up high-technology entities. As was widely reported, some of those entities had only one product and no track record of profitability. One year later, some of those entities, in need of capital infusions, have been unable to satisfy their financing needs through the equity market, given its current volatility. In response, many high-technology entities have sought capital through debt financing. Given the lack of profitability on the part of some of these entities, many lenders have sought to protect their investments by imposing highly restrictive covenants as part of the terms of financing. Auditors should consider the audit risk associated with such circumstances along with the reporting and disclosure problems likely to occur. For example:

- Auditors should be alert to loan covenant violations that cause long-term debt to become a current liability. In some instances, such a reclassification may raise questions about the entity's ability to continue as a going concern.
- Loan agreements may include covenants that require the borrower to maintain predetermined financial ratios or specified minimum or maximum amounts for certain financial statement items. Restrictions may be imposed on capital expenditures, dividends, or, in certain cases, executive compensation and benefits. If a violation has occurred and exists at the balance-sheet date, no matter how "insignificant" or "technical," FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor* (AC B05), requires that the entire loan be classified as a current liability, unless one of the following conditions is met:
  1. The creditor waives or subsequently loses, for more than one year from the balance-sheet date, its right to demand repayment.
  2. The obligation contains a grace period within which the debtor may "cure" the violation, and it is "probable" that the violation will be cured.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

If the second condition is met, thereby resulting in a long-term debt classification of the obligation, paragraph 5 of FASB Statement No. 78 (AC B05.118) requires that the circumstances be disclosed. For public entities, rule 4.08(c) of 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 notes to the financial statements should disclose the amount of the obligation and the period of the waiver.

- An increasingly common clause in loan agreements is 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 uses criteria in FASB Statement No. 5, *Accounting for Contingencies* (AC C59), should be followed to evaluate the likelihood of debt acceleration. Such evaluations are very subjective, and the rationale for the entity's conclusion should be properly assessed by the auditor.
- Some loans 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. The FASB's Emerging Issues Task Force (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 (except in the rare instance that a lender waives that right for a period of one year).

.12 Auditors should carefully consider the implications of loan covenant violations while planning and performing the audit. Auditors may wish to consider applying procedures such as the following:

- Obtain written confirmation of lender waivers of loan covenant violations or of lenders' lack of knowledge of any violations or intents to call a loan. Evaluate all waivers carefully and assess whether the lender has truly waived its right to call the debt.
- Carefully read loan amendments that management represents as constituting waivers of covenant violations; lenders may have amended the financial covenant requirements but otherwise retained their right to call the debt.
- 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 passed adjustments that, if made, would affect loan covenant provisions.
- Be alert for escalating quarterly loan covenant requirements that cover the period rather than the end of a quarter. An entity may be in compliance at the end of one quarter but immediately be in noncompliance if a more restrictive covenant is effective on the following day.

.13 In some cases, the issuance of the financial statements may be delayed until appropriate lender waivers can be obtained or cures effected. To avoid having to extend other audit procedures past the normal fieldwork date, the auditor may dual-date the report by giving one date for the completion of fieldwork and a subsequent date for the waiver or cure; see SAS No. 1, section 530, *Dating of the Independent Auditor's Report* (AU section 530). Auditors should obtain sufficient evidential matter to support the lender's waiver or the entity's actions that effected the cure. In the event that the defaults are not cured, auditors should consider the effect on the overall continued existence of the entity as a going concern in accordance with SAS No. 59 (AU section 341).

Impairment of Long-Lived Assets

.14 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 useful-

ness. In some cases these assets may not lend themselves to modification and could be rendered obsolete. Additionally, the passage of the Telecommunications Act of 1996 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, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08), may need to be applied.

.15 In March 1995, the FASB issued Statement No. 121 (AC I08), which requires that long-lived assets and certain identifiable intangibles and goodwill related to those assets 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. 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 costs 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. The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. Accordingly, this is the first year that auditors will evaluate management's implementation of the Statement (AC I08).

.16 FASB Statement No. 121 (AC I08) is likely to have a significant impact on many construction contractors, given the inherently capital-intensive nature of the industry. Auditors may face issues relating to the recoverability of the carrying amount of certain long-lived assets if, as expected, a general economic slowdown occurs in the latter part of 1996. In evaluating a construction contractor's implementation of FASB Statement No. 121 (AC I08), major issues to be considered by auditors include the following:

- *The appropriate classification of long-lived assets as either those being held and used or those to be disposed of.* Auditors should obtain an understanding of the policies and procedures used by the contractor to classify long-lived assets pursuant to FASB Statement No. 121 (AC I08), as well as evaluating whether those classifications are proper.
- *The identification of events or circumstances indicating that the carrying amounts of assets to be held and used may not be recoverable.* Auditors should obtain an understanding of the policies and procedures used by the contractor to identify such events and circumstances. Examples of such events and circumstances could include the following:
  - — A dramatic change in the manner in which an asset is used
  - — A reduction in the extent to which an asset is used
  - — Forecasts showing lack of long-term profitability
  - — A change in the law or business environment
  - — A substantial drop in the market value of an asset
- *The assumptions used in the underlying calculation of estimated future cash flows when testing for asset impairment used in management's impairment test, and assumptions used in estimating the fair value of assets for which an impairment loss is to be recognized.* A contractor's estimate of future cash flows from asset use and the fair value of assets used in calculating impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AU section 342). Procedures to be employed should include one or a combination of the following: (1) reviewing and testing the process used by management to develop the estimates, (2) developing an independent expectation to corroborate the reasonableness of the estimates, and (3) reviewing subsequent events or transactions occurring before the completion of fieldwork.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- *The recording of assets to be disposed of at the lower of carrying amount or fair value less costs to sell.* Auditors should verify that the contractor has appropriately classified and valued long-lived assets to be disposed of.
- The disclosure requirements of FASB Statement No. 121. Auditors should verify that all disclosure requirements of FASB Statement No. 121 (AC I08) have been included in the contractor's financial statements.

Control Environment

.17 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. Internal control in these entities often include unique characteristics that may affect an auditor's assessment of control risk. Characteristics that may increase control risk include those suggested in the following circumstances:

- Many high-technology entities 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.
- High-technology enterprises may seek to boost declining earnings by cutting overhead. Such cost reductions may be imposed on nonrevenue-producing areas such as the accounting department. This may place a strain on existing accounting, reporting, and control functions, thus increasing the likelihood of errors.
- Owners and managers of high-technology enterprises frequently are entrepreneurs who may be more likely to give priority to research and development 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 entities 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 start-up or developmental-stage high-technology enterprises may engender informal accounting systems with inadequate control procedures.

If internal control in 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 as required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319).[2] 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.

Going Concern

.18 The price wars and competitive pressures pervasive throughout the industry are factors likely to increase the level of business risk faced by many high-technology entities. Accordingly, auditors should be alert to conditions and events which, when considered in the aggregate, indicate that there could be substantial doubt about their client's ability to continue as a going concern. For example, such conditions

[2] SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AU section 319), revises the definition and description of internal control and makes conforming changes to relevant terminology. SAS No. 78 (AU section 319) was issued in December 1995 and is effective for audits of financial statements for periods beginning on or after January 1, 1997. See "New Pronouncements" in the "Audit Issues and Developments" section for further discussion of this matter.

and events could include (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 trade union difficulties, or (4) 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 client's ability to continue as a going concern.

.19 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 generally accepted auditing standards 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.

.20 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 for a reasonable period of time not to exceed one year beyond the date of the financial statements being audited. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

.21 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 need for disclosure of the principal conditions and events that initially caused the auditor to believe there was substantial doubt. 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).

.22 For those entities 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 AICPA Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code.*

Revenue Recognition

.23 Entities in the high-technology industry may be particularly susceptible to revenue recognition problems during the current year given declining growth rates of revenue. Additionally, there have been a number of 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. 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, the customer, or a third party.

Some specific circumstances to consider are described in the following paragraphs.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.24 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.

.25 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.

.26 The SEC 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, 466, 495, 513, 513A, 546, 572, 581, 615, and 711).
- 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, 215, 292, and 624).
- Recorded sales in which the seller has continuing involvement or that are subject to a significant future contingency (see AAERs 40, 58, 65,78, 86, 131,145, 225, 303, 475, 615, 645, 646, 647, 689, 690, and 737).

Auditors should be alert to those high risk circumstances in which an entity may prematurely recognize revenue.

.27 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.

.28 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. See the "Accounting Issues and Developments" section of this Audit Risk Alert for a discussion of the proposed SOP that would modify the provisions of SOP 91-1.

.29 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.

.30 Entities in the computer industry, as well as other segments of the high-technology industry, may sell products that include a combination of product maintenance and customer-support contracts, or they may sell, separately, 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.

.31 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.

New Pronouncements

Auditing Standards

.32 *SAS No. 75.* In September 1995, the Auditing Standards Board (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 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.

.33 *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 an 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 does not provide the accountant with the representations required in paragraphs 6 and 7 of SAS No. 72 (AU section 634.06 and .07). The Statement is effective for letters issued pursuant to paragraph 9 of SAS No. 72 (AU section 634.09) after April 30, 1996.

.34 *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, 544, 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 is effective for engagements beginning after December 15, 1995.

.35 *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. 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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.36 *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.

.37 A table outlining the significant provisions of the newly issued auditing standards is set forth in the Exhibits section of this Audit Risk Alert.

Attestation Standards

.38 *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 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.

.39 *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 provides guidance on the quantity, type, and content of working papers for attestation engagements and is effective for engagements beginning after December 15, 1995.

.40 *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 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 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.

.41 *Quality Control Standards.* In May 1996, the ASB issued Statements 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.

.42 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 201.01), and 202, *Compliance With Standards* (ET section 202.01), 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 (QC section 20) 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; engage-

ment 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.

Ethics Ruling—Indemnification of a Client

.43 Recently, the AICPA Professional Ethics Executive Committee issued Ethics Ruling No. 102, *Member's Indemnification of a Client* (ET section 191.204 and .205), as published in the January 1996 *Journal of Accountancy*. This ruling (ET section 191.204 and .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. In assessing their independence, auditors of high-technology enterprises should consider the implication of indemnification arrangements requested by their clients, in light of this new ethics ruling (ET section 191.204 and .205).

AICPA Exposure Drafts: Proposed SASs

.44 *Consideration of Fraud in a Financial Statement Audit.* In May 1996 the AICPA issued an exposure draft of a proposed Statement on Auditing Standards, *Consideration of Fraud in a Financial Statement Audit and Amendments to Statements on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures, *and No. 47,* Audit Risk and Materiality in Conducting and Audit. The proposed Statement would provide expanded operational guidance on the consideration of fraud in conducting a financial statement audit. The proposed changes in auditing standards also clarify the auditor's present responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud. In addition, the proposed changes provide added guidance on the standard of due professional care in the performance of work, including the need to exercise professional skepticism, and the concept of reasonable assurance. In addition to amending SAS Nos. 1 (AU sections 110 and 230) and 47 (AU section 312), the proposed Statement would—

- Describe fraud and its characteristics.
- Require the auditor to specifically assess the risk of material misstatement due to fraud and provide categories of fraud risk factors that should be considered in the auditor's assessment.
- Provide guidance on how the auditor should respond to the results of the assessment.
- Provide guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud.
- Describe related documentation requirements.
- Provide guidance regarding the auditor's communication about fraud to management, the audit committee, and others.

.45 *Amendment to SAS No. 31,* Evidential Matter. In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Amendment to SAS No. 31,* Evidential Matter. This proposed Statement would provide guidance for a practitioner who has been engaged to audit an entity's financial statements where significant information is transmitted, processed, maintained, or accessed electronically. The proposed Statement would include examples of evidential matter in electronic form and provide that an auditor should consider the time during which such evidential matter exists or is available in determining the nature, timing, and extent of substantive tests. In addition, the proposed Statement would indicate that an auditor may determine that, in certain engagement environments where evidential matter is in electronic form, it would not be practical or possible to reduce detection risk to an acceptable level by performing only substantive tests. The proposed Statement would provide that in such circumstances, an auditor should consider performing tests of controls to support an assessed level of control risk below the maximum for affected assertions.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.46 *Investments in Debt and Equity.* In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Investments in Debt and Equity*. This proposed Statement would revise the guidance on auditing investments to make that guidance consistent with recently issued accounting standards, particularly FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80).

Allocation of Purchase Price in "Purchase" Business Combinations

.47 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).

.48 After the acquisition or merger with the high-technology company, 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.

.49 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.

.50 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.

.51 EITF Issue No. 96-7, *Accounting for Deferred Taxes on In-Process Research and Development Activities Acquired in a Purchase Business Combination*, addresses the issue of whether a deferred tax liability should be recognized at the consummation date of a purchase business combination, for the initial difference (that is, prior to the write-off of in-process R&D) between the amounts assigned for financial reporting purposes to in-process R&D and its underlying tax basis. The Task Force reached a consensus that the write-off of amounts assigned for financial reporting purposes to in-process R&D occurs prior to the measurement of deferred taxes in a purchase business combination. Accordingly, deferred taxes are not provided on the initial differences between the amounts assigned for financial reporting and tax purposes, and in-process R&D is charged to expense on a gross basis at acquisition.

Research and Development Arrangements

.52 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.

.53 *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.

.54 *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.

.55 *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.

.56 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.

Accounting Issues and Developments

Costs of Internally Developed and Purchased Software

.57 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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.58 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 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.

.59 EITF Issue No. 96-6, *Accounting for the Film and Software Costs Associated with Developing Entertainment and Educational Software Products,* raises the issue of how companies should account for the film and software costs associated with developing entertainment and educational products. However, because of the position taken by the SEC staff, the Task Force was not asked to reach a consensus on this Issue. The SEC's position is included in the EITF Abstracts.

AICPA Exposure Draft: Proposed SOP, *Software Revenue Recognition*

.60 In June 1996, the AICPA issued an exposure draft of a proposed SOP, *Software Revenue Recognition.* This SOP provides guidance on applying generally accepted accounting principles in recognizing revenue on software transactions. This proposed SOP would supersede SOP 91-1, *Software Revenue Recognition,* and would require the following:

1. If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement should be accounted for in conformity with Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts,* using the relevant guidance in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts,* unless specified criteria for separate accounting for any service element are met.
2. Separate accounting for a service element of an arrangement to which contract accounting applies is required if both of the following criteria are met.
   a. The services are not essential to the functionality of any other element of the transaction.
   b. The services are stated separately in the contract such that the total price of the arrangement would be expected to vary as the result of inclusion or exclusion of the services.
3. If an arrangement to deliver software or a software system does not require significant production, modification, or customization of software, revenue should be recognized when all of the following criteria are met:
   a. Persuasive evidence of an agreement exists.
   b. Delivery has occurred.
   c. The vendor's fee is fixed or determinable.
   d. Collectibility is probable.
4. Software arrangements may consist of multiple elements, that is, additional software products, upgrades or enhancements, rights to exchange or return software, postcontract customer support (PCS), or services, including elements deliverable only on a when-and-if-available basis. If contract accounting does not apply, the vendor's fee must be allocated to the various elements based on vendor-specific objective evidence of fair values. If sufficient vendor-specific objective evidence of

fair values does not exist, all revenue from the arrangement should be deferred until such sufficient evidence exists, or until all elements have been delivered. Exceptions to this guidance are provided for PCS, subscriptions, and arrangements in which the fee is based on the number of copies. Vendor-specific objective evidence is limited to (*a*) the price charged when the element is sold separately, or (*b*) if not yet being sold separately the price for each element established by management having the relevant authority.

5. The portion of the license fee allocated to an element should be recognized as revenue when all of the revenue recognition criteria have been met. In applying those criteria, delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of any delivered elements. Additionally, collectibility of that portion of the fee is not considered to be probable if the amount of the fees attributable to delivered elements is subject to forfeiture, refund, or other concession if the undelivered elements are not delivered.

As drafted, the provisions of this proposed SOP would be effective for fiscal years beginning after December 15, 1996 with earlier application encouraged. The cumulative effect of changes caused by adopting the provisions of this proposed SOP would be included in the determination of net income in conformity with APB Opinion No. 20, *Accounting Changes* (AC A06).

Delayed Effective Dates—Accounting Pronouncements

.61 *Disclosures about Fair Value of Financial Instruments.* FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), issued in December 1991, was effective for financial statements issued for fiscal years ending after December 15, 1992. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995. In that a sizable portion of high-technology entities may be smaller, development-stage enterprises, financial statements for years ended during 1996 will be subject to the provisions contained therein. In such circumstances, auditors should consider whether management has made all disclosures required by FASB Statement No. 107 (AC F25).

.62 FASB Statement No. 107 (AC F25) requires disclosure of the fair 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. Certain financial instruments (for example, lease contract, deferred-compensation arrangements, and insurance contracts) are excluded from the scope of the Statement (AC F25).

.63 *Disclosures about Derivative Financial Instruments.* FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), issued in October 1994, was effective for financial statements issued for fiscal years ending after December 15, 1994. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995.

.64 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), to require disaggregation of information about financial instruments with off-balance-sheet risk of accounting loss by class, business activity, risk, or other category that is consistent with the entity's management of those instruments. The Statement (AC F25) also amends FASB Statement No. 107 (AC F25) to require that fair value information be presented without combining, aggregating, or netting the fair value of derivative financial instruments with the fair value of nonderivative financial instruments and be presented together with the related carrying amounts in the body of the financial statements, a single footnote, or a summary table in a form that makes it clear whether the amounts represent assets or liabilities.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.65 Auditors should consider whether the provisions of FASB Statement No. 119 (AC F25) apply to their high-technology clients and, if so, evaluate whether the client's financial statement disclosures are adequate and appropriate in view of the requirements set forth therein.

Restructurings

.66 A significant increase in the level of organizational restructuring undertaken by high-technology enterprises is likely this year, based on factors such as—

- The Telecommunications Act, which is expected to generate an increased rate of mergers, acquisitions, and consolidations.
- The need for greater cost efficiencies and economies of scale to offset declining revenue growth.
- Intense competitive pressures, which will force many entities to expand into new markets.
- The anticipated growth in the Internet market, for which many high-technology entities are preparing through the reallocation of assets along with significant capital expenditures.

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 write-downs 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 internal control, the appropriateness and completeness of recorded liabilities relating to current restructuring plans, and the appropriate period for reporting the costs associated with restructurings.

.67 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 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.

.68 EITF Issue No. 96-9, *Classification of Inventory Markdowns and Other Costs Associated with a Restructuring*, raises the issue of whether inventory markdowns associated with an exit plan or a restructuring activity should be classified in the income statement as a cost of goods sold or as an exit or a restructuring cost. The Task Force agreed to not address this Issue. However the position taken by the SEC is included in the EITF Abstracts.

.69 For publicly held entities, the SEC's 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 and, in a "two-step" income statement, should generally be classified as an operating expense.

Management's Discussion and Analysis Public Companies

.70 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 an impact on future operations, or those matters that have not affected the most recent period presented but are expected to materially affect future periods.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.71

Exhibit

Significant Provisions of Newly Issued SASs

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, 544, 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]).

Information Sources

.72 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.

.73 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.

.74 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.

.75 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.76 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.

* * * *

.77 This Audit Risk Alert supersedes *High-Technology Industry Developments—1995/96.*

* * * *

.78 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1996/97* [AAM section 8010] and *Compilation and Review Alert—1996/97* [AAM section 8015].

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.79 **Information Sources**

Organization	General Information	Fax/Phone 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. 1) 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) 942-4040 *SEC Public Reference Room* (202) 942-8090	*Information Line* (202) 942-8088 (ext. 3)	SEC's Homepage www.sec.gov	*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 22209-9998	*General Information* (703) 522-5055		

[*The next page is 8481.*]

AAM Section 8210

Real Estate Industry Developments—1996/97

Industry and Economic Developments

.01 In last year's *Real Estate Industry Developments*, it was noted that the state of uncertainty that had existed in the real estate industry continued. That state continues to exist in 1996, as investors, having suffered through a prolonged recession in the industry, continue to display hesitancy despite improvement in many indicators.

.02 Positive trends related to vacancy rates and housing starts continue to emerge, but there are variances by region and property type. Auditors should be aware of the risks relevant to the property type and geographical region(s) in which their clients operate (and not just where the clients' headquarters are located).

.03 In the 1980s and early 1990s, the commercial markets experienced an oversupply of space. The primary factors contributing to the oversupply were the overbuilding of the 1980s combined with the general economic recession, a trend towards corporate downsizing, and the changing demographics of many entities. As the industry began to suffer the results of the oversupply, new construction slowed drastically.

.04 Over the past several years, the demand for commercial space has been improving. However, much of that demand has been met by space that was already available, and no more than a limited level of new construction has been required. As vacancy rates continue to decline, and capital continues its slow return to the real estate market (albeit from new sources, as discussed later), indications are that new construction is picking up. Although many observers feel that the industry will not return to the exaggerated overbuilding of several years ago, concern does exist that the industry may overreact.

.05 In the residential market, demand for houses continues to be linked to mortgage rates. Mortgage rates continue to be low compared to recent historical rates. However, any future increases in interest rates would have an adverse impact on housing demand.

.06 Throughout the early 1990s, 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 (which existed for the real estate industry during the early 1990s). 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.

.07 While capital has begun to return to the market, the sources of that capital have changed. Although the traditional investors such as banks, pension funds, and life insurance companies remain the major sources of capital, alternative sources, primarily REITs and issuers of collateralized mortgage-backed securities (CMBSs), have increased in significance. Some of the largest real estate capital providers have been converting debt assets into debt securities, providing an efficient way for real estate to be financed. Securitization of real estate continues to increase. A record level of CMBS issuance is expected this year.

.08 The current securitization activity continues an upswing that started when the Resolution Trust Company (RTC) needed to dispose of large numbers of mortgages as quickly as possible. The return of capital is likely to accelerate now that legislation related to Financial Asset Securitization Investment Trusts (FASITs)

has been passed. FASITs, with less restrictive qualification and operational requirements than Real Estate Mortgage Investment Conduits (REMICs), likely will increase the credit availability to most market segments, particularly small businesses and developers. Unlike a REMIC, a FASIT is permitted to increase or decrease its asset pool after the assets have been placed in the portfolio. As a result, construction financing will qualify for securitization, making financing more available to real estate developers. Although passage of the FASIT legislation is viewed as a positive development for the industry, some concerns exist that the increased availability of financing may lead to a return to overbuilding.

.09 Also contributing to the fear of overbuilding is the increased availability of credit already existing in some markets, even before the September 1, 1997 effective date of the FASIT legislation. Lending activity has increased in response to the slow upward trend in real estate values. As a result of the increased lending, construction activity in some markets has begun to pick up, which also contributes to the fears of overbuilding.

.10 Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AU section 311), as amended, 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 markets described above.

Regulatory Matters

.11 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) 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), requires auditors to 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.

.12 Specific laws and regulations that may affect the real estate industry are discussed in the following paragraphs.

Private Securities Litigation Reform Act of 1995

.13 In December of 1995, the Congress passed over the President's veto the Private Securities Litigation Reform Act of 1995. One important aspect of this legislation is the inclusion of Section 10A into the Securities Exchange Act of 1934. Section 10A codifies certain professional auditing standards, provides a broad definition for "illegal acts," and expands the obligations of auditors to timely report certain uncorrected illegal acts.

.14 New Section 10A codifies existing auditing standards in four areas. It requires auditors to identify illegal acts (which is currently required by SAS No. 54 [AU section 317]), identify related parties (which is currently required by SAS No. 45[1]), and evaluate whether substantial doubt exists about an entity's ability to continue as a going concern (which is currently required by SAS No. 59,[2] as amended by SAS No. 64[3] and SAS No. 77[4]), Section 10A also codifies and expands the auditor's responsibility to report illegal acts pursuant to SAS No. 53.[5]

---

[1] *Omnibus Statement on Auditing Standards—1983* (AU sections 313, 334, and 557).

[2] *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341).

[3] *Omnibus Statement on Auditing Standards—1990* (AU sections 341, 508, and 543).

[4] *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 sections 311, 341, 544, and 623).

[5] *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU section 316).

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.15 Auditors should note that Section 10A broadly defines "illegal acts" to include "an act or omission that violates any law, or any rule or regulation having the force of law." This definition is especially significant when it is considered in relation to the specific determinations an auditor must make and the expanded responsibilities of auditors to timely report certain uncorrected illegal acts.

.16 For example, Section 10A specifies that when the auditor becomes aware of information indicating that an illegal act may have occurred, regardless of the perceived impact of the illegal act on the issuer's financial statements, the auditor must make certain determinations. The auditor must (1) determine whether it is likely that an illegal act has occurred; (2) if so, determine the possible effects (including any contingent fines, penalties, and damages) on the issuer's financial statements; and (3) as soon as practicable, inform management of the illegal act(s) and assure the issuer's Board of Directors is also adequately informed of such act(s) (unless the illegal act is clearly inconsequential).

.17 However, the auditor's responsibility is expanded beyond the present guidance under GAAS to include the requirement that auditors report to the issuer's Board of Directors the auditor's belief that the illegal act has a material effect on the financial statements of the issuer, senior management has not taken "timely and appropriate remedial actions with respect to the illegal act," and the auditor reasonably expects the failure to take remedial action will result in the issuance of a non-standard report or the auditor's resignation from the audit engagement.

.18 Once auditors report to the Board of Directors that appropriate remedial actions have been taken, an issuer must inform the SEC of the auditor's conclusions within one business day of receiving the auditor's report. If the issuer fails to inform the SEC, the auditor is required to notify the SEC within one business day. Section 10A, through the Exchange Act, provides for the imposition of penalties of up to $500,000 on auditors for willful failure to comply with the reporting responsibilities created by Section 10A.

.19 The SEC has proposed a rule to implement the reporting requirements set forth in Section 10A with a deadline for comments of October 28, 1996. The proposed rule would specify, among other things, that registrants and auditors should submit any notice or report required by Section 10A in a written, confidential communication rather than on a public disclosure form, that the SEC's Office of the Chief Accountant should receive the report, that the report should include information identifying the issuer and the auditor, and that the report would be exempt from the Freedom of Information Act to the same extent as SEC investigative records. In addition, practitioners should be aware that neither Section 10A nor the release alters existing auditor reporting requirements.

U.S. Department of Housing and Urban Development Regulations

.20 Through the Federal Housing Administration (FHA), 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 (GAS; also commonly referred to as the "Yellow Book") issued by the Comptroller General of the United States, and the Consolidated Audit Guide for Audits of HUD Programs, issued by the HUD Office of the Inspector General (OIG).

.21 Before accepting HUD audits, auditors should be aware of the HUD oversight program. Representatives of HUD have the ability to review workpapers of individual engagements. If HUD determines that the audit is not in compliance with the HUD audit program, the individual (rather than the firm) that performed the audit can be banned from performing future HUD audits. Furthermore, HUD might refer the matter to the individual's state board of accountancy.

Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance

.22 Because real estate entities may be recipients of governmental assistance, auditors should consider the guidance in AICPA 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.

.23 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 of a governmental entity under GAAS, an audit under *Government Auditing Standards*, or 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.

.24 SAS No. 74 (AU section 801) provides general guidance to the auditor on the:

1. Application of 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.
2. Performance of a financial audit in accordance with *Government Auditing Standards*.
3. Performance of a single or organization-wide audit or a program-specific audit in accordance with federal audit requirements.
4. Communication 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

.25 Developers are required to make full disclosure 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. See the discussion on SAS No. 22 (AU section 311) and SAS No. 54 (AU section 317) in the "Regulatory Matters" section of this Audit Risk Alert.

Regulation Z of the Consumer Credit Protection Act

.26 Because 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 that are applicable to all real estate transactions, regardless of amount, in which individual borrowers are involved in nonbusiness transactions. Failure to comply could be considered an illegal act that has an indirect effect on the financial statements.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Tax Matters

.27 Many real estate transactions such as "synthetic" leases or formation of an umbrella partnership REIT (UPREIT) or a DownREIT are structured to achieve specific tax purposes. Each of these transactions is discussed below. Further discussion of accounting topics relevant to these types of transactions is included in the "Accounting Developments" section of this Audit Risk Alert.

.28 *UPREITs.* In the formation of a typical UPREIT, 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. 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 UPREIT structure, the REIT's consolidated financial statements report the assets and liabilities contributed by the sponsor at the sponsor's historical cost basis. One of the reasons for the popularity of the UPREIT conversion is that the seller can defer tax by accepting operating partnership units as consideration.

.29 *DownREITs.* In the formation of a typical DownREIT, an existing REIT forms an operating partnership with the property owners of the desired acquisition property, generally with the existing REIT as the general partner. The owner contributes the assets to the operating partnership and, in return, receives partnership units that can be exchanged at some future date for shares of stock in the REIT. Similar to UPREITs, one of the benefits of a DownREIT structure is that the seller can defer tax by accepting partnership units as consideration. Additionally, the DownREIT structure is easier to implement than an UPREIT conversion.

.30 *Synthetic Leases.* The use of synthetic leases is becoming more common in the real estate industry. Use of a synthetic lease allows the lessee to obtain financing while permitting off-balance sheet treatment for the related obligation and asset. Establishment of a typical synthetic lease might include the following steps:

- A nonconsolidated special purpose entity (SPE) would be established to act as the lessor of the property in question.
- The lessee would sign a lease under which the monthly net rental payments would cover the SPE-lessor's debt service.
- The SPE-lessor would obtain nonrecourse financing to be used to obtain the property, using the lease as security.

.31 The lease agreement would be structured so that upon expiration, the lessee would have the option of renewing the lease, purchasing the property, or causing the property to be sold. If the property is sold for an amount greater than the SPE-lessor's investment, the lessee would retain the excess. If the sales proceeds do not cover the SPE-lessor's investment, the lessee would be required to make a contingent rental payment to the SPE-lessor in the amount of the shortfall, subject to the limitation of the residual value guarantee. The present value of the minimum lease payments (base rental payments plus the residual value guarantee) to the SPE-lessor must be less than 90 percent of the original cost of the property, or capital lease treatment would result.

.32 One reason a lessee might wish to use a synthetic lease is that such an arrangement permits the lessee to use off-balance sheet treatment for the asset and obligation, yet retain the benefit of any appreciation in the property during the lease term. Additionally, because the lessee will be considered the owner of the property for tax purposes, the lessee will be entitled to claim deductions for interest on the debt and tax depreciation on the property.

.33 Auditors should be aware that the accounting literature covering synthetic leases, including Financial Accounting Standards Board (FASB) Emerging Issue Task Force (EITF) Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions*, and EITF Issue No. 96-21, *Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities*, is complex, and failure to comply with all of the requirements could result in material misstatement of the financial statements.

.34 Auditors also should be aware that the use of synthetic leases, UPREITs, DownREITs, or similar strategies may affect audit risk. If structured incorrectly, these types of transactions or arrangements may have significant adverse impact on the financial statements of clients. For example, one of the main reasons to use synthetic leases is the ability to retain off-balance sheet treatment for the related asset. However, if the synthetic lease is structured incorrectly, the entity may be required to consolidate the SPE that was formed to act as the lessor of the property. This would defeat the purpose of the synthetic lease structure.

Audit Issues and Developments

General Risk Factors

.35 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.

.36 *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.

.37 *Lengthy Development or Holding Periods.* By their nature, real estate projects involving construction require significant lead time. Delays may result in increased costs and potentially affect the accounting for the assets being constructed. See the section entitled "Asset Impairment."

.38 *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

.39 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. FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08), which is effective for financial statements for fiscal years beginning after December 15, 1995, 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."

.40 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.

.41 Conditions or events such as the following may indicate a need for assessing the recoverability of investments in real estate:

- Cash flows from operating activities are insufficient to cover debt service.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- 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.
- Rental demand for a rental project currently under construction is not meeting projections.
- Auditors' reports on financial statements of investee properties are modified for reasons that relate to real estate investments. For example, 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.

.42 Lack of an asset-impairment evaluation system may indicate a material weakness 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.

.43 Auditors also should 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 that the entity intends to dispose of should be accounted for in accordance with paragraphs 15 through 17 of the Statement (AC I08.134-136) ("assets to be disposed of ").

.44 SAS No. 73, *Using the Work of a Specialist* (AU section 336), provides guidance on auditing internal or external appraisals of real estate.

.45 *Real Estate Properties Held for Investment.* 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). If events or changes in circumstances indicate that impairment may exist, the entity is required to estimate the future cash flows expected to result from the use of the asset and its eventual disposition.

.46 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.

.47 *Real Estate to Be Disposed Of.* 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. Determination of whether the carrying amounts of real estate projects require writedowns should be done on a project-by-project basis, in accordance with paragraph 24 of FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects* (AC Re2.124), as amended by FASB Statement No. 121 (AC I08).

.48 In assessing the valuation of assets to be disposed of, auditors should consider various issues, including the following:

- 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 appropriate costs in the estimate of costs to sell? Have the costs to sell been discounted, if appropriate?

.49 In deliberating FASB Statement No. 121 (AC I08), the FASB decided not to provide an exception for assets subject to nonrecourse debt. The FASB considers the recognition of an impairment loss and the recognition of gain on extinguishment of debt to be two separate events.

Foreclosed Real Estate

.50 SOP 92-3, *Accounting for Foreclosed Assets*, provides guidance on measuring foreclosed assets after foreclosure. Under 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.

.51 Auditors should be aware that some believe that the "held for sale" presumption of SOP 92-3 has been effectively superseded by FASB Statement No. 121 (AC I08). The FASB has added a project to its agenda to address certain provisions of FASB Statement No. 121 (AC I08). It is possible that, as a result of this project, that interpretation could be formalized.

.52 SOP 92-3 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 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.

Revenue Recognition

.53 As discussed in the "Tax Matters" section of this Audit Risk Alert, certain real estate transactions are structured to achieve a desired result. Auditors should analyze such creative funding deals to ensure that their clients have accounted for the transaction properly.

.54 The persistent feeling that the industry is on the verge of a recovery may lead to clients forecasting improvements in financial results that may not fully materialize. Auditors should consider the appropriate-

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

ness of their clients' revenue-recognition policies, or changes therein. A number of clients may view the continued 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 (AU sections 313, 334, and 557) describes procedures that are designed to determine the existence of related parties as defined by FASB Statement No. 57 (AC R36).

Availability of Funding

.55 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.

.56 SAS No. 59 (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

.57 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

.58 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. 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. As discussed in the "Accounting Developments" section of this Audit Risk Alert,

in October 1996 the AICPA issued SOP 96-1, *Environmental Remediation Liabilities*. This SOP includes benchmarks to aid in the determination of when environmental remediation liabilities should be recognized in accordance with FASB Statement No. 5 (AC C59). It also provides guidance on the display of environmental remediation liabilities in financial statements and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations.

.59 Auditors also should be aware of the consensuses reached in EITF Issues No. 93-5, *Accounting for Environmental Liabilities*, and No. 95-23, *The Treatment of Certain Site Restoration/Environmental Exit Costs When Testing a Long-Lived Asset for Impairment*. In EITF Issue No. 93-5, the EITF reached a consensus that 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. In EITF Issue No. 95-23, the EITF reached a consensus that future cash flows for environmental costs that are associated with a long-lived asset should be excluded from the undiscounted expected future cash flows used to test the asset for recoverability under FASB Statement No. 121 (AC I08). For environmental costs that have not been recognized as a liability for accounting purposes, the EITF reached a consensus that whether environmental exit costs should be in the undiscounted expected future cash flows used to test a long-lived asset for recoverability under FASB Statement No. 121 (AC I08) depends on management's intent with respect to the asset. The EITF Issue provides examples of management's intent and the corresponding treatment of the environmental exit costs in the FASB Statement No. 121 (AC I08) recoverability test.

.60 Auditors of publicly held companies should also consider the requirements of the Securities Exchange Commission (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 accounting for environmental issues.

.61 For further discussion, see *Audit Risk Alert—1996/97* [AAM section 8010].

Real Estate Investment Trusts

.62 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, to only seven IPOs in 1995. REIT activity has increased again in 1996, although the level of activity is nowhere near the level of 1993 and 1994.

.63 REITs require new capital to fund acquisitions for growth. Other than IPOs, REITs have been implementing several other methods of raising capital, each of which presents issues that an auditor should be aware of.

.64 *Secondary Public Offerings.* In 1995, secondary offerings far exceeded IPO activity. 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.

.65 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.66 *Bond Financings.* In 1995, REITs were active in the bond market. Publicly rated debt sometimes can be issued more cheaply than equity. To the extent a REIT stock is considered undervalued, public debt is a more cost-effective method of raising capital. The relatively low weighted average cost of capital permits REITs to purchase real estate at low yields without diluting earnings. The achievement of an investment grade rating has made this an attractive method of capital formation for several REITs.

.67 *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 (RTC) 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.

.68 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.

.69 *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 UPREIT. Formation of an UPREIT is discussed in the "Tax Matters" section of this Audit Risk Alert. Also, for reasons discussed below, a traditional REIT may wish to convert itself to an UPREIT in order to place itself in an advantageous position for future property acquisitions.

.70 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. As discussed in the "Accounting Developments" section of this Audit Risk Alert, in EITF Issue No. 95-7, *Implementation Issues Related to the Treatment of Minority Interests in Certain Real Estate Investment Trusts,* the EITF discussed certain issues related to minority interests in REITs.

.71 Auditors of REITs should be aware of the requirements of SEC SAB No. 97, *The Inappropriate Application of Staff Accounting Bulletin No. 48,* Transfers of Nonmonetary Assets by Promoters or Shareholders, *to Purchase Business Combinations Consummated Just Prior to or Concurrent With an Initial Public Offering, and the Identification of an Accounting Acquirer in Accordance With APB Opinion No. 16,* Business Combinations, *for Purchase Business Combinations Involving More Than Two Entities,* and the relationship between SAB No. 97 and EITF Issue No. 94-2.

.72 When property owners look to sell their properties on a tax-deferred basis, an UPREIT 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.

.73 *Formation of a DownREIT.* As discussed in the "Tax Matters" section of this Audit Risk Alert, a DownREIT is a joint venture formed by an existing REIT with the owners of the desired acquisition property. All current properties continue to be held directly by the REIT. The REIT generally is the general partner of the joint venture.

.74 Auditors should be aware of several disadvantages of the DownREIT structure. First, the structure may not provide for central ownership of all the REIT's properties. Future property acquisitions may become cumbersome. Also, the lack of central ownership may increase the administrative burden of managing and

recordkeeping for the REIT properties. Auditors also should determine that the acquired property's cash flow and taxable income is not blended with those of the other REIT properties. Additionally, the DownREIT structure gives rise to potentially significant issues related to gain recognition, new basis, and consolidation. Finally, because of the complexity of the DownREIT structure, financial statement disclosures should be reviewed carefully.

Liquidity and Cash Flow Information

.75 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 also should be presented in a balanced manner, including cash flows from operations, investing, and financing activities. The SEC staff also has 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

.76 The SEC staff has noted that publicly held real estate entities increasingly 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 captions in financial statements themselves are inappropriate because they suggest that the amount represents cash flow for the period, which is rarely the case. Cash flow from operations is the appropriate financial statement caption, which must be included in a balanced presentation with cash flows from investing and financing activities when discussing cash flows 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.

.77 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 is 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

.78 Interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments derive their value have increased in volatility over the past several months. As a result, a number of entities have incurred significant losses attributable to the use of derivatives. Entities in the real estate industry sometimes use such instruments as risk management tools (hedges) or as speculative investment vehicles. Derivatives nearly always increase audit risk. Although the financial statement assertions about transactions involving derivatives are generally similar to assertions about other transactions, the auditor's approach to achieving related audit objectives may differ because certain derivatives, such as

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

forward contracts, swaps, options, and other financial instruments 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—1996/97* [AAM section 8010]. In addition, auditors may wish to refer to the SEC's proposal on comprehensive disclosure requirements for derivatives and other financial instruments, issued for public comment in early 1996. The SEC anticipates issuance of a final staff bulletin on this topic by December 31, 1996.

Auditing Pronouncements

.79 As summarized in the following Exhibit, five new SASs, which are discussed below, have been issued recently.

.80

Exhibit

Significant Provisions of Newly Issued SASs

Pronouncement	Pronouncements Affected	Key Provisions
SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*	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	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	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*	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	SAS No. 58	Eliminates the requirement to add an uncertainties paragraph to the auditor's report (does not affect SAS No. 59).

.81 *SAS No. 75.* 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 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 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.

.82 *SAS No. 76.* In September 1995, the AICPA issued SAS No. 76, *Amendments to Statement on Auditing Standards No. 72,* Letters for Underwriters and Certain Other Requesting Parties (AU section 634 and AT

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

section 300). The SAS (AU section 634 and AT section 300) 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 paragraph 6 of SAS No. 72 (AU section 634.06). SAS No. 76 (AU section 634 and AT section 300) is effective for letters issued pursuant to paragraph 9 of SAS No. 72 (AU section 634.09) after April 30, 1996.

.83 *SAS No. 77.* In November 1995, the AICPA issued SAS No. 77 (AU sections 311, 341, 544, 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, *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 sections 311, 341, 544, and 623), is effective for engagements beginning after December 15, 1995.

.84 *SAS No. 78.* In December 1995, the AICPA 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 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.

.85 *SAS No. 79.* In December 1995, the AICPA 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. SAS No. 79 (AU section 508) does not affect SAS No. 59 (AU section 341) nor does it preclude the auditor from adding a paragraph to the auditor's report to emphasize a matter disclosed in the financial statements.

.86 As discussed in SAS No. 79 (AU section 508), a matter involving an uncertainty is one that is expected to be resolved at a future date, at which time conclusive evidential matter concerning its outcome would be expected to become available. Uncertainties include, but are not limited to, contingencies covered by FASB Statement No. 5 (AC C59) and matters related to estimates covered by SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertion about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate. If the auditor is unable to obtain sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualification or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

.87 SAS No. 79 (AU section 508) is effective for reports issued or reissued on or after February 29, 1996, with earlier application permitted.

.88 *SAS No. 80.* In December 1996, the AICPA issued a new SAS, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter (AU section 326), which is effective for engagements beginning on or after January 1, 1997. This Statement (AU section 326) provides guidance for a practitioner who has been engaged to audit an entity's financial statements where significant information is transmitted, processed, maintained, or accessed electronically. The new Statement (AU section 326) includes examples of evidential matter in electronic form and provide that an auditor should consider the time during which such evidential matter exists or is available in determining the nature, timing, and extent of substantive tests. In addition, the Statement (AU section 326) indicates that an auditor may determine that, in certain entities when evidential matter is in electronic form, it would not be practical or possible to reduce detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. The Statement (AU section 326) provides that in such circumstances, an auditor should perform tests of controls to support an assessed level of control risk below the maximum for affected assertions. Evidence provided by these tests of controls, when combined with that provided by substantive tests, should be sufficient to support the auditor's opinion to be issued.

.89 Additionally, at the time of this writing, an exposure draft of the following proposed SAS was outstanding.

.90 *Consideration of Fraud in a Financial Statement Audit.* In May 1996 the AICPA issued an exposure draft of a proposed Statement on Auditing Standards, *Consideration of Fraud in a Financial Statement Audit and Amendments to Statements on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures, and No. 47, Audit Risk and Materiality in Conducting and Audit. The proposed Statement would provide expanded operational guidance on the consideration of fraud in conducting a financial statement audit. The proposed changes in auditing standards also clarify the auditor's present responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud. In addition, the proposed changes provide added guidance on the standard of due professional care in the performance of work, including the need to exercise professional skepticism, and the concept of reasonable assurance. In addition to amending SAS Nos. 1 and 47 (AU section 312), the proposed Statement would—

- Describe fraud and its characteristics.
- Require the auditor to specifically assess the risk of material misstatement due to fraud and provide categories of fraud risk factors that should be considered in the auditor's assessment.
- Provide guidance on how the auditor should respond to the results of the assessment.
- Provide guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud.
- Describe related documentation requirements.
- Provide guidance regarding the auditor's communication about fraud to management, the audit committee, and others.

Accounting Developments

FASB Statement on Impairment

.91 In March 1995, the FASB issued FASB Statement No. 121 (AC I08). As discussed previously, FASB Statement No. 121 (AC I08) has particular importance to the real estate industry. FASB Statement No. 121

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

(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 circumstances indicate that their carrying amounts may not be recoverable. In performing the review for impairment, 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 expected 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.

.92 The Statement (AC I08) requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying value or fair value less cost to sell, except for those assets that are covered by APB Opinion No. 30 (AC I13).

.93 It also amends FASB Statement No. 67 (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. Projects under development and land to be developed are considered assets to be held and used.

.94 The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged.

FASB Statement on Transfers and Servicing of Financial Assets and Extinguishment of Liabilities

.95 In June 1996, the FASB issued Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (AC F38). This Statement (AC F38) provides accounting and reporting standards for transfers and servicing of financial assets and extinguishment of liabilities. Those standards are based on consistent application of a financial-components approach that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. This Statement (AC F38) provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

.96 A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interest in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

1. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

2. Either (*a*) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right—to pledge or exchange the transferred assets or (*b*) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.

3. The transferor does not maintain effective control over the transferred assets through (*a*) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (*b*) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

.97 FASB Statement No. 125 (AC F38) requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interest in transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

.98 FASB Statement No. 125 (AC F38) requires that servicing assets and liabilities be subsequently measured by (1) amortization in proportion to and over the period of estimated net servicing income or loss and (2) assessment for asset impairment or increased obligation based on their fair values.

.99 FASB Statement No. 125 (AC F38) requires that debtors reclassify financial assets pledged as collateral and that secured parties recognize those assets and their obligation to return them in certain circumstances in which the secured party has taken control of those assets.

.100 FASB Statement No. 125 (AC F38) requires that a liability be derecognized if and only if either (1) the debtor pays the creditor and is relieved of its obligation for the liability or (2) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

.101 FASB Statement No. 125 (AC F38) provides implementation guidance for assessing isolation of transferred assets and for accounting for transfers of partial interest, servicing of financial assets, securitizations, transfers of sales-type and direct financial lease receivables, securities lending transactions, repurchase agreements including "dollar rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishment of liabilities.

.102 FASB Statement No. 125 (AC F38) supersedes FASB Statements No. 76, *Extinguishment of Debt*, and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. This Statement (AC F38) amends FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80), to clarify that a debt security may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. This Statement (AC F38) amends and extends to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (AC Mo4), and supersedes FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*. This Statement (AC F38) also supersedes FASB Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt*, No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*, and No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*.

.103 FASB Statement No. 125 (AC F38) is effective for transfers and servicing of financial assets and extinguishment of liabilities occurring after December 31, 1996, and is to be applied prospectively. Earlier or retroactive application is not permitted.

Stock-Based Compensation

.104 In October 1995, the FASB issued Statement No. 123, *Accounting for Stock-Based Compensation* (AC C36), which establishes financial accounting for stock-based employee compensation plans. The Statement (AC C36) encourages companies to account for stock compensation awards using a fair value method. Fair value is determined based on the stock price at the date the awards are granted. The resulting compensation cost would be recognized as an expense in the income statement over the service period. FASB Statement No. 123 (AC C36) also applies to equity instruments issued for goods or services provided by persons other than employees. The accounting requirements of this Statement (AC C36) are effective for transactions entered into in fiscal years that begin after December 15, 1995, though they may be adopted on issuance.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

FASB Statement on Derivatives

.105 FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), issued in October 1994, was effective for financial statements issued for fiscal years ending after December 15, 1994. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995.

.106 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), to require disaggregation of information about financial instruments with off-balance-sheet risk of accounting loss by class, business activity, risk, or other category that is consistent with the entity's management of those instruments. The Statement (AC F25) also amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), to require that fair value information be presented without combining, aggregating, or netting the fair value of derivative financial instruments with the fair value of nonderivative financial instruments and that it be presented together with the related carrying amounts in the body of the financial statements, a single footnote, or a summary table in a form that makes it clear whether the amounts represent assets or liabilities.

.107 Auditors should consider whether the provisions of FASB Statement No. 119 (AC F25) apply to their clients, and if so, evaluate whether the client's financial statement disclosures are adequate and appropriate in view of the requirements set forth therein. Also, as discussed in the "Audit Issues and Developments" section of this Audit Risk Alert, auditors should be aware that the SEC anticipates that a final staff accounting bulletin will be issued by December 31, 1996 on the topic of comprehensive disclosure requirements for derivatives and other financial instruments.

FASB Statement on Disclosures About Fair Value of Financial Instruments

.108 FASB Statement No. 107 (AC F25) was effective for financial statements issued for fiscal years ending after December 15, 1992. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995. For those real estate entities with less than $150 million in total assets as of December 15, 1992, financial statements for years ended during 1996 will be subject to the provisions of FASB Statement No. 107 (AC F25). In such circumstances, auditors should consider whether management has made all disclosures required by FASB Statement No. 107 (AC F25).

.109 FASB Statement No. 107 (AC F25) requires disclosure of the fair 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. Certain financial instruments (for example, lease contracts, deferred-compensation arrangements, and insurance contracts) are excluded from the scope of the Statement (AC F25).

.110 Auditors should be aware that in September 1996, the FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Elimination of Certain Disclosures about Financial Instruments by Small Nonpublic Entities—an Amendment of FASB Statement No. 107*. This proposed Statement would make the disclosures about the fair value of financial instruments prescribed in FASB Statement No. 107 (AC F25) optional for entities that meet all of the following criteria:

1. The entity is a nonpublic entity.
2. The entity's total assets are less than $10 million on the date of the financial statements.

3. The entity has not held or issued any derivative financial instruments as defined in FASB Statement No. 119 (AC F25) during the reporting period.

.111 The proposed Statement would be effective upon issuance. The FASB expects to issue a final Statement in the fourth quarter of 1996.

Emerging Issues Task Force Issues

.112 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 since the release of *Audit Risk Alert—Real Estate Industry Developments 1995/96* follows; readers should consult detailed minutes for additional information.

.113 In EITF Issue No. 95-6, *Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation*, the EITF reached a consensus that, regardless of the method of accounting used by a REIT for its investment in a service corporation, the service corporation should not be considered an independent third party and the costs capitalized by the REIT for leasing services provided by the service corporation should be no greater than the amount of costs that would have been capitalized under FASB Statement No. 13 (AC L10), as amended by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Leases and Initial Direct Costs of Leases* (AC L20), had the REIT incurred the costs directly.

.114 The EITF also reached a consensus that the existence of certain factors (listed in the EITF Abstract) indicate the REIT has the ability to exercise at least significant influence over the service corporation and that, accordingly, the REIT should not account for its investment in the service corporation using the cost method.

.115 In EITF Issue No. 95-7, the EITF reached a consensus that although a minority interest balance may be negative, the minority interest charge in the REIT's consolidated income statement should be the greater of (1) the minority interest holder's share of the operating partnership's earnings for the year (if any) or (2) the amount of distributions to the minority interest holder during the year. Any amount by which (1) exceeds (2) for the year should be credited directly to the REIT's equity (with a corresponding debit to minority interest) until the minority interest deficit that existed at the formation of the REIT is eliminated. If the minority interest deficit increases after the formation (for example, due to operating partnership distributions in excess of earnings) and then is reduced (but still is greater than the deficit at formation), the reduction should first be credited to the majority interest to the extent of minority interest losses and distributions previously absorbed through earnings by the majority interest.

.116 The EITF also reached a consensus that the REIT should account for any subsequent acquisitions of the sponsor's minority interest in the operating partnership for cash in a manner that is consistent with the accounting for the formation of the REIT. This second consensus is applicable only to REITs with operating structures described in the Issue and Issue No. 94-2.

AICPA Statement of Position 94-6 on Disclosure of Certain Significant Risks and Uncertainties

.117 In December 1994, the AICPA issued SOP 94-6. The SOP is 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. The SOP 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 the financial statements. If specified disclosure criteria are met, the SOP requires entities to also include in their financial statements disclosures about certain significant estimates and current vulnerabilities due to certain concentrations.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.118 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

.119 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
- Financial results reliant on a single lessee
- Funding commitments from one financial institution related to project development

.120 Auditors should be alert to the requirements of this new SOP and its impact upon the financial statement disclosures of the entity being audited. Auditors should consider carefully whether all significant estimates and concentrations have been identified and considered for disclosure.

AICPA Statement of Position 96-1 on Environmental Remediation Liabilities

.121 In October, 1996, the AICPA issued SOP 96-1. This 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 the determination of when environmental remediation liabilities should be recognized in accordance with FASB Statement No. 5 (AC C59).
- That an accrual for environmental liabilities should include—
  - — Incremental direct costs of the remediation effort, as defined.
  - — Costs of compensation and benefits for those employees who are expected to devote a significant amount of time directly to the remediation effort, to the extent of the time expected to be spent directly on the remediation effort.
- That the measurement of the liability should include—
  - — The entity's allocable share of the liability for a specific site.
  - — The entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- That the measurement of the liability should be based on enacted laws and existing regulations and policies, and on the remediation technology that is expected to be approved to complete the remediation effort.
- That the measurement of the liability 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 that the measurement may be discounted to reflect the time value of money if the aggregate amount of the liability or the component of the liability and the amount and timing of cash payments for the liability or component are fixed or reliably determinable.
- Guidance on the display of environmental remediation liabilities in financial statements and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations.

.122 The provisions of SOP 96-1 are effective for fiscal years beginning after December 15, 1996. Earlier application is encouraged. The effect of initially applying the SOP should be reported as a change in accounting estimate. Restatement of previously issued financial statements is not permitted.

Accounting Standards Executive Committee Conforming Changes

.123 In March 1996, the Accounting Standards Executive Committee (AcSEC) of the AICPA updated its technical guidance to conform certain SOPs and Practice Bulletins with pronouncements issued recently by the FASB. AcSEC made conforming changes to the following SOPs and Practice Bulletins:

- SOP 75-2 and SOP 78-2, both entitled *Accounting Practices of Real Estate Investment Trusts*
- SOP 78-9, *Accounting for Investments in Real Estate Ventures*
- SOP 90-11, *Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*
- SOP 93-6, *Employers' Accounting for Employee Stock Ownership Plans*
- Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*, exhibit F, Accounting and Disclosure for Reinsurance Transactions
- Practice Bulletin 9, *Disclosures of Fronting Arrangements by Fronting Companies*

Auditors should be aware of these changes.

Information Sources

.124 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.

.125 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.

.126 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. In 1996 many organizations have established Web Sites on the World Wide Web.

.127 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.128 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.

* * * *

.129 This Audit Risk Alert replaces *Real Estate Industry Developments—1995/96.*

* * * *

.130 Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1996/97* [AAM section 8010] and *Compilation and Review Alert—1996/97* [AAM section 8015].

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.131 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.

.132

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. WebSite: http://www.aicpa.org	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		WebSite: http://www.fasb.org	*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) 942-8090	*Information Line* (202) 942-8088, ext. 4 (202) 942-7114 (tty)	WebSite: http://www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)

[*The next page is 8501.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

.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

Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

.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*

 Copyright © 1995, American Institute of Certified Public Accountants, Inc.

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.

* * * *

.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.

[*The next page is 8521.*]

AAM Section 8230
Retail Industry Developments—1996/97

Industry and Economic Developments

Industry Profile

.01 The retail industry is broadly defined as being comprised of those businesses engaged in the distribution of products and services directly to the consumer market. Retailing is one of the largest and most diversified of domestic industries, consisting of two million firms that generate more than $2 trillion in annual sales while employing over 18 million people. Individual retail establishments are generally classified by the following: (1) the type of merchandise carried, (2) the level of specialization, that is, the variety of merchandise offered, and (3) in-store versus nonstore sales format. The United States Department of Commerce classifies retailing activities into the following general categories:

- Food stores
- General merchandise
- Apparel and accessory stores
- Furniture, home furnishings, and equipment stores
- Equipment stores
- Automotive dealers
- Gasoline service stations
- Eating and drinking establishments
- Supply and mobile home dealers
- Drug and proprietary stores
- Miscellaneous retail stores
- Building materials, hardware, and garden

The ownership of a retail business can take a variety of forms including the independent or single-store retailer, chain stores, or franchises.

.02 *Independent Retailer.* By far the most common form of retail ownership is the small, owner-operated firm. Such entities comprise approximately 80 percent of all retail establishments, while accounting for more than 50 percent of all retail sales. This form of ownership is characterized by ease of entry, comparatively low initial capital outlays and few legal obstacles (such as the general absence of rigorous licensing requirements). These minimal barriers explain the prevalence of this form of ownership, as well as the industry's intense competition. A high rate of business failure is also a hallmark of the independent retail ownership form in that it tends to attract a disproportionate number of relatively unsophisticated entrepreneurs. Auditors should therefore be alert to the possibility that in these circumstances accounting records and internal control may be inadequate (this matter is discussed in greater detail in the "Audit Issues and Developments" section of this Audit Risk Alert under "Control Environment").

.03 *Chain Stores.* Chain stores are characterized by common ownership of multiple retail units and centralized management. Regional and national retail outlets typically adopt this form of organization.

.04 *Franchises.* Franchises involve a contractual relationship whereby, for an initial fee and, typically, a percentage of future gross sales, an individual entrepreneur (franchisee) is granted the right by a sponsoring organization (franchisor) to operate an established business. The rights and obligations of both parties to the arrangement are set forth in a legal document known as the franchise agreement. Auditors of entities adopting this form of ownership should become familiar with the franchise agreement so they can identify those matters that may have accounting or disclosure implications for the franchisee.

.05 For analytical purposes, retail establishments are often categorized on the basis of financial attributes such as gross margin and inventory turnover. For example, retail establishments with otherwise diverse activities such as supermarkets, pharmacies, discount stores, and building material outlets are sometimes grouped into a single category based on their tendency to generate low gross margins and high inventory turnover. Retail establishments such as jewelry stores, men's clothing stores, and furniture stores may also be viewed as a particular retail category in that they tend to generate, conversely, high gross margins and low inventory turnover. Comparing a retail client's results with overall performance in these categories can provide auditors with useful insight into the reasonableness of certain financial statement assertions. Auditors may therefore wish to consider the value of analytical tools such as a retailer's gross profit margin and inventory turnover ratio when addressing the guidance set forth under AICPA Statement on Auditing Standards (SAS) No. 56, *Analytical Procedures* (AU section 329). SAS No. 56 (AU section 329) requires the use of analytical procedures in the planning and overall review stages of all audits.

.06 Retail enterprises range in size and age from well established multinational corporations to small development-stage enterprises. See Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 7, *Accounting and Reporting by Development Stage Enterprises* (AC De4), for relevant accounting guidance. Development-stage enterprises present auditors with unique risks. In developing an audit strategy, assessing risk, and designing substantive procedures, auditors should consider characteristics of the entity such as the following:

- 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 Although retail sales are generally consummated through store operations, electronically conducted sales transactions are becoming more prevalent as the necessary technology becomes available to both retailers and consumers. The consensus among industry observers is that the allure of so-called on-line commerce will, in the foreseeable future, become overwhelming because, on the Internet, no store ever closes, and no location is isolated from the rest of the planet. Sales transactions consummated through electronic means, such as the Internet, will present unique challenges to the auditor, particularly in the areas of internal control and evidential matter. In recognition of this developing trend the Auditing Standards Board (ASB) has issued an exposure draft amending SAS No. 31, *Evidential Matter* (AU section 326). The amendment would provide guidance to auditors relating to electronic information and the testing of related controls. See "New Pronouncements" under the "Audit Issues and Developments" section of this Audit Risk Alert for further discussion.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

Economic Developments

.08 The Christmas shopping season, of crucial importance to retailers, netted dismal results for 1995, the worst holiday sales figures since 1990. As a result, annual retail sales for 1995 rose only 4.5 percent over the previous year, which is significantly lower than the 7 percent annual growth rate common during the benchmark 1980s. The poor holiday season showing led to reduced profits in early 1996 as retailers were forced to offer steep discounts to move unsold inventories. Although many larger retailers recovered from the holiday "fire-sales," smaller stores that were unable to match such price reductions have been driven out of business.

.09 The industry rebounded later in the first quarter of 1996 on the basis of a surge in consumer spending. A stronger than expected economy in the second quarter lifted retail sales through May, though they declined slightly in June. Despite these favorable results, industry analysts estimate that 1996 sales growth will be limited to a disappointing 4 percent to 5 percent annual increase (with the nation's major retailers expected to reap the largest gains). The low expectations for 1996 retail performance are primarily based on current economic and demographic conditions such as the following:

- Stagnant family incomes (as evidenced by government statistics showing that real average hourly wages grew by approximately one percent annually between 1990 and 1995)
- An aging population that is curtailing in spending
- A current downward trend in the consumer confidence index
- An all-time high nonmortgage debt-to-income ratio of 19 percent for consumers, along with sharply rising credit card delinquencies

.10 The modest level of expected growth is likely to be mitigated in many retail segments by the heavy discounting that has become common practice throughout much of the industry. This is expected to hold true even for industry segments such as consumer electronics, which performed well in 1995. Despite expectations of continued sales growth, market segments such as this one will be operating on extremely narrow gross margins largely due to intense competitive pressures. These retailers have attempted to offset the impact of discounting by offering customers separately priced extended warranty and product maintenance contracts. This strategy has been successful for some in recouping the profits lost through discounting. In these circumstances, auditors should become familiar with the terms of such agreements and consider whether management has applied the appropriate accounting treatment to these transactions. This topic is explored further in the "Accounting Issues and Developments" section of this Audit Risk Alert under "Product Warranties, Extended Warranties and Product Maintenance Contracts."

.11 High levels of promotional activity have accompanied the aforementioned product discount programs. Accordingly, auditors should consider whether their clients have properly addressed the accounting and disclosure issues relating to advertising expenses. The accounting treatment for advertising costs is addressed in the "Accounting Issues and Developments" section of this Audit Risk Alert under "Advertising Costs."

.12 On Wall Street, retail stocks mirrored the industry's poor performance in the early part of the year. Although the Standard and Poor's Composite Index of 500 Stocks Index rose nearly 38 percent in 1995, the retail stores index was up just 12 percent. Early in the year some investment advisors forecast that retail stocks, beaten down by liquidations and cost-conscious consumers, had nowhere to go but up. And indeed, retail stocks did rebound by midyear. However, the general consensus is that this recovery will be short-lived and that 1996 will be a disappointing year for retail stocks. Auditors may wish to consider the impact of stock performance on the control environment of publicly held retail clients. Management's philosophy and operating style may be adversely affected by pressure from stockholders stemming from poor stock performance. This situation could, for example, manifest itself in overly aggressive positions on accounting

issues adopted by management to more extreme instances of intentional material misstatement of the financial statements. The ASB has considered the issue of management fraud as detailed in its recently issued exposure draft of a proposed SAS, "Consideration of Fraud in a Financial Statement Audit." See the "Audit Issues and Developments" section of this Audit Risk Alert under "AICPA Exposure Drafts: Proposed SASs," for further information.

.13 During 1995, approximately 15,000 retail establishments sought protection from their creditors by filing for bankruptcy under Chapter 11. These filings, which include several prominent national and regional chains, represented a 20 percent increase over 1994 bankruptcy activity. The consensus of industry analysts is that the retail trade is currently "overstored," that is, there are too many stores chasing too few consumer dollars. Accordingly, future growth for retailers can only come from taking market share away from the competition. Such competitive pressures will continue to have an impact on bankruptcy filings. For example, established retailers will face increasing threats from nontraditional retailers. These include direct consumer sales being carried out by manufacturers and wholesalers, who sell their products directly to the consumer through outlets such as "superstores" or warehouse clubs. Based on these circumstances, retail economists are predicting an even greater increase in bankruptcies for 1996. In these 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). The "Audit Issues and Developments" section of this Audit Risk Alert includes further discussion of this matter.

.14 In addition to bankruptcies, cost cutting, restructurings, and downsizing undertaken by local, regional and national retailers have led to an increased number of store closings. During the first quarter of 1996, approximately 3,500 retail stores outlets closed down operations. In these circumstances, auditors should consider whether management has addressed relevant accounting guidance such as the FASB's Emerging Issues Task Force (EITF) Issue 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. 96-9, *Classification of Inventory Markdowns and Other Costs Associated with a Restructuring* (guidance provided by the Securities and Exchange Commission), and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC I08). Additionally, auditors should consider whether the store closing constitutes the disposal of a business segment. If it is determined that the store(s) is a component of the retail enterprise whose activities represent a separate major line of business or class of customer, auditors should consider whether management has properly applied the accounting treatment specified 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).

.15 The highly competitive environment has resulted in a "consolidation fever" spreading throughout retailing. According to industry analysts, it is becoming increasingly difficult for regional chains to succeed in metropolitan markets. Larger companies who benefit from economies of scale and enhanced purchasing power have targeted weaker retailers seeking bargain basement sales while weaker firms are seeking buyers to avoid bankruptcy. Industry analysts predict a developing trend whereby, through acquisition and consolidation, "the strong will get stronger" at the expense of weaker retailers. Auditors should consider whether management has appropriately accounted for an acquisition or consolidation in accordance with relevant accounting literature such as APB Opinion No. 16, *Business Combinations* (AC B50).

Audit Issues and Developments

Going-Concern Issues

.16 Economic and demographic factors coupled with the retail industry's intensely competitive environment contributed to record bankruptcies for 1995. This trend is expected to continue in 1996. Accordingly,

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

auditors should be alert to conditions and events which, when considered in the aggregate, indicate that there could be substantial doubt about a retailer's ability to continue as a going concern. For example, such conditions and events could include the following:

1. Negative trends such as recurring operating losses or working capital deficiencies
2. Financial difficulties such as working capital loan defaults or denial of trade credit from suppliers
3. Internal matters such as uneconomic long-term commitments
4. External matters such as legal proceedings that could jeopardize the entity's ability to operate

In such circumstances auditors may conclude that, based upon such conditions and events, there is substantial doubt about the retailer's ability to continue as a going concern.

.17 Accordingly, 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 generally accepted auditing standards 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.

.18 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 for a reasonable period of time not to exceed one year beyond the date of the financial statements being audited. However, the results of auditing procedures designed and performed to achieve other audit objectives may bring such contrary information to the auditor's attention.

.19 If, after considering the identified conditions and events in the aggregate, the auditor believes 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 need for disclosure of the principal conditions and events that initially caused the auditor to believe there was substantial doubt. 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).

.20 For those retailers emerging from bankruptcy reorganization pursuant to Chapter 11 of the Bankruptcy Code, the auditor should consider whether the retailer is following the accounting guidance of AICPA Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code.*

Merchandise Inventory

.21 Merchandise inventory is generally the most significant asset on the balance sheet of a retailing enterprise. Given the current industry and economic environment, auditors should be alert to the potential for a high level of audit risk associated with this area.

.22 Many retail businesses are now confronted with problems such as declining sales, narrow profit margins, and intense competition. These conditions may increase the likelihood that management will adopt

overly aggressive positions in accounting for particular inventory transactions. For example, the failure to adequately assess inventory obsolescence might be used as a means of overstating ending inventory in order to inflate solvency ratios. Accordingly, when auditing inventory in these circumstances, auditors should adopt an approach of heightened professional skepticism.

.23 Audit risk relating to merchandise inventory generally involves issues such as the following:

- *The proper cutoff of sales and purchase transactions.* Transactions occurring near year-end should be examined to ensure that they are recorded in the period in which the related revenue has been earned or the expense has been incurred. Procedures that may be performed by the auditor to assess the proper cutoff of sales and purchase transactions (see the completeness assertion in paragraph 3 of SAS No. 31 [AU section 326.03]) could include the observation of physical inventory counts, analytical procedures comparing the relationship of inventory balances to recent purchasing and sales activities, along with testing the client's cutoff procedures for shipping, receiving, sales, sales returns, purchases, and purchase returns.

- *Inventory valuation.* Current industry and economic conditions suggest increased significance in assessing the net realizable value of inventory; the proper application of inventory cost flow assumptions; and the consideration of obsolescence, shrinkage, and changes in demand on inventory valuation. Procedures that may be performed by the auditor to assess the valuation of the client's merchandise inventory (see the valuation assertion in paragraph 3 of SAS No. 31 [AU section 326.03]) might include examining paid vendors' invoices and current market value quotations, assessing inventory obsolescence by analyzing inventory turnover, comparisons with industry experience and trends, and for highly specialized merchandise (for example, jewels) the guidance set forth in SAS No. 73, *Using the Work of a Specialist* (AU section 336), should be considered.

- *Inventory ownership.* Failure to determine ownership can result in the overstatement of inventory through, for example, improper sales or purchase cutoff, incorrect assessment of when title passes in sales or purchase transactions (FOB shipping point or FOB destination). Procedures that may be performed by the auditor to assess whether the inventory balance shown on the client's balance sheet is actually owned by the client (see the rights and obligations assertion in paragraph 3 of SAS No. 31 [AU section 326.03]) might include observing physical inventory counts, obtaining confirmation of inventories at locations outside the entity, testing cutoff procedures relating to sales, sales returns, purchases, and purchase returns, as well as examining paid vendors' invoices, shipping terms, consignment agreements, and bill and hold arrangements.

- *The physical existence of merchandise inventory.* A key audit objective is to establish the existence of inventory. Procedures that may be performed by the auditor to make this assessment (see the existence assertion in paragraph 3 of SAS No. 31 [AU section 326.03]) might include observation of the client's physical inventory count, obtaining confirmation of inventories at locations outside the entity, along with the testing of inventory transactions between a preliminary physical inventory date and the balance sheet date.

Revenue and Purchasing Cycles

.24 *Accounts Receivable.* A retailer's accounts receivable may include, among other items, customer accounts, installment or layaway plans, as well as amounts due from third-party charge companies that are not included in cash. Some of the major issues facing the auditor in this area include the collectibility of the account balance, the validity of receivables, along with evaluating the client's procedures for safeguarding cash receipts, and the collections of accounts receivable.

.25 Given the current economic difficulties faced by many retailers, there is likely to be a high level of audit risk associated with credit sales. In order to address the problems of a diminishing customer base, the potential exists for management to relax restrictions on granting credit to the point where collectibility may

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

be called into question. Accordingly, auditors should consider the client's procedures for granting credit to new customers as well as authorizing credit for established customers. This should also factor into the auditor's evaluation of the adequacy of the allowance for doubtful accounts.

.26 In the current environment, auditors should be alert to the potential for the overstatement of assets, such as accounts receivable. Given the inordinately high rate of retail business failures, lenders, in an effort to protect their investments, may establish restrictive loan covenant provisions specifying minimum levels of liquidity to be maintained by the debtor. As such, auditors should be alert to the potential manipulation of solvency ratios through the overstatement of current assets such as accounts receivable.

.27 Procedures that may be performed by the auditor to assess the validity of accounts receivable include various analytical reviews and, principally, direct confirmation by the auditor with customers. In this regard, auditors may wish to refer to the AICPA publication, Auditing Procedure Study (APS), *Confirmation of Accounts Receivable* (Product Code No. 021064). This APS discusses the relationship of financial statement assertions to accounts receivable audit objectives and how those objectives may be achieved by using confirmations. The APS illustrates and discusses four different kinds of confirmation forms (positive, negative, blank, and expanded-field forms) and presents guidance on selecting an appropriate confirmation form for various client situations. Finally, the APS identifies practical suggestions for improving the quality and quantity of accounts receivable confirmation responses. The APS includes a copy of SAS No. 67, *The Confirmation Process* (AU section 330).

.28 *Sales.* Declining sales revenues in the current environment suggest an increased level of audit risk in this area. Auditors may wish to place special emphasis on evaluating the adequacy of client procedures relating to the proper cutoff of sales, returns and allowances, and shipping. Auditors may wish to pay particular attention to specialized credit transactions, large, end-of-year transactions including consignment and bill-and-hold arrangements. Management must be in a position to establish that the earnings process is complete before revenue related to these transactions can be recognized.

.29 Additionally, in connection with credit sales, auditors should assess management's consideration 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), which requires the disclosure of information about significant concentrations of credit risk.

.30 *Accounts Payable.* Retailers typically have a significant number of vendors to whom they are liable for merchandise and expense items. Accounts payable is generally the most significant current liability on the retailer's balance sheet. Given the current economic circumstances, auditors should be alert to the potential for the understatement of liabilities and the related expense. To accomplish specified audit objectives, auditors may wish to utilize procedures such as the following:

- Analytical procedures to test the reasonableness of payables
- Search for unrecorded liabilities
- Reviews of cutoff procedures relating to purchases and purchase returns
- Direct confirmation with vendors (in certain extreme circumstances)

Impairment of Long-Lived Assets

.31 In March 1995, the FASB issued Statement No. 121 (AC I08) which requires that long-lived assets and certain identifiable intangibles and goodwill related to those assets 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. 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 costs 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. The Statement (AC I08) is effective for financial statements for fiscal years beginning after December 15, 1995. Accordingly, this is the first year that auditors will evaluate management's implementation of the Statement (AC I08).

.32 In evaluating management's implementation of FASB Statement No. 121 (AC I08) issues to be considered by auditors include the following:

- *The appropriate classification of long-lived assets as either those being held and used or those to be disposed of.* Auditors should obtain an understanding of the policies and procedures used by management to classify long-lived assets pursuant to FASB Statement No. 121 (AC I08) as well as evaluating whether those classifications are proper.
- *The identification of events or circumstances indicating that the carrying amounts of assets to be held and used may not be recoverable.* Auditors should obtain an understanding of the policies and procedures used by management to identify such events and circumstances. Examples of such events and circumstances could include the following:
  - — A dramatic change in the manner in which an asset is used
  - — A reduction in the extent to which an asset is used
  - — Forecasts showing lack of long-term profitability
  - — A change in the law or business environment
  - — A substantial drop in the market value of an asset
- *The assumptions used in the underlying calculation of estimated future cash flows when testing for asset impairment used in management's impairment test, and assumptions used in estimating the fair value of assets for which an impairment loss is to be recognized.* Management's estimates of future cash flows from asset use and the fair value of assets used in calculating impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AU section 342). Procedures to be employed should include one or a combination of the following: (1) reviewing and testing the process used by management to develop the estimates, (2) developing an independent expectation to corroborate the reasonableness of the estimates, or (3) reviewing subsequent events or transactions occurring before the completion of fieldwork.
- *The recording of assets to be disposed of at the lower of carrying amount or fair value less cost to sell.* Auditors should verify that management has appropriately classified and valued long-lived assets to be disposed of.
- *The disclosure requirements of FASB Statement No. 121.* Auditors should verify that all disclosure requirements of FASB Statement No. 121 (AC I08) have been included in the client's financial statements.

Control Environment

.33 Minimal barriers to enter the retail trade guarantee that a sizable number of entities will be young, development-stage enterprises. Internal control in 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:

- Many retail entities 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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- Owners and managers of retail entities frequently are entrepreneurs who may be more likely to give priority to the business of selling over accounting systems and related control activities. As a result, internal control, accounting, and financial reporting functions may receive less support and attention than might be warranted.
- Owners and managers of small retail entities may not be as well versed in matters of accounting, finance, and administration.
- The limited resources of some start-up retail enterprises may engender informal accounting systems with inadequate internal control.

If internal control of a retail entity includes the preceding 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 as required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU section 319).[1] 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.

New Pronouncements

Auditing Standards

.34 *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 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.

.35 *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 does not provide the accountant with the representations required in paragraphs 6 and 7 of SAS No. 72 (AU section 634.06 and .07). The Statement is effective for letters issued pursuant to paragraph 9 of SAS No. 72 (AU section 634.09) after April 30, 1996.

.36 *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, 544, 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 is effective for engagements beginning after December 15, 1995.

.37 *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), pub-

[1] SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AU section 319), revises the definition and description of internal control and makes conforming changes to relevant terminology. SAS No. 78 (AU section 319) was issued in December 1995 and is effective for audits of financial statements for periods beginning on or after January 1, 1997. See the "New Pronouncements" section for further discussion of this matter.

lished by the Committee of Sponsoring Organizations of the Treadway Commission. 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.

.38 *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 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.

.39 A table outlining the significant provisions of the newly issued auditing standards is set forth in the "Exhibits" section of this Audit Risk Alert.

Attestation Standards

.40 *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 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.

.41 *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 provides guidance on the quantity, type, and content of working papers for attestation engagements and is effective for engagements beginning after December 15, 1995.

.42 *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 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 the discussion in the preceding section) and *Internal Control—Integrated Framework.* The amendment 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.

.43 *Quality Control Standards.* 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.

.44 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 201.01), and 202, *Compliance With Standards* (QC section 202.01), 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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

No. 1 (QC section 10) with the following five broad elements: (1) independence, integrity, and objectivity; (2) personnel management; (3) acceptance and continuance of clients and engagements; (4) engagement performance; and (5) 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.

Ethics Ruling—Indemnification of a Client

.45 Recently, the AICPA Professional Ethics Executive Committee issued Ethics Ruling No. 102, *Member's Indemnification of a Client* (ET section 191.204 and .205), as published in the January 1996 Journal of Accountancy. This ruling (ET section 191.204 and .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. In assessing their independence, auditors of retail enterprises should consider the implication of indemnification arrangements requested by their clients, in light of this new ethics ruling (ET section 191.204 and .205).

AICPA Exposure Drafts: Proposed SASs

.46 *Consideration of Fraud in a Financial Statement Audit.* In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Consideration of Fraud in a Financial Statement Audit and Amendments to Statements on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures, *and No. 47,* Audit Risk and Materiality in Conducting and Audit. The proposed Statement would provide expanded operational guidance on the consideration of fraud in conducting a financial statement audit. The proposed changes in auditing standards also clarify the auditor's present responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud. In addition, the proposed changes provide added guidance on the standard of due professional care in the performance of work, including the need to exercise professional skepticism, and the concept of reasonable assurance. In addition to amending SAS Nos. 1 (AU sections 110 and 230) and 47 (AU section 312), the proposed statement would—

- Describe fraud and its characteristics.
- Require the auditor to specifically assess the risk of material misstatement due to fraud and provide categories of fraud risk factors that should be considered in the auditor's assessment.
- Provide guidance on how the auditor should respond to the results of the assessment.
- Provide guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud.
- Describe related documentation requirements.
- Provide guidance regarding the auditor's communication about fraud to management, the audit committee, and others.

.47 *Amendment to SAS No. 31,* Evidential Matter. In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Amendment to SAS No. 31,* Evidential Matter. This proposed Statement would provide guidance for a practitioner who has been engaged to audit an entity's financial statements where significant information is transmitted, processed, maintained, or accessed electronically. The proposed Statement would include examples of evidential matter in electronic form and provide that an auditor should consider the time during which such evidential matter exists or is available in determining the nature, timing, and extent of substantive tests. In addition, the proposed Statement would indicate that an auditor may determine that, in certain engagement environments where evidential matter is in electronic form, it would not be practical or possible to reduce detection risk to an acceptable level by performing only substantive tests. The proposed Statement would provide that in such circumstances, an auditor should consider performing tests of controls to support an assessed level of control risk below the maximum for affected assertions.

.48 *Investments in Debt and Equity.* In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Investments in Debt and Equity.* This proposed Statement would revise the guidance on auditing investments to make that guidance consistent with recently issued accounting standards, particularly FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (AC I80).

Accounting Issues and Developments

Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities

.49 In June 1996, the FASB issued FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities.* This Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishment of liabilities. Those standards are based on consistent application of a financial-components approach that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. This Statement provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

.50 A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interest in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

1. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

2. Either (*a*) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right—to pledge or exchange the transferred assets or (*b*) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.

3. The transferor does not maintain effective control over the transferred assets through (*a*) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (*b*) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

.51 FASB Statement No. 125 requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interest in transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

.52 FASB Statement No. 125 requires that servicing assets and liabilities be subsequently measured by (*a*) amortization in proportion to and over the period of estimated net servicing income or loss and (*b*) assessment for asset impairment or increased obligation based on their fair values.

.53 FASB Statement No. 125 requires that debtors reclassify financial assets pledged as collateral and that secured parties recognize those assets and their obligation to return them in certain circumstances in which the secured party has taken control of those assets.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.54 FASB Statement No. 125 requires that a liability be derecognized if and only if either (*a*) the debtor pays the creditor and is relieved of its obligation for the liability or (*b*) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

.55 FASB Statement No. 125 provides implementation guidance for assessing isolation of transferred assets and for accounting for transfers of partial interest, servicing of financial assets, securitizations, transfers of sales-type and direct financial lease receivables, securities lending transactions, repurchase agreements including "dollars rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishment of liabilities.

.56 FASB Statement No. 125 supersedes FASB Statements No. 76, *Extinguishment of Debt*, and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse.* This Statement amends FASB Statement No. 115 (AC I80) to clarify that a debt security may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. This Statement amends and extends to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (AC Mo4), and supersedes FASB Statement No. 122, *Accounting for Mortgage Servicing Rights.* This Statement also supersedes Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt*, No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*, and No. 87-3, *Accounting for Mortgage Servicing Fees and Rights.*

.57 FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishment of liabilities occurring after December 31, 1996, and is to be applied prospectively. Earlier or retroactive application is not permitted.

Revenue Recognition When Right of Return Exists

.58 In the normal course of business, many retail entities offer their customers the option to return purchased merchandise. This policy may be a matter of contract or simply a matter of existing practice. Typically, the product may be returned for a refund of the purchase price, for a credit applied to amounts owed or to be owed for other purchases, or in exchange for other products. FASB Statement No. 48, *Revenue Recognition When Right of Return Exists* (AC R75), specifies how an enterprise should account for sales of its product in which the buyer has a right to return the product. FASB Statement No. 48 (AC R75) provides that revenue from such sales transactions shall be recognized at the time of sale only if all of the following conditions are met:

1. The seller's price to the buyer is substantially fixed or determinable at the date of sale.
2. The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product.
3. The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
4. The buyer acquiring the product for resale has economic substance apart from that provided by the seller.[2]
5. The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.
6. The amount of future returns[3] can be reasonably estimated.

---

[2] This condition relates primarily to buyers that exist "on paper," that is, buyers that have little or no physical facilities or employees. It prevents enterprises from recognizing sales revenue on transactions with parties that the sellers have established primarily for the purpose of recognizing such sales revenue.

[3] Exchanges by ultimate customers of one item for another of the same kind, quality, and price (for example, one color or size for another) are not considered returns for the purposes of FASB Statement No. 48 (AC R75).

If these conditions are not met, revenue recognition is postponed; if they are met, sales revenue and cost of sales reported in the income statement must be reduced to reflect estimated returns, and expected costs or losses must be accrued.

.59 The ability to make a reasonable estimate of the amount of future returns as specified in item 6 above depends on many factors and circumstances that vary from one case to the next. FASB Statement No. 48 (AC R75) outlines examples of factors that may impair the ability to make a reasonable estimate, such as the following:

- Technological obsolescence or changes in demand
- Relatively long periods in which a product may be returned
- The absence of historical experience with similar type of sales of similar products
- The absence of a large volume of relatively homogeneous transactions

.60 In circumstances where the right of return exists, the auditor should assess the client's application of FASB Statement No. 48 (AC R75) by referring to the full text of the Statement.

.61 For publicly held companies, the activity in the allowance for sales returns and allowances should be disclosed consistent with the requirements of Article 5.04 (c), Schedule II of Regulation S-X.

Product Warranties, Extended Warranties, and Product Maintenance Contracts

.62 Typically, sales to retail consumers are typically made subject to a product warranty. Such an arrangement will generally provide for repair services or replacement parts during a specified warranty period. The warranty represents an obligation incurred by the retailer in connection with the sale of products or services that may require further performance by the seller after the sale has taken place. Because of the uncertainty surrounding claims that may be made under warranties, warranty obligations fall within the definition of a contingency as set forth under FASB Statement No. 5, *Accounting for Contingencies* (AC C59). FASB Statement No. 5 (AC C59) provides that losses from warranty obligations shall be accrued when both of the following conditions are met:

1. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.
2. The amount of loss can be reasonably estimated.

The loss accrued is commonly based on previous experience with regard to the same product line, or absent that, related products or the experience of other enterprises in the same business may be appropriate. If there is no basis to calculate a reasonable estimate of the loss accrual, the possibility of material future warranty costs may suggest that a sale should not be recorded before the expiration of the warranty period or until sufficient experience allows for the calculation of a reasonable estimate. If no accrual is made, the nature of the contingency and the range of potential loss or the fact that such an estimate cannot be made should be disclosed in the financial statements. In accordance with FASB Statement No. 5 (AC C59), if no accrual is made for warranty costs because one or both of the conditions for accrual are not met, or if an exposure to loss exists in excess of the amount accrued, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

.63 Auditors may wish to read relevant sales agreements and examine historical trends to determine the existence of warranty obligations along with the nature and extent of any warranty liability. Where applicable, the auditor should assess the valuation of the estimated liability recorded by the client.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.64 It is common practice for many retail establishments, particularly those selling consumer electronics, household appliances, and automobiles, to offer extended warranty and product maintenance contracts to provide warranty protection or product services not included in the product sales price. The losses incurred due to heavy discounting are often recouped through the sale of either or both the separately priced warranty and maintenance contracts.

.65 An extended warranty is an agreement to provide warranty protection in addition to the scope of coverage of the manufacturer's original warranty, if any, or to extend the period of coverage provided by the manufacturer's original warranty. A product maintenance contract is an agreement to perform certain agreed-upon services to maintain a product for a specified period of time. A contract is separately priced if the customer has the option of purchasing the services provided under the contract for an expressly stated amount separate from the price of the product.

.66 FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts* (AC R75), addresses how revenue and costs from a separately priced extended warranty or product maintenance contract be recognized. The bulletin (AC R75) provides the following:

1. Revenue from separately priced extended warranty and product maintenance contracts should be deferred and recognized in income on a straight-line basis over the contract period except in those circumstances in which sufficient historical evidence indicates that the costs of performing services under the contract are incurred on other than a straight-line basis. In those circumstances, revenue should be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract.
2. Costs that are directly related to the acquisition of a contract and that would have not been incurred but for the acquisition of that contract (incremental direct acquisition costs) should be deferred and charged to expense in proportion to the revenue recognized. All other costs, such as costs of services performed under the contract, general and administrative expenses, advertising expenses, and costs associated with the negotiation of a contract that is not consummated, should be charged to expense as incurred.
3. A loss should be recognized on extended warranty or product maintenance contracts if the sum of expected costs of providing services under the contracts and unamortized acquisition costs exceeds related unearned revenue. Extended warranty or product maintenance contracts should be grouped in a consistent manner to determine if a loss exists. A loss should be recognized first by charging any unamortized acquisition costs to expense. If the loss is greater than the unamortized acquisition costs, a liability should be recognized for the excess.

Advertising Costs

.67 An increased level of product promotion occurred during 1995. Industry analysts expect that level to increase during 1996 as retailers advertise in an attempt to develop a competitive edge. Additionally, many retail chains, unable to sustain heavy discounting, have been forced to abandon the "every day low pricing" strategy. In turn, they have increasingly begun to rely on advertising to promote special sales.

.68 SOP 93-7, *Reporting on Advertising Costs*, defines advertising as a customer acquisition activity involving the promotion of an industry, an entity, a brand, a product name, or specific products or services so as to create or stimulate a positive entity image, or to create or stimulate a desire to buy the entity's products or services. SOP 93-7 provides guidance on accounting for advertising costs in annual financial statements for the following:

1. Reporting the costs of advertising, which should be expensed either as incurred or the first time the advertising takes place, except for direct-response advertising:
   a. The primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and

b. that results in probable future economic benefits.

2. For direct-response advertising that may result in reported assets (that is, capitalized pursuant to the criteria set forth in items *a.* and *b.* above) as follows:
   a. How such assets should be measured initially
   b. How the amounts ascribed to such assets should be amortized
   c. How the realizability of such assets should be assessed

Additionally, SOP 93-7 requires that the notes to the financial statements should disclose the following:

1. The accounting policy for reporting advertising, indicating whether such costs are expensed as incurred or the first time the advertising takes place
2. A description of the direct-response advertising reported as assets (if any), the accounting policy for it, and the amortization period
3. The total amount charged to advertising expense for each income statement presented, with separate disclosure of amounts, if any, representing a write down to net realizable value
4. The total amount of advertising reported as assets in each balance sheet presented

.69 The following is an example of the disclosures required by the SOP:

Note X. Advertising

The Company expenses the production costs of advertising the first time the advertising takes place, except for direct-response advertising, which is capitalized and amortized over its expected period of future benefits.

Direct-response advertising consists primarily of magazine advertisements that include order coupons for the Company's products. The capitalized costs of the advertising are amortized over the three-month period following the publication of the magazine in which it appears.

At December 31, 19XX, $1,000,000 of advertising was reported as assets. Advertising expense was $10,000,000 in 19XX, including $500,000 for amounts written down to net realizable value.

Preopening Expenses

.70 Selling space expansion grew at an annual rate of approximately 5 percent in 1995 and is expected to grow at the same rate during the current year. The construction of new retail facilities includes supercenters and huge specialty outlets such as home improvement and consumer electronics stores. Costs related to the planning and preparation for the opening of new retail store locations such as these are generally considered to be period costs and industry practice has been to expense these costs as they are incurred. However, costs that are directly related to a store opening and that are expected to benefit future periods may be deferred and amortized if there is objective evidence that probable future net operating results will be sufficient to recover such costs. The deferral of costs would be discontinued upon the store's opening. In practice, the amortization period for preopening expenses rarely extends beyond one year.

Delayed Effective Dates—Accounting Pronouncements

.71 *Disclosures about Fair Value of Financial Instruments.* FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (AC F25), issued in December 1991, was effective for financial statements issued for fiscal years ending after December 15, 1992. However, for entities with less than $150 million in total

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995. In that a sizable portion of retail entities may be smaller, development state enterprises, financial statements for years ended during 1996 will be subject to the provisions contained therein. In such circumstances, auditors should consider whether management has made all disclosures required by FASB Statement No. 107 (AC F25).

.72 FASB Statement No. 107 (AC F25) requires disclosure of the fair 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 requires disclosure of descriptive information pertinent to estimating the value of a financial instrument. Certain financial instruments (for example, lease contract, deferred-compensation arrangements, and insurance contracts) are excluded from the scope of the Statement (AC F25).

.73 *Disclosures about Derivative Financial Instruments.* FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), issued in October 1994, was effective for financial statements issued for fiscal years ending after December 15, 1994. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995.

.74 FASB Statement No. 119 (AC F25) requires disclosures about derivative financial instruments such as futures; forward, swap, and option contracts; and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statement No. 105 (AC F25) to require disaggregation of information about financial instruments with off-balance-sheet risk of accounting loss by class, business activity, risk, or other category that is consistent with the entity's management of those instruments. The Statement (AC F25) also amends FASB Statement No. 107 (AC F25) to require that fair value information be presented without combining, aggregating, or netting the fair value of derivative financial instruments with the fair value of nonderivative financial instruments and be presented together with the related carrying amounts in the body of the financial statements, a single footnote, or a summary table in a form that makes it clear whether the amounts represent assets or liabilities.

.75 Auditors should consider whether the provisions of FASB Statement No.119 (AC F25) apply to their retail clients, and if so, evaluate whether the client's financial statement disclosures are adequate and appropriate in view of the requirements set forth therein.

.76

Exhibit

Significant Provisions of Newly Issued SASs

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, 544, 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]).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

Information Sources

.77 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.

.78 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.

.79 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.

.80 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.81 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.

* * * *

.82 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1996/97* [AAM section 8010] and *Compilation and Review Alert—1996/97* [AAM section 8015].

.83 **Information Sources**

Organization	General Information	Fax/Phone 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. 1) 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) 942-4040 *SEC Public Reference Room* (202) 942-8090	*Information Line* (202) 942-8088 (ext. 3)	SEC's Homepage www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)
U.S. Department of Commerce	Herbert C. Hoover Building 14th Street between Pennsylvania and Constitution Avenues Washington, DC 20230	*General Information* (202) 482-2000 Bureau of Economic Analysis 1441 L Street, Washington, DC 20230 (202) 606-9600		
National Association of Retail Dealers of America	10 E. 22nd Street Lombard, Il 60148	*General Information* (708) 953-8950		
National Retail Federation	325 7th St. NW, Ste. 1000 Washington, DC 20004-2802	*General Information* (202) 783-7971		
International Mass Retail Association, Inc.	1700 North Moore Street, Ste. 2250 Arlington, VA 22209	*General Information* (703) 841-2300 *Fax* (703) 841-1184		

[*The next page is 9001.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

TABLE OF CONTENTS

Section		*Paragraph*
9100	Supervision and Review Procedures	.01-.15
	Introduction	.01-.02
	Authoritative Literature	.03-.07
	Phases of Supervision and Review	.08
	Review Organization	.09-.10
	Firm Policy and Procedures Regarding Supervision and Review	.11-.12
	Review of Workpapers	.13
	Supervisory Review	.14
	Purpose of Form	.15
9200	In-Charge's Engagement Review Program	.010-.150
	I. General Procedures	.010
	A. General	.010
	II. Working Paper Areas	.020-.150
	A. Cash	.020
	B. Receivables	.030
	C. Inventories	.040
	D. Investments	.050
	E. Prepaid Expenses, Intangible Assets, Deferred Charges, Etc.	.060
	F. Property, Plant, and Equipment	.070
	G. Current Liabilities	.080
	H. Long-Term Debt	.090
	I. Deferred Credits	.100
	J. Income Taxes	.110
	K. Commitments and Contingencies	.120

Section		*Paragraph*
9200	In-Charge's Engagement Review Program—continued	
	L. Capital Accounts	.130
	M. Income and Expenses	.140
	N. Other	.150
9210	Partner's Engagement Review Program	.01
9220	Partner's Engagement Review Program Supplement for Not-for-Profit Organizations	.010-.130
	I. General Audit Procedures	.010
	A. General	.010
	II. Working Paper Areas	.020-.120
	A. Cash	.020
	B. Receivables	.030
	C. Investments	.040
	D. Collections of Works of Art and Similar Items	.050
	E. Property, Plant, and Equipment	.060
	F. Liabilities	.070
	G. Deferred Revenue	.080
	H. Commitments and Contingencies	.090
	I. Fund Balance	.100
	J. Revenues, Expenses, Support, and Capital Additions	.110
	K. Other	.120
	III. Audits of Governmental Grantees	.130
	A. General	.130
9230	Partner's Engagement Review Program Supplement for Banks	.010-.090
	I. General Procedures	.010
	A. General	.010
	II. Working Papers	.020-.090
	A. General	.020
	B. Cash	.030
	C. Investment and Trading Securities	.040
	D. Federal Funds and Repurchase/Reverse Repurchase Agreements	.050
	E. Loans	.060
	F. Deposits	.070
	G. Director's Examinations	.080
	H. Trust Operations	.090
9500	Report Processing	.01-.21
	Drafting the Report	.01-.04
	Uniformity	.03
	Draft of Report	.04
	Report Production	.05-.13
	Report Guide Sheet	.12
	Report Production Control	.13
	Signing Reports	.14-.17
	Delivery of Completed Work	.18-.21

[*The next page is 9101.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

[*The next page is 9201.*]

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?	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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?	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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

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?	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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)?	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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.	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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			
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			
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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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?	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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

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?	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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?	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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?	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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

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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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										
		FYE	Report letter	Due	Review		Rework		Rework review		Type & proof	Final read	Multilith	Hold	Final release
					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.*

TABLE OF CONTENTS

Section		*Paragraph*
10,100	Format of Accountants' Reports	.01-.37
	Report Preparation	.01
	Reports on Audited Financial Statements	.02
	Standard Report	.03
	Modifications of the Standard Auditor's Report	.04
	Scope Limitations	.05
	Departures From GAAP	.06-.09
	Errors, Irregularities, and Illegal Acts	.10-.11
	Consistency Exceptions	.12-.14
	Uncertainties	.15-.22
	Reporting on Supplementary Information	.23-.24
	Reporting on a Single Statement	.25
	Relying on the Work of a Specialist	.26-.27
	Lack of Independence	.28
	Reissuance of Audit Reports as Predecessors	.29-.31
	Reissuance of the Audit Report Subsequent to the Date of Original Issue	.32-.33
	Subsequent Discovery of Facts Existing at Report Date	.34-.37
10,210	Unqualified Opinions	.010-.220
	Auditor's Standard Report—Comparative Financial Statements	.010
	Auditor's Standard Report—Single Year Financial Statements	.020
	Report on a Single Statement Audit (Balance Sheet Only Presented)	.030
	Reference to Other Auditors—Successor Auditor's Report When Predecessor's Report (Unqualified) Is Not Presented	.040
	Reference to Other Auditors in Report	.050
	Reference to Other Auditors—Successor Auditor's Unqualified Report When Predecessor's Report That Included an Explanatory Paragraph Is Not Presented	.060

Section		*Paragraph*
10,210	Unqualified Opinions—continued	
	Reference to Other Auditors—Successor Auditor's Report When Prior Year Financial Statements Have Been Restated Following Issuance of the Predecessor's Report	.070
	Reference to Other Auditors—Prior Year Financial Statements Restated Following a Pooling of Interests	.080
	Reference to Other Auditors—Successor Auditor Report When Prior Period Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations	.083
	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	.084
	Reference to Other Accountants—Report on Nonpublic Entity Presented With Prior Period Financial Statements Reviewed by a Predecessor Accountant Who Has Ceased Operations	.085
	Reference to Other Accountants—Report on Nonpublic Entity Presented With Prior Period Financial Statements Compiled by a Predecessor Accountant Who Has Ceased Operations	.086
	Change in Accounting Principles or Method of Accounting	.090
	Going Concern—Uncertainty	.100
	Liquidation Basis of Accounting—Single Year Financial Statements	.110
	Liquidation Basis of Accounting—Comparative Financial Statements	.120
	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	.130
	Comparative Financial Statements—Subsequent Restatement of Prior-Period Financial Statements to Conform With Generally Accepted Accounting Principles	.140
	Comparative Financial Statements—Current Year's Statements Audited and Prior Year's Statements Reviewed	.150
	Comparative Financial Statements—Current Year's Statements Audited and Prior Year's Statements Compiled	.160
	Comparative Financial Statements—Current Year's Statements Audited and Disclaimer on Prior Year's Unaudited Statements	.170
	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	.180
	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	.190
	Correction of an Error, Not Involving an Accounting Principle	.200
	Subsequent Event Prior to Issuance of Auditor's Report	.210
	Reissued Report Due to Subsequent Discovery of Facts Existing at the Date of Auditor's Report	.220
10,220	Adverse Opinions	.01
	Departures from GAAP	.01
10,230	Disclaimers of Opinion	.01-.03
	Beginning Inventory Not Observed (First Examination)	.01
	Inability to Obtain Sufficient Competent Evidential Matter Due to a Scope Limitation	.02
	Scope Limitation—Inventory and GAAP Departure—Capitalized Lease Obligations	.03

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

Section		Paragraph
10,240	Qualified Opinions	.010-.080
	Scope Limitation—Investment in Foreign Affiliate (Assuming Effects Are Such That Qualification Rather Than Disclaimer is Appropriate)	.010
	Departure from GAAP—Leases Not Capitalized	.020
	Departure from GAAP—Leases Not Capitalized—Pertinent Facts Disclosed in Note	.030
	Inadequate Disclosure—Omission of Disclosures	.040
	Inadequate Disclosure—Omission of Statement of Cash Flows	.050
	Change in Accounting Principle Without Reasonable Justification	.060
	Change in Accounting Principle Not in Conformity with Generally Accepted Accounting Principles	.070
	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	.080
10,245	Information Accompanying Audited Financial Statements	.010-.110
	Omission of Supplementary Information Required by the FASB	.010
	Omission of Supplementary Information Required by the GASB	.015
	Material Departures From FASB Guidelines on Supplementary Information	.020
	Material Departures From GASB Guidelines on Supplementary Information	.025
	Prescribed Procedures Not Completed Regarding Supplementary Information Required by the FASB	.030
	Prescribed Procedures Not Completed Regarding Supplementary Information Required by the GASB	.035
	Unresolved Doubts About Adherence to Guidelines Regarding Supplementary Information Required by FASB	.040
	Unresolved Doubts About Adherence to Guidelines Regarding Supplementary Information Required by GASB	.045
	Report on Accompanying Information	.050
	Disclaimer on Accompanying Information (Not Audited)	.060
	Disclaimer on Part of the Accompanying Information (Not Audited)	.070
	Qualification on Basic Financial Statements and Accompanying Information (Departure From GAAP)	.080
	Supplementary Information Required by the FASB Included in Auditor-Submitted Document	.090
	Supplementary Information Required by the GASB Included in Auditor-Submitted Documents	.095
	Consolidating Information Not Separately Audited	.100
	Unqualified Opinion on Selected Financial Data in a Client-Prepared Document That Includes Audited Financial Statements	.110
10,250	Engagements to Report on Internal Control	.010-.170
	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	.010
	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	.020
	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	.030

Section *Paragraph*

10,250 Engagements to Report on Internal Control—continued
Adverse Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control 040
Qualified Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control Due to a Scope Limitation 050
Disclaimer of Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control Due to a Scope Limitation 060
Unqualified Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control Based in Part on the Report of Another Practitioner 070
Unqualified Opinion on Management's Assertion About the Effectiveness of a Segment of the Entity's Internal Control 080
Unqualified Opinion on Management's Assertion About the Suitability of Design of the Entity's Internal Control 090
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 100
Communication of Internal Control Structure Matters Noted in an Audit 110
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 120
Report on Policies and Procedures Placed in Operation at a Service Organization 130
Report on Policies and Procedures Placed in Operation at a Service Organization and Tests of Operating Effectiveness 140
Reports on Internal Control Required by SEC Rule 17a-5 150
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 160
Independent Auditor's Report on Internal Control Structure Required by Regulation 1.16 of the Commodity Futures Trading Commission 170

10,260 Special Reports 010-.140
Cash Basis Statements 010
Income Tax Basis Statements 020
Regulatory (Statutory) Basis Statements 030
Report Relating to Amount of Sales for the Purpose of Computing Rental 040
Royalties 050
Profit Participation 060
Report on Federal and State Income Taxes in Financial Statements 070
Proposed Acquisition 080
Claims of Creditors 090
Compliance With Contractual Provisions (Separate Report) 100
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 110
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 . . .120
Report on a Statement of Assets Sold and Liabilities Transferred to Comply With a Contractual Agreement 121
Report on the Application of Accounting Principles 130
Report on Financial Statements Presented in Conformity With a Prescribed Basis of Accounting (Property and Liability Insurance Company) 140

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

Section		*Paragraph*
10,270	Unaudited Financial Statements of a Public Entity	.01-.04
	Disclaimer	.01
	Current Period Financial Statements Unaudited—Prior Period Financial Statements Audited	.02
	Disclaimer—Cash Basis Statements	.03
	Disclaimer—Regulatory (Statutory) Basis Statements	.04
10,280	Lack of Independence	.01
	Disclaimer	.01
10,300	Review of Interim Financial Information	.01
	Independent Accountant's Report	.01
10,400	Accountants' Reports on Condensed Financial Statements and Selected Financial Data	.01-.03
	Unqualified Opinion on Condensed Financial Statements	.01
	Adverse Opinion on Condensed Financial Statements Due to Inadequate Disclosure	.02
	Review Report on Condensed Financial Statements	.03
10,500	Reports on Personal Financial Statements	.01-.17
	Auditor's Standard Report	.01
	Audit Report—Statement of Financial Condition Only	.02
	Audit Report—Departure From GAAP—Inappropriate Valuation Methods—Adverse Opinion	.03
	Audit Report—Departure From GAAP—Inappropriate Valuation Methods—Qualified Opinion	.04
	Audit Report—Disclaim Opinion Because of Scope Limitation—Inadequate Records	.05
	Audit Report—Scope Limitation—Inadequate Records	.06
	Audit Report—Income Tax Basis	.07
	Accountants' Standard Compilation Report	.08
	Compilation Report—Statement of Financial Condition Only	.09
	Compilation Report—Omission of Substantially All Disclosures	.10
	Compilation Report—GAAP Departure—Material Assets at Cost	.11
	Compilation Report—Income Tax Basis	.12
	Compilation Report—Financial Statements Included in a Prescribed Form	.13
	Accountant's Standard Review Report	.14
	Review Report—Statement of Financial Condition Only	.15
	Review Report—GAAP Departure—Failure to Include a Provision for Estimated Income Taxes on the Differences Between the Estimated Current Value of Assets and the Estimated Current Amounts of Liabilities and Their Tax Bases	.16
	Review Report—Historical Cost Basis	.17
10,600	Reports on Employee Benefit Plans	.01-.22
	Unqualified Opinion—Defined Benefit Plan Assuming End-of-Year Benefit Information Date	.01
	Unqualified Opinion—Defined Benefit Plan Assuming Beginning-of-Year Benefit Information Date	.02
	Unqualified Opinion—Defined Contribution Profit-Sharing Plan	.03
	Unqualified Opinion—Employee Health and Welfare Benefit Plan	.04
	Unqualified Opinion—Employee Health and Welfare Benefit Plans	.05
	Unqualified Opinion—Supplemental Schedules Required by ERISA and DOL Regulations	.06

Section *Paragraph*

10,600 Reports on Employee Benefit Plans—continued
Unqualified Opinion—Defined Benefit Pension Plan Prepared on the Modified Cash Basis 07
Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations 08
Qualified Opinion—Omitted or Incomplete Schedule or Material Inconsistency 09
Qualified Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted 10
Adverse Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted 11
Modified Report—Disclosure of Immaterial Prohibited Transaction With Party in Interest Omitted 12
Qualified Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted—Related-Party Transaction 13
Limited-Scope Audits Under DOL Regulations 14
Limited-Scope Audit in Prior Year 15
Limited-Scope Audit in Current Year 16
Multiemployer Pension Plan Assuming Limited-Scope Audit 17
Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations in a Limited Scope Engagement 18
Trust Established Under an Employee Benefit Plan 19
Defined Benefit Plan Assuming Inadequate Procedures to Value Investments 20
Defined Benefit Plan Assuming Nonreadily Marketable Investments 21
Savings Plan Containing Separate Investment Fund Option Information 22

10,650 Reports on Financial Statements of Brokers and Dealers in Securities 01-.03
Unqualified Opinion on Financial Statements and Supplementary Schedules Required by the SEC 01
Qualified Opinion—Departure From GAAP 02
Separate Report on Supplementary Schedules 03

10,700 Reports for Investment Companies 01-.05
Unqualified Opinion on the Financial Statements 01
Unqualified Opinion on the Financial Statements for a Multicolumnar Presentation of the Portfolios Constituting the Series 02
Unqualified Opinion on the Financial Statements Presenting One of the Portfolios or Entities Constituting the Series 03
Unqualified Opinion on the Financial Statements With an Explanatory Paragraph Due to Absence of Ascertainable Market Values (Documentation Supports Valuation) 04
Qualified Opinion on the Financial Statements Due to Absence of Ascertainable Market Values (Documentation Does Not Support Valuation) 05

[*The next page is 10,101.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

- *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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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:

[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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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]

Independent Auditor's Report

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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.070 Reference to Other Auditors—Successor Auditor's Report When Prior Year Financial Statements Have Been Restated Following Issuance of the Predecessor's Report

Independent Auditor's Report

Addressee:

We have audited the balance sheet of ABC Company as of December 31, 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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.150 Comparative Financial Statements—Current Year's Statements Audited and Prior Year's Statements Reviewed

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 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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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]).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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)

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.*

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).]

* 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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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 investment 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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.)

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.)

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.)

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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."

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

---

[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).]

---

[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)."

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

[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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

[1] For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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."

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

---

[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.

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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]

---

* 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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

---

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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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]

---

[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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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)

Independent Auditor's Report

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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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].).

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.05 Unqualified Opinion—Employee Health and Welfare Benefit Plans*

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits and of plan benefit obligations of Allied Industries Benefit Plan as of December 31, 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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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

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.

TABLE OF CONTENTS

Section	*Paragraph*
11,100 Quality Control—General	.01-.06
AICPA Requirements	.01-.06
11,200 Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice	.01-.193
Chapter 1—Overview of Statements on Quality Control Standards	.01-.17
Independence, Integrity, and Objectivity	.07-.08
Personnel Management	.09-.10
Acceptance and Continuance of Clients and Engagements	.11-.12
Engagement Performance	.13-.14
Monitoring	.15-.16
Illustrative Examples	.17
Chapter 2—National CPA Firm's System of Quality Control for its Accounting and Auditing Practice	.18-.62
Independence, Integrity, and Objectivity	.19-.26
Personnel Management	.27-.36
Acceptance and Continuance of Clients and Engagements	.37-.44
Engagement Performance	.45-.52
Monitoring	.53-.62
Chapter 3—Regional Accountants' System of Quality Control for its Accounting and Auditing Practice	.63-.107
Independence, Integrity, and Objectivity	.64-.71
Personnel Management	.72-.81
Acceptance and Continuance of Clients and Engagements	.82-.89
Engagement Performance	.90-.97
Monitoring	.98-.107
Chapter 4—AnyCity CPAs' System of Quality Control for its Accounting and Auditing Practice	.108-.155
Independence, Integrity, and Objectivity	.109-.116
Personnel Management	.117-.126
Acceptance and Continuance of Clients and Engagements	.127-.134
Engagement Performance	.135-.142
Monitoring	.143-.155

Section *Paragraph*

11,200 Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice—continued
Chapter 5—Jane Brown, CPA's System of Quality Control for Her Accounting Practice 156-.192
Independence, Integrity, and Objectivity 157-.160
Personnel Management 161-.166
Acceptance and Continuance of Clients and Engagements 167-.174
Engagement Performance 175-.182
Monitoring 183-.192
Glossary of Selected Terms 193

11,300 Sample Quality Control Forms 01-.19
Independence Checklist for Employees 01
Independence and Representation Checklist for Other Auditors 02
Scheduling Request 03
History of Staff Assignments 04
Client History of Personnel Assigned 05
Scheduling Master Plan 06
Consultation Log 07
Consultation Worksheet 08
Pre-Employment Application 09
Interview Report 10
Record of Professional Development 11
Professional Development Summary
In Hours 12
In Dollars 13
Performance Evaluation 14
Job Evaluation Report 15
Knowledge and Skill Form 16
Employee Annual Performance Appraisal 17
New Client Acceptance Checklist 18
Summary Monitoring/Inspection Report 19

[*The next page is 11,101.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

AAM Section 11,100
Quality Control—General

This section of the Audit and Accounting Manual has been redesigned in response to the new quality control standards issued by the AICPA.

AICPA Requirements

.01 Article VI—*Scope and Nature of Services*—of the AICPA's *Principles of Professional Conduct* (ET section 57), requires that "members should practice in firms that have in place internal quality-control procedures to ensure that services are competently delivered and adequately supervised." Because of the public interest in the services provided by and the reliance placed on the objectivity and integrity of CPA's, a CPA firm should have a system of quality control for its practice.

.02 The AICPA has issued two new statements on quality control standards, which are effective January 1, 1997, to give firms improved guidance for establishing and maintaining a quality control system for their accounting and auditing practices. The two statements are: 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*, issued in 1979.

.03 SQCS No. 2 (QC section 20) redefines a firm's accounting and auditing practice to include all audit, attest, accounting and review, and other services for which professional standards have been established by the AICPA under rules 201 (ET section 201.01) and 202 (ET section 202.01) of the AICPA Code of Professional Conduct. SQCS No. 2 (QC section 20) replaces the nine specific quality control elements in SQCS No. 1 with five broad elements.

.04 Presented in AAM section 11,200 is a *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice.* Following the guide are sample quality control forms to aid practitioners in implementing a quality control system.

.05 Certain questions arise about the new standards and their practice-monitoring implications. They include:

- How will the new standards be considered during a peer review year when they may be applicable to only part of the year?
- Will all elements of quality control be subject to peer review?
- What level of compliance will be acceptable under the practice-monitoring programs?

These questions are being addressed by the applicable practice-monitoring committees. Those committees and the AICPA staff will be revising applicable materials, including the peer review checklists, to reflect SQCS Nos. 2 (QC section 20) and 3 (QC section 30) appropriately.

.06 Certain sample documents (in particular, the sample quality control documents for various types of CPA firms) have been temporarily omitted from this edition of the Audit and Accounting Manual in order to undergo the revisions necessary to conform such sample documentation to the new quality control standards.

[*The next page is 11,201.*]

AAM Section 11,200

Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice

NOTICE TO READERS

This Guide presents recommendations of the AICPA Joint Task Force on Quality Control Standards (task force) on the application of Statements on Quality Control Standards. This Guide has not been approved, disapproved, or otherwise acted on by the Auditing Standards Board, the membership, or the governing body of the American Institute of Certified Public Accountants. Therefore, the contents of the Guide, including the recommendations, are not authoritative.

The suggested policies and procedures presented herein are illustrative only and firms are encouraged to consider these examples in designing and maintaining a quality control system that is appropriate for their accounting and auditing practice. A firm's policies and procedures should be sufficient for it to obtain reasonable assurance of complying with the requirements of Statements on Quality Control Standards, which, in turn, should be sufficient for a firm to obtain reasonable assurance of complying with professional standards. In considering an appropriate quality control system for its accounting and auditing practice, a firm should be aware that although some of the illustrative procedures are not explicitly required by professional standards, they present the views of the task force regarding an appropriate quality control system. The views of the task force are provided through illustrative examples of four hypothetical firms and their systems of quality control.

For handy paperback version of this guide call the AICPA Order Department at (800) 862-4272.

Chapter 1

OVERVIEW OF STATEMENTS ON QUALITY CONTROL STANDARDS

.01 Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (QC section 20), provides that a CPA firm shall have a system of quality control for its accounting and auditing practice and describes the elements of quality control and other matters essential to the effective implementation and maintenance of the system. A system of quality control is broadly defined as a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality.

.02 SQCS No. 2, paragraph 4 (QC section 20.04), provides that the nature, extent, and formality of a firm's quality control policies and procedures depend on a number of factors, such as its size, the number of its offices, the degree of authority allowed its personnel and its offices, the knowledge and experience of its personnel, the nature and complexity of its practice, and appropriate cost-benefit considerations.

.03 A firm should establish a system of quality control that includes policies and procedures related to each of the five elements of quality control identified in SQCS No. 2 (QC section 20), which are as follows:

a. Independence, Integrity, and Objectivity

b. Personnel Management

c. Acceptance and Continuance of Clients and Engagements

d. Engagement Performance

e. Monitoring

.04 The monitoring element of quality control is further described in SQCS No. 3, *Monitoring a CPA Firm's Accounting and Auditing Practice* (QC section 30).

.05 The elements of quality control are interrelated. For example, the maintenance of *Integrity, Objectivity,* and, where required, *Independence* requires a continuing assessment of client relationships that affect policies and procedures for the acceptance and continuance of clients and engagements. Similarly, the element of *Personnel Management* encompasses criteria for professional development, hiring, advancement, and assignment of the firm's personnel to engagements, which affect policies and procedures developed to meet the objectives of the quality control element of *Engagement Performance.* Similarly, policies and procedures for the quality control element of *Monitoring* evaluate whether the policies and procedures that are required by the firm related to each of the other four elements of quality control are suitably designed and are being effectively applied.

.06 When a firm merges, acquires, sells or otherwise changes a portion of its practice, the surviving firm should evaluate and, as necessary, revise, implement, and maintain firm-wide quality control policies and procedures appropriate in light of the changed circumstances.

Independence, Integrity, and Objectivity

.07 The objective of the *Independence, Integrity, and Objectivity* element of a system of quality control is to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.08 This objective ordinarily would be satisfied by establishing and maintaining policies such as—

- Requiring that personnel adhere to applicable independence, integrity, and objectivity requirements. Regulations, interpretations, and rulings of the AICPA, state CPA societies, state boards of accountancy, state statutes, the Securities and Exchange Commission (SEC), and other regulatory agencies should be considered where applicable.
- Communicating policies and procedures relating to independence, integrity, and objectivity to personnel.
- Confirming the independence of another firm engaged to perform part (or parts) of an engagement, or when acting as principal auditor.

Personnel Management

.09 The objective of the *Personnel Management* element of a system of quality control is to provide the firm with reasonable assurance that all personnel have the proficiency to perform their assigned responsibilities. Attributes or qualities that enhance the proficiency of personnel who perform, supervise, or review work include integrity, objectivity, intelligence, judgment, competence, experience, and motivation.

.10 This objective ordinarily would be satisfied by establishing and maintaining policies such as—

- Hiring personnel who possess the appropriate characteristics to enable them to perform competently.
- Assigning personnel who have the degree of technical training and proficiency required in the circumstances. In making assignments, the nature and extent of supervision to be provided should be considered. Generally, the more qualified and experienced the personnel assigned to a particular engagement, the less direct supervision is needed. Conversely, the less qualified and less experienced the personnel assigned, the more direct supervision generally is needed.
- Having personnel participate in general and industry-specific continuing professional education and professional development activities that enable them to fulfill responsibilities assigned, and satisfy applicable continuing professional education requirements of the AICPA and regulatory agencies.
- Selecting for advancement only those who have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.

Acceptance and Continuance of Clients and Engagements

.11 The objective of the *Acceptance and Continuance of Clients and Engagements* element of a system of quality control is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. Such policies and procedures should provide the firm with reasonable assurance that (*a*) the likelihood of association with a client whose management lacks integrity is minimized, (*b*) the firm undertakes only those engagements that can be completed with professional competence, (*c*) the risks associated with providing professional services in particular circumstances are appropriately considered, and (*d*) an understanding is reached with the client regarding the services to be performed.

.12 These objectives ordinarily would be satisfied, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining policies such as—

- Evaluating factors that have a bearing on management's integrity.
- Evaluating whether the engagement the firm will perform can be completed with professional competence and, accordingly, undertaking only those engagements that can be completed with professional competence; and appropriately considering the risk associated with providing professional services in particular circumstances.

- Obtaining an understanding with the client regarding the services to be performed.

Engagement Performance

.13 The objective of the *Engagement Performance* element of a system of quality control is to provide the firm with reasonable assurance that the work performed by engagement personnel meets the applicable professional standards, regulatory requirements, and the firm's standards of quality. Policies and procedures for engagement performance encompass all phases of the design and execution of the engagement. To the extent appropriate and as required by applicable professional standards, these policies and procedures should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. Policies and procedures should also provide that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate.

.14 This objective ordinarily would be satisfied by establishing and maintaining policies such as—

- Requiring that all engagements be planned to meet professional, regulatory, and the firm's requirements.
- Requiring that the work performed and the reports and other communications issued meet professional, regulatory, and the firm's requirements.
- Identifying areas and specialized situations where consultation is necessary and requiring personnel to refer to authoritative literature or other sources or consult, on a timely basis, with individuals within or outside the firm, when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues).

Monitoring

.15 The objective of the *Monitoring* element of a system of quality control is to provide the firm with reasonable assurance that the policies and procedures relating to the other elements of quality control are suitably designed and being effectively applied. Monitoring is an ongoing consideration and evaluation process.

.16 This objective ordinarily would be satisfied by establishing and maintaining policies for considering and evaluating, on an ongoing basis—

- The relevance and adequacy of the firm's quality control policies and procedures.
- The appropriateness of the firm's guidance materials and any practice aids.
- The effectiveness of professional development activities.
- Compliance with the firm's policies and procedures.

Illustrative Examples

.17 The remainder of this Guide provides illustrative examples of the types of policies a firm should consider for each of the elements of quality control. Each chapter provides examples of procedures that a firm might consider in implementing and maintaining such policies. The specific policies and procedures used by a firm would not necessarily include all those described or be limited to those illustrated. Most firms will find it appropriate to communicate their policies and procedures in writing. These examples are based on the assumption that each firm's quality control policies and procedures are in writing and distributed to all personnel. The illustrative examples are provided through four hypothetical firms—National CPA Firm, Regional Accountants, AnyCity CPAs, and Jane Brown, CPA—with the following characteristics:

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

a. National CPA Firm is one of the largest firms in the country. It has sixty offices, eight hundred partners, five thousand professionals, five hundred publicly held clients, and it performs services for clients in a variety of industries. (Chapter 2)

b. Regional Accountants has ten offices in three states and is centrally managed. Regional has thirty-five partners, two hundred professionals, and twenty-five SEC clients. In addition to servicing SEC clients, it has a concentration in audit and attest services for financial institutions. (Chapter 3)

c. AnyCity CPAs is a local, one-office firm with three partners and ten professionals. Its accounting and auditing practice includes a concentration in employee benefit plan audits. AnyCity CPAs has no SEC clients. (Chapter 4)

d. Jane Brown, CPA, is a sole owner without any professional staff, who occasionally hires per diem professionals. Her accounting practice consists only of services performed under Statements on Standards for Accounting and Review Services (SSARSs). (Chapter 5)

Chapter 2

NATIONAL CPA FIRM'S SYSTEM OF QUALITY CONTROL FOR ITS ACCOUNTING AND AUDITING PRACTICE

.18 This chapter describes how National CPA Firm implements each element of quality control for its accounting and auditing practice. National CPA Firm is a hypothetical firm. It is presumed to be one of the largest firms in the country. It has sixty offices, eight hundred partners, five thousand professionals, and five hundred publicly held clients, and performs services for clients in a variety of industries.

Independence, Integrity, and Objectivity

.19 The objective of the *Independence, Integrity, and Objectivity* element of a system of quality control is to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.

.20 National CPA Firm satisfies this objective by establishing and maintaining the following policies and procedures.

.21 **Policy 1**

Personnel will adhere to applicable independence, integrity, and objectivity requirements. These requirements include regulations, interpretations, and rulings of the AICPA, state CPA societies, state boards of accountancy, state statutes, the Securities and Exchange Commission, and other regulatory agencies where applicable.

.22 National CPA Firm implements this policy by—

a. Developing and maintaining a Professional Practice Manual that contains policies and procedures relating to independence, integrity, and objectivity. Such policies and procedures contain the firm's interpretations of professional and regulatory requirements, and guidance for identifying and resolving potential issues.

b. Designating a quality assurance partner in each office to provide guidance, answer questions, and resolve matters.

c. Designating a partner in its national office to answer more complex matters and determine the circumstances that might require consultation with sources outside the firm.

d. Identifying circumstances where documentation of the resolution of matters is appropriate.

e. Obtaining written representations from personnel, upon hire and on an annual basis, stating whether they are familiar with and are in compliance with professional standards and the firm's policies and procedures regarding independence, integrity, and objectivity. The quality assurance partner in each office is responsible for obtaining such representations and reviewing compliance files for completeness. A partner in its national office is responsible for resolving reported exceptions.

f. Requiring the managing partner in each office to periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence.

.23 **Policy 2**

Personnel will be familiar with policies and procedures relating to independence, integrity, and objectivity.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.24 National CPA Firm implements this policy by—

a. Providing each of its personnel with access to a personal computer and software that has access to databases containing professional and regulatory literature and advising them that they are expected to be familiar with that literature.

b. Emphasizing the concepts of independence, integrity, and objectivity in its professional development meetings, in the acceptance and continuance of clients and engagements, and in the performance of engagements, including discussing the types of nonattest services that could impact independence.

c. Informing personnel on a timely basis of those entities to which independence policies apply, by—

1. Preparing and maintaining lists of entities to which independence policies apply.
2. Making the lists available to personnel who need them to determine their independence (including personnel new to the firm or to an office, and certain former partners[1]).
3. Notifying personnel of changes in the lists on a timely basis via a memorandum or the firm's E-mail system.

.25 **Policy 3**

Confirm the independence of another firm performing parts of an engagement, or when we act as principal auditor.

.26 National CPA Firm implements this policy by—

a. Describing in its Professional Practice Manual the form, content, and frequency of independence representations that are to be obtained.

b. Requiring that such representations be documented.

Personnel Management

.27 The objective of the *Personnel Management* element of a system of quality control is to provide the firm with reasonable assurance that all personnel have the proficiency to perform their assigned responsibilities. Attributes or qualities that enhance the proficiency of personnel who perform, supervise, or review work include integrity, objectivity, intelligence, judgment, competence, experience, and motivation.

.28 National CPA Firm satisfies this objective by establishing and maintaining the following policies and procedures.

.29 **Policy 1**

Personnel who are hired will possess the appropriate characteristics to enable them to perform competently.

.30 National CPA Firm implements this policy by—

a. Maintaining a national human resource function that establishes the firm's hiring objectives and evaluates the firm's personnel needs, including—

[1] AICPA's *Professional Standards*, volume 2, ET section 101.04, discusses circumstances when activities of a former practitioner could affect the firm's independence.

- Designating a partner in its national office to be responsible for evaluating the firm's overall personnel needs and establishing hiring objectives based on factors such as clientele, anticipated growth, personnel turnover, and individual advancement.
- Developing and maintaining a Human Resource Manual that identifies attributes, achievements, and experiences desired in entry-level and experienced personnel.
- Establishing criteria to evaluate personal characteristics such as integrity, competence, and motivation.
- Setting guidelines for additional procedures that are necessary when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions.

b. Designating a qualified individual in each practice office to be responsible for managing the human resource function. This individual's responsibilities include—

- Preparing budgets of personnel needs for all levels.
- Identifying sources of employment candidates such as universities and executive recruiters, and coordinating the hiring process within the practice office.
- Selecting and training those individuals who will be interviewing candidates or otherwise participating in the hiring process.
- Summarizing and evaluating the results of the hiring process for each candidate and providing final approval for hiring.

.31 Policy 2

The firm will make personnel assignments based on the degree of technical training and proficiency required in the circumstances and the nature and extent of supervision to be provided.

.32 National CPA Firm implements this policy by designating an appropriate person in each office to be responsible for assigning personnel to engagements based on such factors as—

- Engagement size and complexity.
- Specialized experience or expertise required.
- Personnel availability and involvement of supervisory personnel.
- Timing of the work to be performed.
- Continuity and rotation of personnel.
- Opportunities for on-the-job training.
- Situations where independence or objectivity concerns exist.

For partner and manager assignments, such person shall be a partner, and in the case of high-risk engagements, approval of the partner assignment is to be obtained from the industry partner or the quality assurance partner.

.33 Policy 3

Personnel will participate in general and industry-specific continuing professional education and professional development activities that enable them to satisfy responsibilities assigned and fulfill applicable continuing professional education requirements of the AICPA and regulatory agencies.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.34 National CPA Firm implements this policy by—

a. Maintaining a national professional development group to develop firm requirements and program materials for professional development and assigning responsibility for the professional development function to the Director of Professional Development. The group's responsibilities include—

- Setting guidelines for participation by personnel in professional development programs and considering the requirements of the AICPA, state boards of accountancy, and regulatory agencies in establishing the firm's CPE requirements.
- Maintaining appropriate documentation evidencing that personnel have met the professional educational requirements of the firm, the AICPA, and other regulatory bodies.
- Providing an orientation program and training for newly employed personnel to inform them of their professional responsibilities and the firm's policies.
- Preparing publications and programs designed to inform personnel of their responsibilities and opportunities.
- Developing in-house staff training programs that focus on general and industry-specific accounting and auditing subject matter.

b. Assigning responsibility to an office or industry partner to establish a professional development program that provides that personnel in the office or those serving clients in an industry participate in professional development activities in accordance with firm guidelines and in subjects that are relevant to their responsibilities.

c. Communicating and distributing to personnel changes in accounting, auditing, and independence, integrity, and objectivity requirements and the firm's guidance with respect to them.

d. Encouraging participation in other professional development activities for personnel at each level within the firm, such as participation in external professional development programs, including graduate-level university and self-study courses, membership in professional organizations, serving on professional committees, and writing for professional publications.

.35 **Policy 4**

Personnel selected for advancement will have the qualifications necessary to fulfill the responsibilities they will be called on to assume.

.36 National CPA Firm implements this policy by—

a. Maintaining a national human resource function to identify and communicate, in the firm's Human Resource Manual, the qualifications necessary to fulfill responsibilities at each professional level within the firm by—

1. Establishing the criteria for evaluating personnel at each professional level and for advancement to the next higher level of responsibility.
2. Developing evaluation forms for each professional staff classification.

b. Assigning responsibility to a partner in each office for making advancement and termination decisions for staff and recommendations for manager- and partner-level advancements and terminations to the firm's management committee. Such responsibilities should include—

1. Identifying responsibilities and requirements for evaluations at each level indicating who will prepare the evaluations and when they will be prepared.
2. Reviewing evaluations with the individual being evaluated on a timely basis.

c. Counseling personnel regarding their progress and career opportunities by—

1. Annually summarizing and reviewing with personnel the evaluation of their performance, including an assessment of their progress with the firm. Considerations should include performance, future objectives of the firm and the individual, assignment preferences, and career opportunities.
2. Annually evaluating partners by means of counseling, peer evaluation, or self-appraisal, as appropriate, regarding whether they continue to have the qualifications to fulfill their responsibilities or to assume added responsibilities.

Acceptance and Continuance of Clients and Engagements

.37 The objective of the *Acceptance and Continuance of Clients and Engagements* element of a system of quality control is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. Such policies and procedures should provide the firm with reasonable assurance that (*a*) the likelihood of association with a client whose management lacks integrity is minimized, (*b*) the firm undertakes only those engagements that can be completed with professional competence, (*c*) the risks associated with providing professional services in particular circumstances are appropriately considered, and (*d*) an understanding with the client regarding the services to be performed is reached.

.38 National CPA Firm satisfies this objective, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining the following policies and procedures.

.39 **Policy 1**

The firm will evaluate factors that have a bearing on management's integrity.

.40 National CPA firm implements this policy by—

a. Developing and maintaining a Professional Practice Manual that contains policies and procedures relating to the acceptance of prospective clients and the continuance of current clients. Such policies and procedures state that the firm's clients should not present undue risks to the firm, including damage to the firm's reputation.

b. Advising personnel that they are expected to be familiar with the firm's policies and procedures for acceptance and continuance of clients.

c. Obtaining and evaluating information before accepting or continuing a client, as applicable:

1. Available information regarding the client and its operations from sources such as annual reports, interim financial statements, registration statements, Form 10-K, Form 8-K, other reports to regulatory agencies, enforcement actions by regulatory agencies, and income tax returns.
2. The nature and purpose of the services to be provided by making inquiries of client management.
3. Information regarding the client and its management and principals that may have a bearing on evaluating the client by making inquiries of third parties such as bankers, legal counsel, investment bankers, underwriters, and other members of the financial or business community who may have appropriate knowledge. Inquiries might also be made about management's attitude toward compliance with outside regulatory or legislative requirements and the presence of reportable conditions, especially those that management is unwilling to correct. In certain circumstances, background checks by investigative firms are required.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

d. Communicating with the predecessor accountant when required or suggested by professional standards. This communication also includes inquiries regarding the nature of any disagreements, and other events required to be reported by Form 8-K, and whether evidence of "opinion shopping" exists.

e. Evaluating the information obtained regarding management's integrity.

.41 Policy 2

The firm will evaluate whether the engagement can be completed with professional competence and accordingly undertake only those engagements that can be completed with professional competence and appropriately consider the risk associated with providing professional services in particular circumstances.

.42 National CPA Firm implements this policy by—

a. Evaluating whether the practice office has obtained or can reasonably expect to obtain the knowledge and expertise necessary to enable it to perform the engagement, for example, through use of other practice offices' resources.

b. Specifying conditions that require evaluation of a specific client or engagement, obtaining relevant information to determine whether the relationship should be continued, and establishing a time period for evaluations to be made (for example, continuance decisions should be made at least annually). Conditions include the following:

- Significant changes in the client, for example, a major change in ownership, senior personnel, directors, advisors, the nature of its business, or its financial stability.
- Changes in the nature or scope of the engagement, including requests for additional services.
- Changes in the strategic focus or composition of the firm, for example, a decision to discontinue services to clients in a particular industry.
- The existence of conditions that would have caused the firm to reject the engagement had such conditions existed at the time of the initial acceptance. These conditions may include unreliable processes for making accounting estimates, questionable estimates by management, questions regarding the entity's ability to continue as a going concern, or other factors that may increase the risk of being associated with the client.
- Client delinquent in paying fees. (This may also affect the firm's independence.)
- Engagements for entities operating in highly specialized or regulated industries, including financial institutions, governmental entities, and engagements for employee benefit plans.
- Engagements for entities in the development stage.

c. Evaluating the information obtained regarding the acceptance or continuance of the client or engagement.

1. All information obtained about the client or the specific engagement is to be evaluated by the engagement partner and a recommendation is made regarding whether the client or engagement should be accepted or continued.
2. The engagement partner completes a client acceptance form and submits it to the practice office managing partner for approval.
3. The engagement partner signs a step in the planning program noting client continuance, and a form documenting client continuance is completed if conditions identified in *b.* above exist.

4. The managing partner of the practice office is responsible for evaluating and approving the recommendation made by the engagement partner. In certain defined circumstances, such as new SEC engagements and high-risk engagements, documented acceptance may also require the approval of the national office.

.43 **Policy 3**

The firm will obtain an understanding with the client regarding the services to be performed.

.44 National CPA Firm implements this policy by requiring that all understandings with the client be in writing by obtaining an engagement letter for all engagements, thus minimizing the risk of misunderstandings regarding the nature, scope, and limitations of the services to be performed.

Engagement Performance

.45 The objective of the *Engagement Performance* element of a system of quality control is to provide the firm with reasonable assurance that the work performed by engagement personnel meets the applicable professional standards, regulatory requirements, and the firm's standards of quality. Policies and procedures for engagement performance encompass all phases of the design and execution of the engagement. To the extent appropriate and as required by applicable professional standards, these policies and procedures should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. Policies and procedures should also provide that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate.

.46 National CPA Firm satisfies this objective by establishing and maintaining the following policies and procedures.

.47 **Policy 1**

Planning for engagements will meet professional, regulatory, and the firm's requirements.

.48 National CPA Firm implements this policy by developing, maintaining, and providing personnel with the firm's Professional Practice Manual, which prescribes the factors to be considered in the planning process by the engagement team and the extent of documentation of the considerations which may vary depending on the size and complexity of the engagement. Planning considerations include—

- Making the engagement partner or another qualified individual responsible for planning an engagement and assigning responsibilities to appropriate personnel during the planning phase.
- Developing or updating background information.
- Requiring planning documentation that includes—
  - — Development of proposed work program, tailored to the specific engagement.
  - — Staffing requirements and the need for specialized knowledge, which may have to be obtained from another practice office.
  - — Considering economic conditions affecting the client or its industry and their potential impacts on the conduct of the engagement.
  - — Considering risks and how they may affect the procedures to be performed.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

— Preparing a budget that allocates a sufficient amount of time so the engagement will be performed in accordance with professional standards and the firm's quality control policies and procedures.

.49 **Policy 2**

The engagement will be performed, supervised, reviewed, documented, and communicated in accordance with the requirements of professional standards, regulatory authorities, and the firm.

.50 National CPA Firm implements this policy by—

a. Providing personnel with the firm's Professional Practice Manual, which—

1. Prescribes the form and content of working papers, including firm-generated forms, checklists, and questionnaires that are to be used in the performance of engagements, the form in which instructions are given to other offices or correspondents, and the extent to which their work is reviewed and documented.
2. Specifies the extent of overall engagement review at all professional levels so that the financial statements meet professional and firm presentation and disclosure standards.
3. Specifies the extent of review that should be performed of communications to be made to management and the board of directors.

b. Assigning responsibility for the review of all reports, financial statements, and working papers to a reviewer senior to the preparer in accordance with procedures outlined in the firm's Professional Practice Manual to obtain reasonable assurance that—

1. The nature, timing, and extent of procedures performed are consistent with risk assessments made and the approach described in the planning documentation and that exceptions are appropriately investigated. The appropriateness of planned procedures should be reconsidered when significant changes in risk factors occur or are identified between the planning phase of the engagement and the execution of substantive procedures.
2. Firm-prescribed forms, checklists, and questionnaires, tailored as appropriate, are used in the performance of the engagement and reporting on it.

c. Requiring a second review of the report, financial statements, and selected working papers by a partner or manager as prescribed in the firm's Professional Practice Manual. The extent of review varies based on the type of engagement; for example, audits of SEC clients and high-risk engagements, as defined by the firm, receive the most extensive review.

d. Adhering to the following guidelines set up by the firm regarding the review of working papers, financial statements, and for documentation of the review process:

1. All reviewers are to have appropriate experience, competence, and responsibility.
2. All work performed and the reports and financial statements issued are to be complete and comply with professional standards and firm policy.
3. Appropriate documentation is required on all engagements evidencing review of working papers, financial statements, and reports. Necessary documentation includes completion of the firm's review and approval documentation.

e. Requiring that differences of professional judgment within an engagement team or with consultants be resolved with the assistance of the office's quality assurance partner and a designated partner in the firm's national office, where applicable. The resolution of the differences must be appropriately documented. If a member of the team continues to disagree with the resolution, he or she may disassociate himself or herself from the resolution of the matter and will be offered the opportunity to document that a disagreement still exists.

.51 Policy 3

The firm will identify areas and specialized situations where consultation is required and will require personnel to refer to authoritative literature and practice aids and to consult, on a timely basis, with individuals within or outside the firm when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues).

.52 National CPA Firm implements this policy by—

a. Providing personnel with the firm's Professional Practice Manual, which specifies the firm's consultation policies and procedures. Areas or specialized situations that may require consultation include—

- Application of newly issued technical pronouncements.
- Industries with special accounting, auditing, or reporting requirements.
- Emerging practice problems.
- Choices among alternative generally accepted accounting principles upon initial adoption or when an accounting change is made.
- Reissuance of a report, consideration of omitted procedures after a report has been issued, or subsequent discovery of facts that existed at the time a report was issued.
- Filing requirements of regulatory agencies.
- Meetings with the SEC and other regulators, at which the firm is to be called on to support the applications of generally accepted accounting principles which have been questioned.

b. Designating individuals within the firm as consultants in certain areas. Personnel are to consult with the appropriate individual when issues arise, as specified in the firm's manuals. When differences arise between the engagement partner and the consultant, all resolutions are determined by the office quality assurance partner and, if it continues to be unresolved, a designated national office partner.

c. Maintaining or providing access to adequate and up-to-date reference libraries in each office, which include materials related to specific industries and regulatory requirements.

d. Requiring that documentation of consultation include all relevant facts and circumstances, reference to professional literature used in the determination, the conclusions reached, and signatures of the engagement partner and consultant. This documentation is to be retained in the engagement working papers and, at the discretion of the consultant, entered in a retrievable database to promote consistency in the application of generally accepted accounting principles in similar circumstances.

Monitoring

.53 The objective of the *Monitoring* element of a system of quality control is to provide the firm with reasonable assurance that the policies and procedures relating to the other elements of quality control are suitably designed and being effectively applied. Monitoring is an ongoing consideration and evaluation process.

.54 National CPA Firm satisfies this objective by establishing and maintaining the following policies and procedures.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.55 **Policy 1**

The firm will consider and evaluate, on an ongoing basis, the relevance and adequacy of its quality control policies and procedures.

.56 National CPA Firm implements this policy by designating a partner or group in its national office to be responsible for quality assurance, including—

a. Assuring that the firm's quality control policies and procedures and its audit methodology remain relevant and adequate. Factors to be considered include—

- Mergers and divestitures of portions of the practice.
- Changes in professional standards and SEC or other regulatory requirements applicable to the firm's practice.
- Results of annual inspections and peer reviews.
- Review of litigation and regulatory enforcement actions against the firm and others.
- The impact that changes in technology may have on clients' methods of doing business.
- Changes in clients' industries that impact their operations.
- Changes in applicable AICPA membership requirements.

b. Determining whether personnel have been appropriately informed of their responsibilities for maintaining the firm's standards of quality in performing their duties.

c. Identifying the need to—

1. Revise policies and procedures related to the other elements of quality control because they are ineffective or inappropriately designed.
2. Improve compliance with firm policies and procedures that are related to the other elements of quality control.

.57 **Policy 2**

The firm will consider and evaluate, on an ongoing basis, the appropriateness of its guidance materials and any practice aids.

.58 National CPA Firm implements this policy by—

a. Reviewing and updating firm practice aids, such as audit programs, forms, and checklists, based on the issuance of new professional pronouncements.

b. Issuing professional practice alerts to notify and provide guidance to personnel regarding new professional standards, regulatory requirements, and related changes to firm policy.

c. Having national office personnel periodically visit offices and interview partners and managers regarding the effectiveness of practice aids and tools.

.59 **Policy 3**

The firm will consider and evaluate, on an ongoing basis, the effectiveness of professional development programs.

.60 National CPA Firm implements this policy by—

a. Having the National Professional Development Group review the summary of evaluations of national training programs to determine whether the national professional development programs are achieving their objectives.

b. Having the National Professional Development Group review the overall professional development plan to determine whether professional staff are receiving the appropriate mix of in-house training, AICPA or state society classroom training, and self-study programs.

c. Having the National Professional Development Group review summaries of CPE records for the firm's professional staff to determine that each practice office has established a means of tracking each professional's compliance with the requirements of the firm, the AICPA, and other regulatory bodies.

d. Interviewing selected professional personnel regarding the effectiveness of training programs.

e. Considering the results of the firm's inspection procedures in connection with the effectiveness of the firm's professional development program.

f. Ascertaining whether inquiries received by individuals consulted within the firm indicate the need for additional CPE programs.

.61 **Policy 4**

The firm will consider and evaluate, on an ongoing basis, compliance with its policies and procedures.

.62 National CPA Firm implements this policy by making its national quality assurance partner responsible for the preparation of checklists and practice aids to be used in performing monitoring and inspection procedures. These procedures include—

- Developing and coordinating the firm's inspection program to achieve feedback about the effectiveness of the firm's policies and procedures.
- Developing a plan for an appropriate test of compliance with the firm's policies and procedures on a sample of engagements. Such a review could be preissuance or postissuance.
- Reviewing correspondence prepared by national office personnel regarding consultation on independence, integrity, and objectivity matters, acceptance and continuance decisions, and engagement performance.
- Reviewing the resolution of matters reported by professional personnel on independence circularization forms to determine that matters have been appropriately considered and resolved.
- Interviewing personnel at all professional management and staff levels to obtain information regarding operating procedures in practice offices and to determine whether personnel are knowledgeable of firm policies and procedures and whether they are being effectively communicated.
- Reviewing the following documentation to determine compliance with firm policies and procedures:
  a. Personnel evaluations, including documentation of hiring and advancement decisions
  b. Documentation of client acceptance and continuance decisions
  c. Participants' evaluations of training programs
  d. Professional development records of professional personnel
  e. Correspondence regarding the resolution of independence matters within the practice office

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- Reviewing a cross-section of engagements that have had a preissuance or postissuance review from selected practice offices using the following criteria:
  a. All partners and those managers who have significant accounting and auditing responsibilities in the selected offices
  b. Significant specialized industries with emphasis given to high-risk industries
  c. First-year engagements
  d. Level of service performed (that is, audit, review, compilation, and agreed-upon procedures)
  e. Level of attestation services performed (that is, examination, review, and agreed-upon procedures)
- Periodically summarizing and communicating inspection findings to firm personnel on a timely basis.
- Communicating findings to practice office personnel and determining the corrective actions to be taken on the engagements reviewed. These findings are discussed and communicated in a report issued to each office. The practice office responds regarding the specific corrective actions or steps to be taken to improve compliance with the firm's policies and procedures and professional standards.
- Communicating the need for improved compliance with or changes to the system of quality control in training programs, partner or manager meetings, and firm policy correspondence.
- Preparing a summary inspection report that evaluates the overall results of the inspection to determine whether—
  a. The firm as a whole needs to improve compliance with the firm's policies and procedures.
  b. Revisions to the firm's quality control policies and procedures are necessary.
- Periodically reviewing the system of personnel evaluation and counseling to ascertain that—
  a. Procedures for evaluation and documentation are being followed on a timely basis.
  b. Requirements established for advancement are being achieved.
  c. Personnel decisions are consistent with evaluations.
  d. Recognition is given to outstanding performance.

Chapter 3

REGIONAL ACCOUNTANTS' SYSTEM OF QUALITY CONTROL FOR ITS ACCOUNTING AND AUDITING PRACTICE

.63 This chapter describes how Regional Accountants implements each element of quality control for its accounting and auditing practice. Regional Accountants is a hypothetical firm. It is presumed to have ten offices in three states and to be centrally managed. Regional has thirty-five partners, two hundred professionals and twenty-five SEC clients. In addition to servicing SEC clients, it has a concentration in audit and attest services for financial institutions.

Independence, Integrity, and Objectivity

.64 The objective of the *Independence, Integrity, and Objectivity* element of a system of quality control is to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.

.65 Regional Accountants satisfies this objective by establishing and maintaining the following policies and procedures.

.66 **Policy 1**

Personnel will adhere to applicable independence, integrity, and objectivity requirements. These requirements include regulations, interpretations, and rulings of the AICPA, state CPA societies, state boards of accountancy, state statutes, the Securities and Exchange Commission, and other regulatory agencies where applicable.

.67 Regional Accountants implements this policy by—

a. Developing and maintaining a manual that contains the firm's policies and procedures relating to independence, objectivity, and integrity. Such policies and procedures contain the firm's interpretations of professional and regulatory requirements, and guidance for identifying and resolving potential issues or situations.

b. Designating one of its partners to provide guidance, answer questions and resolve matters, and determine the circumstances that might require consultation with sources outside the firm.

c. Identifying circumstances where documentation of the resolution of matters is appropriate.

d. Obtaining written representations from personnel, upon hire and on an annual basis, stating whether they are familiar with and are in compliance with professional standards and the firm's policies and procedures regarding independence, integrity, and objectivity.

e. Assigning responsibility for obtaining such representations, reviewing compliance files for completeness, and resolving reported exceptions to the firm's quality control partner.

f. Requiring the managing partner in each office to periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence.

.68 **Policy 2**

Personnel will be familiar with policies and procedures relating to independence, integrity, and objectivity.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.69 Regional Accountants implements this policy by—

a. Providing personnel with access to a computer and software that has access to databases containing professional and regulatory literature and advising them that they are expected to be familiar with that literature.

b. Emphasizing the concepts of independence, integrity, and objectivity in its professional development meetings, in the acceptance and continuance of clients and engagements, and in the performance of engagements, including discussing the implications regarding engagements for financial institutions, such as the prohibition of any member of the engagement team having a loan with the institution, and the types of nonattest services that could affect independence.

c. Informing personnel on a timely basis of those entities to which independence policies apply, by—

1. Preparing and maintaining lists of entities to which independence policies apply.
2. Making the lists available to personnel who need them to determine their independence (including personnel new to the firm or to an office, and certain former partners[2]).
3. Notifying personnel of changes in the lists on a timely basis via a memorandum or the firm's E-mail system.

.70 **Policy 3**

Confirm the independence of another firm performing parts of an engagement, or when we act as principal auditor.

.71 Regional Accountants implements this policy by—

a. Describing in its policies and procedures manual the form, content, and frequency of independence representations that are to be obtained.

b. Requiring that such representations be documented.

Personnel Management

.72 The objective of the *Personnel Management* element of a system of quality control is to provide the firm with reasonable assurance that all personnel have the proficiency to perform their assigned responsibilities. Attributes or qualities that enhance the proficiency of personnel who perform, supervise, or review work include integrity, objectivity, intelligence, judgment, competence, experience, and motivation.

.73 Regional Accountants satisfies this objective by establishing and maintaining the following policies and procedures.

.74 **Policy 1**

Personnel who are hired will possess the appropriate characteristics to enable them to perform competently.

.75 Regional Accountants implements this policy by maintaining firm-wide hiring objectives and evaluating the firm's personnel needs, including—

[2] AICPA's *Professional Standards*, volume 2, ET section 101.04, discusses circumstances when activities of a former practitioner could affect the firm's independence.

- Designating a partner or a qualified individual in each office to be responsible for evaluating that practice office's overall personnel needs and establishing hiring objectives based on factors such as clientele, anticipated growth, personnel turnover, and individual advancement.
- Developing and maintaining personnel policies and procedures that identify attributes, achievements, and experiences desired in entry-level and experienced personnel.
- Establishing criteria to evaluate personal characteristics such as integrity, competence, and motivation.
- Setting guidelines as to additional procedures that are necessary when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions.
- Identifying sources of employment candidates such as universities and executive recruiters, and coordinating the hiring process within the practice office.
- Selecting and training the individuals who will be interviewing candidates or otherwise participating in the hiring process.
- Summarizing and evaluating the results of the hiring process for each candidate and providing final approval for hiring.

.76 **Policy 2**

The firm will make personnel assignments based on the degree of technical training and proficiency required in the circumstances and the nature and extent of supervision to be provided.

.77 Regional Accountants implements this policy by—

a. Designating an appropriate person in each office to be responsible for assigning personnel to engagements based on such factors as—

- Engagement size and complexity.
- Specialized experience and expertise required.
- Personnel availability and involvement of supervisory personnel.
- Timing of the work to be performed.
- Continuity and rotation of personnel.
- Opportunities for on-the-job training.
- Situations where independence or objectivity concerns exist.

b. Designating the quality control partner as the person responsible for approval of the partner assignments on high-risk engagements.

.78 **Policy 3**

Personnel will participate in general and industry-specific continuing professional education and professional development activities that enable them to satisfy responsibilities assigned and fulfill applicable continuing professional education requirements of the AICPA and regulatory agencies.

.79 Regional Accountants implements this policy by—

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

a. Designating one partner responsible for developing firm requirements and program materials for professional development. These responsibilities include—

- Setting guidelines for participation by personnel in professional development programs, and considering requirements of the AICPA, state boards of accountancy, and regulatory agencies in establishing the firm's CPE requirements.
- Maintaining appropriate documentation evidencing that personnel have met the professional education requirements of the firm, the AICPA, and other regulatory bodies.
- Providing an orientation program and training for newly employed personnel to inform them of their professional responsibilities and firm policies.
- Preparing publications and programs designed to inform personnel of their responsibilities and opportunities.
- Developing in-house staff training programs that focus on general and industry-specific accounting and auditing subject matter, including audits of financial institutions.

b. Assigning responsibility to an office or industry partner to maintain a professional development program that provides that personnel in the office or those serving clients in an industry participate in professional development activities in accordance with firm guidelines and in subjects that are relevant to their responsibilities.

c. Communicating and distributing to personnel changes in accounting, auditing, and independence, integrity, and objectivity requirements and the firm's guidance with respect to them.

d. Encouraging participation in other professional development activities for personnel at each level within the firm, such as participation in external professional development programs, including graduate level and self-study courses, membership in professional organizations, serving on professional committees, and writing for professional publications.

.80 **Policy 4**

Personnel selected for advancement will have the qualifications necessary to fulfill the responsibilities they will be called on to assume.

.81 Regional Accountants implements this policy by—

a. Appointing a Director of Human Resources to identify and communicate in the firm's policies and procedures manual the qualifications necessary to fulfill responsibilities at each professional level within the firm by—

1. Establishing the criteria for evaluating personnel at each professional level and for advancement to the next higher level of responsibility.
2. Developing evaluation forms for each professional staff classification.

b. Assigning responsibility to one of its partners for making advancement and termination decisions for staff and recommendations for manager- and partner-level advancements and terminations to the firm's management committee. Such responsibilities should include—

1. Identifying responsibilities and requirements for evaluation at each level and indicating who will prepare evaluations and when they will be prepared.
2. Reviewing evaluations with the individual being evaluated on a timely basis.

c. Counseling personnel regarding their progress and career opportunities by—

1. Annually summarizing and reviewing with personnel the evaluation of their performance, including an assessment of their progress with the firm. Considerations should include performance, future objectives of the firm and the individual, assignment preferences, and career opportunities.
2. Periodically evaluating partners by means of counseling, peer evaluation, or self-appraisal, as appropriate, regarding whether they continue to have the qualifications to fulfill their responsibilities or assume added responsibilities.

Acceptance and Continuance of Clients and Engagements

.82 The objective of the *Acceptance and Continuance of Clients and Engagements* element of a system of quality control is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. Such policies and procedures should provide the firm with reasonable assurance that (*a*) the likelihood of associations with a client whose management lacks integrity is minimized, (*b*) the firm undertakes only those engagements that can be completed with professional competence, (*c*) the risks associated with providing professional services in particular circumstances are appropriately considered, and (*d*) an understanding with the client regarding the services to be performed is reached.

.83 Regional Accountants satisfies this objective, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining the following policies and procedures.

.84 **Policy 1**

The firm will evaluate factors that have a bearing on management's integrity.

.85 Regional Accountants implements this policy by—

a. Developing and maintaining a policies and procedures manual that contains policies and procedures relating to acceptance of prospective clients and the continuance of current clients. Such policies and procedures state that the firm's clients should not present undue risks to the firm, including damage to the firm's reputation.

b. Advising personnel that they are expected to be familiar with the firm's policies and procedures for acceptance and continuance of clients.

c. Obtaining and evaluating information before accepting or continuing a client, as applicable:

1. Available information regarding the client and its operations from sources such as annual reports, interim financial statements, registration statements, Form 10-K, Form 8-K, other reports to regulatory agencies, enforcement actions by regulatory agencies, and income tax returns.
2. The nature and purpose of the services to be provided by making inquiries of client management.
3. Information regarding the client and its management and principals that may have a bearing on evaluating the client by making inquiries of third parties such as bankers, legal counsel, investment bankers, underwriters, and other members of the financial or business community who may have appropriate knowledge. Inquiries might also be made about management's attitude toward compliance with outside regulatory or legislative requirements and the presence of reportable conditions, especially those that management is unwilling to correct. In certain circumstances, background checks by investigative firms are required.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

d. Communicating with the predecessor accountant when required or suggested by professional standards. This communication also includes inquiries regarding the nature of any disagreements and other events required to be reported by Form 8-K, and whether evidence of "opinion shopping" exists.

e. Evaluating the information obtained regarding management's integrity.

.86 **Policy 2**

The firm will evaluate whether the engagement can be completed with professional competence and accordingly undertake only those engagements that can be completed with professional competence and appropriately consider the risk associated with providing professional services in particular circumstances.

.87 Regional Accountants implements this policy by—

a. Evaluating whether the practice office has obtained or can reasonably expect to obtain the knowledge and expertise necessary to enable it to perform the engagement, for example, through the use of another practice office's resources.

b. Specifying conditions that require evaluation of a specific client or engagement, obtaining relevant information to determine whether the relationship should be continued, and establishing a time period for evaluations to be made (for example, continuance decisions should be made at least annually). Conditions include the following:

- Significant changes in the client, for example, a major change in ownership, senior client personnel, directors, advisors, the nature of its business, or its financial stability.
- Changes in the nature or scope of the engagement, including requests for additional services.
- Changes in the strategic focus or composition of the firm, for example, the inability to replace the loss of key personnel who are particularly knowledgeable about a specialized industry, or the decision to discontinue services to clients in a particular industry.
- The existence of conditions that would have caused the firm to reject the engagement had such conditions existed at the time of the initial acceptance. These conditions may include unreliable processes for making accounting estimates, questionable estimates by management, questions regarding the entity's ability to continue as a going concern, and other factors that may increase the risk of being associated with the client.
- Client delinquent in paying fees. (This may also affect the firm's independence.)
- Engagements for entities operating in highly specialized or regulated industries, including financial institutions and governmental entities, and engagements for employee benefit plans.
- Engagements for entities in the development stage.

c. Evaluating the information obtained regarding the acceptance or continuance of the client or engagement.

1. All information obtained about the client or the specific engagement is evaluated by the engagement partner and a recommendation is made regarding whether the client or engagement should be accepted or continued.
2. The engagement partner completes a client acceptance form and submits it to the practice office managing partner for approval.

3. The engagement partner signs a step in the planning program noting client continuance, and a form documenting client continuance is completed if conditions identified in *b.* above exist.
4. The firm's quality control partner is responsible for evaluating and approving the recommendation made by the engagement partner. In certain defined circumstances, such as new SEC engagements or high-risk engagements, documented acceptance or continuance decisions may also require the approval of the firm's managing partner.

.88 **Policy 3**

The firm will obtain an understanding with the client regarding the services to be performed.

.89 Regional Accountants implements this policy by requiring that all understandings with the client be in writing by obtaining an engagement letter for all engagements, thus minimizing the risk of misunderstandings regarding the nature, scope, and limitations of the services to be performed.

Engagement Performance

.90 The objective of the *Engagement Performance* element of a system of quality control is to provide the firm with reasonable assurance that the work performed by engagement personnel meets the applicable professional standards, regulatory requirements, and the firm's standards of quality. Policies and procedures for engagement performance encompass all phases of the design and execution of the engagement. To the extent appropriate and as required by applicable professional standards, these policies and procedures should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. Policies and procedures should also provide that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues).

.91 Regional Accountants satisfies this objective by establishing and maintaining the following policies and procedures.

.92 **Policy 1**

Planning for engagements will meet professional, regulatory, and the firm's requirements.

.93 Regional Accountants implements this policy by developing, maintaining, and providing personnel with the firm's policies and procedures manual which prescribes the factors to be considered in the planning process by the engagement team and the extent of documentation of the considerations which may vary depending on the size and complexity of the engagement. Planning considerations include—

- Making the engagement partner responsible for planning an engagement and assigning responsibilities to appropriate personnel during the planning phase.
- Developing or updating background information.
- Requiring planning documentation that includes—
  - — Development of proposed work program, tailored to the specific engagement.
  - — Staffing requirements and the need for specialized knowledge, which may have to be obtained from another practice office.
  - — Considering the economic conditions affecting the client or its industry and their potential impacts on the conduct of the engagement.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

— Considering the risks and how they may affect the procedures to be performed.

— Preparing a budget that allocates a sufficient amount of time so the engagement will be performed in accordance with professional standards and the firm's quality control policies and procedures.

.94 Policy 2

The engagement will be performed, supervised, reviewed, documented, and communicated in accordance with the requirements of professional standards, regulatory authorities, and the firm.

.95 Regional Accountants implements this policy by—

a. Providing personnel with the firm's policies and procedures manual, which—

1. Prescribes the form and content of working papers, including firm-generated or purchased forms, checklists, questionnaires that are to be used in the performance of engagements, the form in which instructions are given to other offices or correspondents, and the extent to which their work is reviewed and documented.
2. Specifies the extent of overall engagement review, at all professional levels, so the financial statements meet professional and firm presentation and disclosure standards.
3. Specifies the extent of review that should be performed of communications to be made to management and the board of directors.

b. Assigning responsibility for the review of all reports, financial statements, and working papers to a reviewer senior to the preparer in accordance with procedures outlined in the firm's manual to obtain reasonable assurance that—

1. The nature, timing, and extent of procedures performed are consistent with risk assessments made and the approach described in the planning documentation and that exceptions are appropriately investigated. The appropriateness of planned procedures should be reconsidered when significant changes in risk factors occur or are identified between the planning phase of the engagement and the execution of substantive procedures.
2. Firm-prescribed forms, checklists, and questionnaires, tailored as appropriate, are used in the performance of the engagement and reporting on it.

c. Requiring a second review of the report, financial statements, and selected working papers by a partner or manager as prescribed in the firm's policies and procedures manual. The extent of review varies based on the type of engagement; for example, audits of SEC clients, engagements for financial institutions and high-risk engagements, as defined by the firm, receive the most extensive review.

d. Adhering to guidelines set up by the firm regarding the review of working papers, financial statements, and for documentation of the review process:

1. All reviewers are to have appropriate experience, competence and responsibility.
2. All work performed and the reports and financial statements issued are to be complete and comply with professional standards and firm policy.
3. Appropriate documentation is required on all engagements evidencing review of working papers, financial statements, and reports. Necessary documentation includes completion of the firm's review and approval documentation.

e. Requiring that all differences of professional judgment within an engagement team be resolved by the engagement and quality control partner. The resolution of the differences must be appropriately documented. If a member of the engagement team continues to disagree with the resolution, he or she may disassociate himself or herself from the resolution of the matter and will be offered the opportunity to document that a disagreement still exists.

.96 **Policy 3**

The firm will identify areas and specialized situations where consultation is required and will require personnel to refer to authoritative literature and practice aids and to consult, on a timely basis, with individuals within or outside the firm when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues).

.97 Regional Accountants implements this policy by—

a. Providing personnel with the firm's policies and procedures manual, which specifies the firm's consultation policies and procedures. Areas or specialized situations that may require consultation include—

- Application of newly issued technical pronouncements.
- Industries with special accounting, auditing, or reporting requirements.
- Emerging practice problems.
- Choices among alternative generally accepted accounting principles upon initial adoption or when an accounting change is made.
- Reissuance of a report, consideration of omitted procedures after a report has been issued or subsequent discovery of facts that existed at the time a report was issued.
- Filing requirements of regulatory agencies.
- Meetings with the SEC and other regulators at which the firm is to be called upon to support the application of generally accepted accounting principles which have been questioned.

b. Designating individuals within the firm as consultants in certain areas. Personnel are to consult with the appropriate individual when issues arise. When differences arise between the engagement partner and the consultant, the matter is resolved by the firm's quality control partner.

c. Maintaining or providing access to adequate and up-to-date reference libraries in each office which include materials related to specific industries, specialties, and regulatory requirements.

d. Requiring that documentation of consultation include all relevant facts and circumstances, reference to professional literature used in the determination, the conclusion reached, and signatures of the engagement partner and consultant. This documentation is to be retained in the engagement working papers, and at the discretion of the consultant, entered in a retrievable database to promote consistency in the application of generally accepted accounting principles in similar circumstances.

Monitoring

.98 The objective of the *Monitoring* element of a system of quality control is to provide the firm with reasonable assurance that the policies and procedures relating to the other elements of quality control are suitably designed and being effectively applied. Monitoring is an ongoing consideration and evaluation process.

.99 Regional Accountants satisfies this objective by establishing and maintaining the following policies and procedures.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.100 **Policy 1**

The firm will consider and evaluate, on an ongoing basis, the relevance and adequacy of its quality control policies and procedures.

.101 Regional Accountants implements this policy by designating a partner or a management-level individual with appropriate authority to be responsible for quality assurance, including—

a. Assuring that the firm's quality control policies and procedures and its audit methodology remain relevant and adequate. Factors to be considered include—

- Mergers and divestitures of portions of the practice.
- Changes in professional standards, and SEC or other regulatory requirements applicable to the firm's practice.
- Results of annual inspections and peer reviews.
- Review of litigation and regulatory enforcement actions against the firm and others.
- Impact that changes in technology may have on clients' methods of doing business.
- Changes in clients' industries that impact their operations.
- Changes in applicable AICPA membership requirements.

b. Determining whether personnel have been appropriately informed of their responsibilities for maintaining the firm's standards of quality in performing their duties.

c. Identifying the need to—

1. Revise policies and procedures related to the other elements of quality control because they are ineffective or inappropriately designed.
2. Improve compliance with firm policies and procedures that are related to the other elements of quality control.

.102 **Policy 2**

The firm will consider and evaluate, on an ongoing basis, the appropriateness of its guidance materials and any practice aids.

.103 Regional Accountants implements this policy by—

a. Reviewing and updating firm practice aids, such as audit programs, forms, and checklists, based on the issuance of new professional pronouncements.

b. Issuing guidance regarding new professional standards, regulatory requirements, and related changes to firm policy.

c. Soliciting comments from partners and managers as to the effectiveness of practice aids and tools.

.104 **Policy 3**

The firm will consider and evaluate, on an ongoing basis, the effectiveness of professional development programs.

.105 Regional Accountants implements this policy by—

a. Designating a partner or qualified individual in each office to review the summary of evaluations of in-house training programs to determine whether the programs are achieving their objectives.

b. Designating a partner or qualified individual in each office to review summaries of CPE records for that office's professional staff to determine that the office has established a means of tracking each individual's compliance with the requirements of the AICPA and other regulatory bodies.

c. Interviewing selected professional personnel regarding the effectiveness of training programs.

d. Considering the results of the firm's inspection in connection with the effectiveness of the firm's professional development program.

e. Ascertaining whether inquiries received by individuals consulted within the firm indicate the need for additional CPE programs.

.106 Policy 4

The firm will consider and evaluate, on an ongoing basis, compliance with its policies and procedures.

.107 Regional Accountants implements this policy by making its quality control partner responsible for preparing inspection checklists and guidance materials, or using materials prepared by the AICPA for performing inspection procedures. These procedures include—

- Developing and coordinating the firm's inspection program to achieve feedback about the effectiveness of the firm's policies and procedures.
- Developing a plan for an appropriate test of compliance with the firm's policies and procedures on a sample of engagements. Such a review could be preissuance or postissuance.
- Reviewing the resolution of matters reported by professional personnel on independence circularization forms to determine that matters have been appropriately considered and resolved.
- Interviewing personnel at all professional management and staff levels to obtain information regarding operating procedures in practice offices and to determine whether personnel are knowledgeable of firm policies and procedures and whether they are being effectively communicated.
- Reviewing the following documentation to determine compliance with firm policies and procedures:
  - *a.* Personnel evaluations, including documentation of hiring and advancement decisions
  - *b.* Documentation of client acceptance and continuance decisions
  - *c.* Participants' evaluations of practice office training programs
  - *d.* Professional development records of personnel
  - *e.* Correspondence regarding the resolution of independence matters within the practice office
- Reviewing a cross-section of engagements from selected practice offices using the following criteria:
  - *a.* All partners and managers who have significant accounting and auditing responsibilities in the selected offices
  - *b.* Engagements for financial institutions
  - *c.* First-year engagements
  - *d.* Significant specialized industries with emphasis given to high-risk industries

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

e. Level of service performed (that is, audit, review, compilation, and attestation)

f. Level of attestation services performed (that is, examination, review, and agreed-upon procedures)

- Summarizing findings resulting from the inspection procedures.
- Communicating findings to practice office personnel and determining the corrective actions to be taken on the engagements reviewed. These findings are discussed and communicated in a report issued to each office. The practice office responds regarding the specific corrective actions or steps to be taken to improve compliance with the firm's policies and procedures and professional standards.
- Preparing a summary inspection report to the firm's senior management that evaluates the overall results of the inspection to determine whether—
  a. The firm as a whole needs to improve compliance with the firm's policies and procedures.
  b. Revisions to the firm's quality control policies and procedures are necessary.
- Communicating the need for improved compliance with or changes to the system of quality control in training programs, partner manager meetings, and firm policy correspondence.
- Periodically reviewing the system of personnel evaluation and counseling to ascertain that—
  a. Procedures for evaluation and documentation are being followed on a timely basis.
  b. Requirements established for advancement are being achieved.
  c. Personnel decisions are consistent with evaluations.
  d. Recognition is given to outstanding performance.

Chapter 4

ANYCITY CPAS' SYSTEM OF QUALITY CONTROL FOR ITS ACCOUNTING AND AUDITING PRACTICE

.108 This chapter describes how AnyCity CPAs implements each element of quality control for its accounting and auditing practice. AnyCity CPAs is a hypothetical firm. It is presumed to be a local, one-office firm with three partners and a total of ten professionals. Its accounting and auditing practice has a concentration of five employee benefit plan audits. AnyCity CPAs has no SEC clients. The firm uses purchased practice aids that have been subjected to peer review in accordance with standards established by the AICPA. These practice aids are supplemented by oral and written communications from the firm's partners. To enhance communications, the firm has chosen to provide its personnel with a written summary of its quality control policies and procedures that contains statements incorporated by reference to policies and procedures from its purchased practice aids, tailored to the specific needs of its practice.

Independence, Integrity, and Objectivity

.109 The objective of the *Independence, Integrity, and Objectivity* element of a system of quality control is to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.

.110 AnyCity CPAs satisfies this objective by establishing and maintaining the following policies and procedures.

.111 **Policy 1**

Personnel will adhere to applicable independence, integrity, and objectivity requirements. These requirements include regulations, interpretations, and rulings of the AICPA, state CPA societies, state boards of accountancy, state statutes, and other regulatory agencies where applicable.

.112 AnyCity CPAs implements this policy by—

a. Designating a partner to provide guidance, answer questions, and resolve matters.

b. Identifying circumstances where documentation of the resolution of matters is appropriate.

c. Obtaining written representations from personnel, upon hire and on an annual basis, stating whether they are familiar with and are in compliance with professional standards and the firm's policies and procedures regarding independence, integrity, and objectivity.

d. Assigning responsibility for obtaining representations, reviewing compliance files for completeness, and resolving reported exceptions to a partner.

e. Having a partner periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence.

.113 **Policy 2**

Personnel will be familiar with policies and procedures relating to independence, integrity, and objectivity.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.114 AnyCity CPAs implements this policy by—

a. Subscribing to and updating the AICPA *Professional Standards* loose-leaf service and other services pertaining to its practice, including a service that contains the Department of Labor's rules and regulations, and making these available in its office library.

b. Emphasizing the concepts of independence, integrity, and objectivity during its staff meetings, in the acceptance and continuance of clients and engagements, and in the performance of engagements, including discussing implications of auditing employee benefit plans and the types of nonattest services that could affect independence.

c. Informing personnel on a timely basis of those entities to which independence policies apply, by—

1. Preparing and maintaining a list of entities to which independence applies.
2. Making the list available to personnel who need it to determine their independence (including personnel new to the firm and certain former partners[3]).
3. Notifying personnel of changes in the list on a timely basis via memorandum or the firm's E-mail system.

.115 **Policy 3**

Confirm the independence of another firm performing parts of an engagement, or when we act as principal auditor.

.116 AnyCity CPAs implements this policy by—

a. Using its purchased practice aids, which prescribe the form, content, and frequency of independence representations that are to be obtained.

b. Requiring that such representations be documented.

Personnel Management

.117 The objective of the *Personnel Management* element of a system of quality control is to provide the firm with reasonable assurance that all personnel have the proficiency to perform their assigned responsibilities. Attributes or qualities that enhance the proficiency of personnel who perform, supervise, or review work include integrity, objectivity, intelligence, judgment, competence, experience, and motivation.

.118 AnyCity CPAs satisfies this objective by establishing and maintaining the following policies and procedures.

.119 **Policy 1**

Personnel who are hired will possess the appropriate characteristics to enable them to perform competently.

.120 AnyCity CPAs implements this policy by—

a. Establishing a general understanding among the partners of the attributes, achievements, and experiences desired in entry-level and experienced personnel.

[3] AICPA's *Professional Standards*, volume 2, ET section 101.04, discusses circumstances when activities of a former practitioner could affect the firm's independence.

b. Establishing criteria to evaluate personal characteristics such as integrity, competence, and motivation.

c. Setting guidelines as to additional procedures that are necessary when hiring experienced personnel such as performing background checks and inquiring about any outstanding regulatory actions.

d. Designating a qualified individual in the firm to be responsible for managing the human resource function.

.121 **Policy 2**

The firm will make personnel assignments based on the degree of technical training and proficiency required in the circumstances and the nature and extent of supervision to be provided.

.122 AnyCity CPAs implements this policy by conducting periodic partner and manager meetings to discuss the assignment of personnel to engagements. The factors to be considered in making such decisions include—

- Engagement size and complexity.
- Specialized experience and expertise required.
- Personnel availability and involvement of supervisory personnel.
- Timing of the work to be performed.
- Continuity and rotation of personnel.
- Opportunities for on-the-job training.
- Situations where independence or objectivity concerns exist.

.123 **Policy 3**

Personnel will participate in general and industry-specific continuing professional education and professional development activities that enable them to satisfy responsibilities assigned and fulfill applicable continuing professional education requirements of the AICPA and regulatory agencies.

.124 AnyCity CPAs implements this policy by—

a. Assigning responsibility to a partner to maintain an office professional development program that—

1. Provides that personnel in the office participate in professional development programs in accordance with firm guidelines and in subjects that are relevant to their responsibilities.
2. Considers requirements of the AICPA, state boards of accountancy, and regulatory agencies in establishing the firm's CPE requirements.

b. Encouraging participation in other professional development activities for personnel at each level within the firm, such as participation in external professional development programs, including graduate-level and self-study courses, membership in professional organizations, serving on professional committees, and writing for professional publications.

c. Communicating and distributing to personnel, when applicable, changes in accounting, auditing, and independence requirements and the firm's guidance with respect to them.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.125 **Policy 4**

Personnel selected for advancement will have the qualifications necessary to fulfill the responsibilities they will be called on to assume.

.126 AnyCity CPAs implements this policy by—

a. Assigning responsibility to a partner for making advancement and termination decisions. Such responsibilities include—

- Identifying responsibilities and requirements for evaluation at each level and indicating who will prepare evaluations and when they will be prepared.
- Using forms for evaluating the performance of personnel.
- Reviewing evaluations with the individual being evaluated on a timely basis.

b. Counseling personnel regarding their progress and career opportunities by—

1. Annually summarizing and reviewing with personnel the evaluation of their performance, including an assessment of their progress with the firm. Considerations should include performance, future objectives of the firm and the individual, assignment preferences, and career opportunities.
2. Periodically evaluating partners by means of counseling, peer evaluation, or self-appraisal, as appropriate.

Acceptance and Continuance of Clients and Engagements

.127 The objective of the *Acceptance and Continuance of Clients and Engagements* element of a system of quality control is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. Such policies and procedures should provide the firm with reasonable assurance that (*a*) the likelihood of association with a client whose management lacks integrity is minimized, (*b*) the firm undertakes only those engagements that can be completed with professional competence, (*c*) the risks associated with providing professional services in particular circumstances are appropriately considered, and (*d*) an understanding with the client regarding the services to be performed is reached.

.128 AnyCity CPAs satisfies this objective, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining the following policies and procedures.

.129 **Policy 1**

The firm will evaluate factors that have a bearing on management's integrity.

.130 AnyCity CPAs implements this policy by—

a. Informing personnel of the firm's policies and procedures, including those outlined in the firm's purchased practice aids, for accepting and continuing clients.

b. Obtaining and evaluating available financial information regarding the client and its operations such as annual reports, interim financial statements, reports to regulatory agencies, income tax returns, and credit reports before accepting or continuing a client.

c. Making inquiries of the client management about the nature and purpose of services to be provided.

d. Making inquiries of the client's bankers, factors, attorneys, credit services, and others having business relationships with the entity.

e. Communicating with the predecessor accountant when required or suggested by professional standards.

f. Evaluating the information obtained regarding management's integrity.

.131 **Policy 2**

The firm will evaluate whether the engagement can be completed with professional competence and accordingly undertake only those engagements that can be completed with professional competence and appropriately consider the risk associated with providing professional services in particular circumstances.

.132 AnyCity CPAs implements this policy by—

a. Evaluating whether the firm has obtained or can reasonably expect to obtain the knowledge and expertise necessary to enable it to perform the engagement.

b. Specifying conditions that require evaluation of a specific client or engagement, obtaining relevant information to determine whether the relationship should be continued, and establishing a time period for evaluations to be made (for example, continuance decisions should be made at least annually). Conditions include the following:

- Significant changes in the client, for example, a major change in senior client personnel, ownership, advisors, the nature of its business, or the financial stability of the client.
- Changes in the nature or scope of the engagement, including requests for additional services.
- Changes in the composition of the firm, for example, the inability to replace the loss of key personnel who are particularly knowledgeable about a specialized industry, or the decision to discontinue services to clients in a particular industry.
- The existence of conditions that would have caused the firm to reject the client or engagement had such conditions existed at the time of the initial acceptance.
- Client delinquent in paying fees. (This may also affect the firm's independence.)
- Engagements for entities operating in highly specialized or regulated industries, including financial institutions, governmental entities, and engagements for employee benefit plans.
- Where there is a burdensome amount of hours required to complete the engagement.
- Engagements for entities in the development stage.

c. Evaluating the information obtained regarding acceptance or continuance of the client or engagement.

1. All information obtained about the client or the specific engagement is evaluated by the engagement partner, who makes a recommendation regarding whether the client or engagement is to be accepted or continued.
2. The engagement partner completes a client acceptance form and submits it to the managing partner for approval.
3. The engagement partner signs a step in the planning program noting client continuance, and a form documenting client continuance is completed if conditions identified above in *b.* above exist.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

4. The managing partner is responsible for evaluating and approving the recommendation made by the engagement partner. If the managing partner recommends not accepting or discontinuing a client relationship, all partners in the firm will review all of the information and participate in the acceptance or continuance decision.

.133 **Policy 3**

The firm will obtain an understanding with the client regarding the services to be performed.

.134 AnyCity CPAs implements this policy by requiring that all understandings with the client be in writing by obtaining an engagement letter on all engagements, thus minimizing the risk of misunderstanding regarding the nature, scope, and limitations of the services to be performed.

Engagement Performance

.135 The objective of the *Engagement Performance* element of a system of quality control is to provide the firm with reasonable assurance that the work performed by engagement personnel meets the applicable professional standards, regulatory requirements, and the firm's standards of quality. Policies and procedures for engagement performance encompass all phases of the design and execution of the engagement. To the extent appropriate and as required by applicable professional standards, these policies and procedures should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. Policies and procedures should also provide that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate.

.136 AnyCity CPAs satisfies this objective by establishing and maintaining the following policies and procedures.

.137 **Policy 1**

Planning for engagements will meet professional, regulatory, and the firm's requirements.

.138 AnyCity CPAs implements this policy by maintaining and providing personnel with the firm's purchased practice aids which prescribe the factors to be considered in the planning process by the engagement team and the extent of documentation of the considerations which may vary depending on the size and complexity of the engagement. Planning considerations include—

- Assigning responsibilities to appropriate personnel during the planning phase.
- Developing or updating background information.
- Developing a planning document that includes—
  - — Proposed work programs, tailored to the specific engagement.
  - — Staffing requirements and the need for specialized knowledge.
  - — Considering the economic conditions affecting the client or its industry and their potential impacts on the conduct of the engagement.
  - — Considering the risks and how they may affect the procedures to be performed.
  - — Preparing a budget that allocates a sufficient amount of time so the engagement will be performed in accordance with professional standards and the firm's quality control policies and procedures.

.139 **Policy 2**

The engagement will be performed, supervised, reviewed, documented, and communicated in accordance with the requirements of professional standards, regulatory authorities, and the firm.

.140 AnyCity CPAs implements this policy by—

a. Providing adequate supervision during the course of an engagement. This supervision is based on the training, ability, and experience of the personnel assigned.

b. Adhering to the guidelines set forth by the firm and in its purchased practice aids for the form and content of working papers.

c. Utilizing appropriately tailored forms, checklists, and questionnaires to assist in the performance of the specific engagement.

d. Adhering to documentation guidelines set by the firm regarding the review of working papers, financial statements, and reports:

1. All reviewers are to have appropriate experience, competence, and responsibility.
2. All work performed and the reports and financial statements issued are to be complete and comply with professional standards and firm policy.
3. All engagements require appropriate evidence of review of working papers, financial statements, and reports.
4. All differences of professional judgment within an engagement team are to be resolved by the engagement and the managing partner. The resolution of the differences must be appropriately documented. If a member of the team continues to disagree with the resolution, he or she may disassociate himself or herself from the resolution of the matter and will be offered the opportunity to document that a disagreement still exists.

.141 **Policy 3**

The firm will identify areas and specialized situations where consultation is required and will require personnel to refer to authoritative literature and practice aids and to consult, on a timely basis, with individuals within or outside the firm when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues).

.142 AnyCity CPAs implements this policy by—

a. Informing personnel of the firm's consultation policies and procedures.

b. Consulting with appropriate individuals within and outside the firm when issues arise in certain areas.

c. Requiring consultation in specialized areas or specialized situations, which may include—

- Application of newly issued technical pronouncements.
- Industries with special accounting, auditing, or reporting requirements, including unusually complex employee benefit plans.
- Emerging practice problems.
- Choices among alternative generally accepted accounting principles upon initial adoption or when an accounting change is made.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

- Reissuance of a report, consideration of omitted procedures after a report has been issued or subsequent discovery of facts that existed at the time a report was issued.
- Filing requirements of regulatory agencies.

d. Maintaining an adequate and up-to-date reference library that is accessible to all professional personnel and that includes materials related to clients served.

e. Documenting all relevant facts, circumstances, professional literature used, and conclusions reached in the engagement working papers.

f. Documenting the resolution of differences of opinion. If on some occasions there is an unresolved disagreement, an outside source may be consulted to assist in determining the appropriate application of accounting principles.

Monitoring

.143 The objective of the *Monitoring* element of a system of quality control is to provide the firm with reasonable assurance that the policies and procedures relating to the other elements of quality control are suitably designed and being effectively applied. Monitoring is an ongoing consideration and evaluation process.

.144 AnyCity CPAs satisfies this objective by establishing and maintaining the following policies and procedures.

.145 Policy 1

The firm will consider and evaluate, on an ongoing basis, the relevance and adequacy of its quality control policies and procedures.

.146 AnyCity CPAs implements this policy by designating a partner or a management-level individual with appropriate authority to be responsible for quality assurance, including—

- Assuring that the firm's quality control policies and procedures and its audit methodology remain relevant and adequate. Factors to be considered include—
  - — Mergers and divestitures of portions of the practice.
  - — Changes in professional standards or other regulatory requirements applicable to the firm's practice.
  - — Results of annual inspections and peer reviews.
  - — Review of litigation and regulatory enforcement actions against the firm and others.
  - — Impact that changes in technology may have on clients' methods of doing business.
  - — Changes in clients' industries that impact their operations.
  - — Changes in applicable AICPA membership requirements.
- Determining whether personnel have been appropriately informed of their responsibilities for maintaining the firm's standards of quality in performing their duties.
- Identifying the need to—
  - *a.* Revise policies and procedures related to the other elements of quality control because they are ineffective or inappropriately designed.

b. Improve compliance with firm policies and procedures that are related to the other elements of quality control.

.147 **Policy 2**

The firm will consider and evaluate, on an ongoing basis, the appropriateness of its guidance materials and any practice aids.

.148 AnyCity CPAs implements this policy by—

a. Reviewing and evaluating firm practice aids, such as audit programs, forms, and checklists, based on the issuance of new professional pronouncements.

b. Providing guidance during staff meetings regarding new professional standards, regulatory requirements, and related changes to firm practice aids.

.149 **Policy 3**

The firm will consider and evaluate, on an ongoing basis, the effectiveness of professional development programs.

.150 AnyCity CPAs implements this policy by—

a. Designating a management-level individual with the responsibility for reviewing the professional development policies and procedures to determine whether they are appropriate, effective, and meeting the needs of the firm.

b. Designating a management-level individual to review summaries of CPE records for the firm's personnel to determine that the office has established a means of tracking each individual's compliance with the requirements of the AICPA and other regulatory bodies.

c. Soliciting information from the firm's personnel during staff meetings regarding the effectiveness of training programs.

.151 **Policy 4**

The firm will consider and evaluate, on an ongoing basis, compliance with its policies and procedures.

.152 For purposes of illustration, two scenarios are described. Scenario I illustrates how AnyCity CPAs satisfies the objective of Policy 4 without performing an inspection of individual engagements. Scenario II illustrates how AnyCity CPAs implements Policy 4 through the use of engagement inspection.

.153 In determining which scenario is appropriate, consideration should be given to SQCS No. 3, *Monitoring a CPA Firm's Accounting and Auditing Practice*, paragraphs 3–7 (QC section 30.03–.07), which sets forth guidance that should be consulted in determining the extent of inspection procedures to be performed, including those related to individual engagements. Also, consideration should be given to time pressures such as report due dates and time budgets when considering whether a firm can effectively monitor its compliance with its policies and procedures through preissuance or postissuance engagement reviews.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Scenario I

.154 AnyCity CPAs implements Policy 4 by—

a. Designating a partner or management-level individual not previously associated with the engagement to perform a preissuance review of the engagement or a postissuance review of the engagement shortly after the release of the report. Deficiencies identified as a result of this process will be continuously summarized and evaluated to determine whether—

1. Additional emphasis should be placed on the specific areas or industries in future engagements.
2. Existing policies and procedures should be modified so any deficiencies noted do not recur.

b. Reviewing correspondence regarding consultation on independence, integrity, and objectivity matters, and acceptance and continuance decisions.

c. Reviewing the resolution of matters reported by professional personnel on independence circularization forms to determine that matters have been appropriately considered and resolved.

d. Summarizing the deficiencies noted resulting from the preissuance and postissuance reviews.

e. Preparing a summary of the deficiencies noted for the partner or management group in order to set forth any recommended changes to the firm's policies and procedures.

f. Communicating the deficiencies noted and the agreed-upon quality control changes to all professional personnel.

Scenario II

.155 AnyCity CPAs implements Policy 4 by—

a. Designating a partner to be responsible for performing an annual inspection using guidance prepared by the AICPA for performing inspection procedures. These procedures include reviewing a cross-section of engagements using the following criteria:

1. Significant specialized industries with emphasis given to high-risk engagements
2. Engagements for employee benefits
3. First-year engagements
4. Level of service performed (that is, audit, review, compilation, and attest)
5. All partners and other management level personnel having accounting and auditing responsibilities

b. Reviewing correspondence regarding consultation on independence, integrity, and objectivity matters, and acceptance and continuance decisions.

c. Reviewing the resolution of matters reported by professional personnel on independence circularization forms to determine that matters have been appropriately considered and resolved.

d. Summarizing findings resulting from the inspection procedures.

e. Preparing a summary inspection report for the partner or management group that evaluates the overall results of the inspection and that sets forth any recommended changes to the firm's policies and procedures.

f. Communicating inspection findings and agreed-upon quality control changes to all professional personnel.

Chapter 5

JANE BROWN, CPA'S SYSTEM OF QUALITY CONTROL FOR HER ACCOUNTING PRACTICE

.156 This chapter describes how Jane Brown, CPA implements each element of quality control for her accounting practice. Jane Brown, CPA is a hypothetical firm that is presumed to be a sole owner without any professional staff who occasionally hires per diem professionals. Her accounting practice consists only of engagements subject to the Statements on Standards for Accounting and Review Services. She uses purchased practice aids that have been subjected to peer review in accordance with standards established by the AICPA. Jane Brown, CPA recognizes that her policies and procedures will have to be changed if she hires full-time or part-time professional staff.

Independence, Integrity, and Objectivity

.157 The objective of the *Independence, Integrity, and Objectivity* element of a system of quality control is to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance), in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.

.158 Jane Brown, CPA satisfies this objective by establishing and maintaining the following policy and procedures.

.159 **Policy 1**

I will adhere to applicable independence, integrity, and objectivity requirements. These requirements include regulations, interpretations, and rulings of the AICPA, state CPA societies, state boards of accountancy, state statutes, and other regulatory agencies where applicable.

.160 Jane Brown, CPA implements this policy by—

a. Purchasing AICPA *Professional Standards* annually.

b. Reviewing unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence.

c. Reviewing relevant pronouncements relating to independence, integrity, and objectivity in the *Journal of Accountancy* and retaining copies of them.

d. Signing a step on each engagement program attesting to her independence and requiring per diem personnel to do the same.

e. Complying with *Statements on Standards for Accounting and Review Services* with respect to disclosing instances where the firm is not independent in the accountant's compilation report.

Personnel Management

.161 The objective of the *Personnel Management* element of a system of quality control is to provide the firm with reasonable assurance that all personnel have the proficiency to perform their assigned responsibilities. Attributes or qualities that enhance the proficiency of personnel who perform, supervise, or review work include integrity, objectivity, intelligence, judgment, competence, experience, and motivation.

.162 Jane Brown, CPA satisfies this objective by establishing and maintaining the following policies and procedures.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.163 **Policy 1**

I will maintain the degree of technical training and proficiency required in the circumstances.

.164 Jane Brown, CPA implements this policy by—

a. Evaluating the knowledge and expertise required to perform the engagement prior to accepting the client or engagement.

b. Accepting only those engagements that can be performed with professional competence.

.165 **Policy 2**

I will participate in general and industry-specific continuing professional education and professional development activities that enable me to satisfy my responsibilities and fulfill applicable continuing professional education requirements of the AICPA and regulatory agencies.

.166 Jane Brown, CPA implements this policy by—

a. Developing a professional development program and considering the requirements of the AICPA and state boards of accountancy.

b. Participating in external professional development programs, including graduate-level and self-study courses.

c. Joining and becoming an active member of professional organizations.

d. Serving on professional committees, writing for professional publications, when appropriate, and participating in other professional activities.

e. Considering changes in the applicable professional standards when determining her professional development program.

Acceptance and Continuance of Clients and Engagements

.167 The objective of the *Acceptance and Continuance of Clients and Engagements* element of a system of quality control is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. Such policies and procedures should provide the firm with reasonable assurance that (*a*) the likelihood of association with a client whose management lacks integrity is minimized, (*b*) the firm undertakes only those engagements that can be completed with professional competence, (*c*) the risks associated with providing professional services in particular circumstances are appropriately considered, and (*d*) an understanding with the client regarding the services to be performed is reached.

.168 Jane Brown, CPA satisfies this objective, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining the following policies and procedures.

.169 **Policy 1**

I will evaluate factors that have a bearing on management's integrity.

.170 Jane Brown, CPA implements this policy by—

a. Obtaining information such as the following before accepting or continuing a client:

- Available information regarding the client and its operations from sources such as prior-year reports, internally generated financial statements (if applicable), income tax returns, and credit reports.
- The nature and purpose of the services to be provided.

b. Inquiring of third parties such as bankers, factors, legal counsel.

c. Communicating with the predecessor accountant when required or suggested by professional standards.

d. Evaluating the information obtained regarding management's integrity.

.171 **Policy 2**

I will evaluate whether the engagement can be completed with professional competence and accordingly undertake only those engagements that can be completed with professional competence and appropriately consider the risk associated with providing professional services in particular circumstances.

.172 Jane Brown, CPA implements this policy by—

a. Considering conditions that require evaluation of a client or specific engagement and obtaining the relevant information to determine whether the relationship should be continued. Conditions include—

- Establishing a time period for evaluations to be made (before the current-year engagement work begins).
- Significant changes in the client, for example, a major change in ownership, senior client personnel, directors, advisors, the nature of the business, or the financial stability of the client.
- Changes in the nature or scope of the engagement, including requests for additional services.
- The existence of conditions that would have caused the firm to reject the client or engagement had such conditions existed at the time of the initial acceptance.
- Client delinquent in paying fees. (This may also affect the firm's independence.)

b. Determining if the knowledge and expertise necessary to perform the engagement exists or can reasonably be obtained.

c. Evaluating the information obtained regarding the engagement and making the acceptance decision and documenting her evaluation or conclusion in a memorandum.

d. Evaluating the information obtained regarding the engagement and making the continuance decision.

.173 **Policy 3**

I will obtain an understanding with the client regarding services to be performed.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.174 Jane Brown, CPA implements this policy by—

a. Adhering to all requirements set forth in professional standards regarding obtaining an understanding with the client.

b. Requiring that the understanding with the client be documented either through an engagement letter or in a memorandum.

Engagement Performance

.175 The objective of the *Engagement Performance* element of a system of quality control is to provide the firm with reasonable assurance that the work performed by engagement personnel meets the applicable professional standards, regulatory requirements, and the firm's standards of quality. Policies and procedures for engagement performance encompass all phases of the design and execution of the engagement. To the extent appropriate and as required by applicable professional standards, these policies and procedures should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. Policies and procedures should also provide that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues).

.176 Jane Brown, CPA satisfies this objective by establishing and maintaining the following policies and procedures.

.177 **Policy 1**

I will plan engagements to meet professional and the firm's requirements.

.178 Jane Brown, CPA implements this policy by adhering to professional standards regarding the planning process and the extent of documentation, if applicable. Engagement planning considerations may include, when applicable—

- Developing or updating background information.
- Obtaining an engagement letter.
- Reviewing prior financial statements and accountant's report.
- Using work programs.

.179 **Policy 2**

I will perform, supervise, review, document, and communicate in accordance with the requirements of professional standards and the firm.

.180 Jane Brown, CPA implements this policy by requiring the use of purchased practice aids on all appropriate engagements including—

- Maintaining availability of purchased practice aids and AICPA professional standards.
- Preparing all working papers and checklists in accordance with firm policy in order to document work performed in accordance with professional standards.
- Reviewing and initialing all engagement working papers in situations where per diem staff are utilized.

.181 **Policy 3**

I will identify areas and specialized situations where consultation is required and I will require personnel to refer to authoritative literature and practice aids and will consult, on a timely basis, with individuals outside the firm when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues).

.182 Jane Brown, CPA implements this policy by—

a. Maintaining a technical reference library to assist in resolving practice problems. The library is updated as needed.

b. Referring to the AICPA's Technical Hotline when a practice problem arises for which the firm needs additional expertise.

c. Requiring that documentation of consultation include all relevant facts and circumstances and references to professional literature used in the determination and conclusion reached. This documentation is to be retained in the engagement working papers.

Monitoring

.183 The objective of the *Monitoring* element of a system of quality control is to provide the firm with reasonable assurance that the procedures relating to the other elements of quality control are suitably designed and being effectively applied. Monitoring is an ongoing consideration and evaluation process.

.184 Jane Brown, CPA satisfies this objective by establishing and maintaining the following policies and procedures.

.185 **Policy 1**

I will consider and evaluate, on an ongoing basis, the relevance and adequacy of my quality control policies and procedures.

.186 Jane Brown, CPA implements this policy by reviewing procedures that identify the need to—

a. Revise policies and procedures that are ineffective due to changes in professional standards or the nature of the practice.

b. Improve compliance with firm policies and procedures that are related to the other elements of quality control.

.187 **Policy 2**

I will consider and evaluate, on an ongoing basis, the appropriateness of my guidance materials and any practice aids.

.188 Jane Brown, CPA implements this policy by reviewing and determining that the firm's purchased practice aids are up-to-date based on the issuance of new professional pronouncements.

.189 **Policy 3**

I will consider and evaluate, on an ongoing basis, the effectiveness of professional development activities.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.190 Jane Brown, CPA implements this policy by—

a. Reviewing CPE records to determine whether the programs (AICPA or state society classroom training and self-study programs) are appropriate for the firm's practice.

b. Reviewing CPE records to determine compliance with the requirements of the AICPA and other regulatory bodies.

.191 Policy 4

I will consider and evaluate, on an ongoing basis, compliance with my policies and procedures.

.192 Jane Brown, CPA implements this policy by performing a postissuance review of selected engagements, in order to—

a. Summarize findings resulting from such reviews.

b. Place additional emphasis on certain deficient areas in future engagements.

c. Determine if existing policies and procedures should be modified so any deficiencies noted do not recur.

.193

Glossary of Selected Terms

Accounting and auditing practice. All audit, attest, accounting and review, and other services for which standards have been established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under Rule 201 or 202 of the AICPA Code of Professional Conduct (ET sections 201.01 and 202.01). Standards may be also established by other AICPA technical committees; engagements that are performed in accordance with those standards are not encompassed in the definition of an accounting and auditing practice.

Firm. Defined in the AICPA Code of Professional Conduct as "a form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council that is engaged in the practice of public accounting, including the individual owners thereof" (ET section 92.05).

Personnel. All individuals who perform professional services for which the firm is responsible, whether or not they are CPAs.

Policy. A definite course or method of action to guide and determine present and future decisions. It is a guide to decision making under a given set of circumstances within the framework of a firm's objectives, goals, and management philosophies.

Procedure. A particular way of accomplishing something, an established way of doing things, a series of steps followed in a definite regular order. It provides for the consistent and repetitive approach to actions.

[*The next page is 11,301.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

AAM Section 11,300
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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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			Year-End			Total Hours
		From	Thru	Hours	From	Thru	Hours	

Audited? Yes _____ No _____
SEC? Yes _____ No _____
Reviewed? Yes _____ No _____
Compiled? Yes _____ No _____
Attestation? 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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.04 History of Staff Assignments

NAME _____

CLIENT/ LOCATION	DATES		RESPONSIBILITY LEVEL	ASSIGNMENT DESCRIPTION				
	INTERIM	YEAR END		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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.06 Scheduling Master Plan

MONTH OF _____

Staff member	Carry forward	Month assign-ments	Nonworking hours								Nonrecurring assignments			Hours for month		
			Vacation	Holiday	Prof dev.	Comp time	CPA exam	Admin	Other	Tax dept	Review dept	Other client #	Other hr	Total assign	Avail-able	(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	XXXXXX	XX	XXXX	XX	(XX)
Evans	X	X	X	X	X	X						XXXXXX	XX	XXXX		(XX)
Frank	XX	X	X	X	X	X	X	X	X	X	X	XXXXXX	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

DATE	MODE OF COMMUNICATION	CLIENT	OFFICE	REQUEST	RESPONSE	MEMORANDUM REQUIRED YES/NO	MEMORANDUM DATE REC'D

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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 _____ NAME ☐ Agency _____ NAME ☐ Friend _____ NAME ☐ Other _____ NAME					
EDUCATIONAL BACKGROUND — ☐ See Below ☐ See Attached Resume					
	NAME & LOCATION OF SCHOOL	MAJOR COURSE	YEARS ATTENDED FROM	YEARS ATTENDED TO	YEAR GRAD.
Elementary					
High or Vocational					
Business or Technical					
College					
Graduate					
ADDITIONAL SKILLS OR MACHINE KNOWLEDGE ☐ See Below ☐ See Attached Resume					

Note: See the AICPA MAP Handbook for an alternative.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 the AICPA MAP Handbook for an alternative.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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.				

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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 the AICPA MAP Handbook for alternatives.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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_____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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 SUPERIOR	A- EXCELLENT	B+ ABOVE AVERAGE	B SATISFACTORY	B- IMPROVEMENT DESIRED	C+ IMPROVEMENT REQUIRED	C 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				Most
				1	2	3	4	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)

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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 2 3 4 5
1 = Did Not Meet Job Requirements	1 = Did Not Meet Job Requirements 2 = Met Most
2 = Met All 3 = Exceeded	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?	( )	( )	( )	( )	( )

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.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, bankers, attorneys, credit services, and if applicable current or former independent CPA, from reviewing the client's financial statements, regulatory agency reports, credit reports, and tax returns, and from other sources such as industry or accounting journals, etc. As much information as possible should be obtained before visiting the potential client. Depending on the type of engagement involved, some information requested on this form may not be applicable, or additional information may be necessary and should be attached.

Services and Reports Required

1. Describe the service and reports requested. _____
   _____
   _____
2. Describe the reason the service is needed, including any regulatory requirements or third parties for which the service or report is intended. _____
   _____
   _____
3. What is the required completion date? _____
   _____
4. Describe any other services not requested for which there appears to be a need. _____
   _____
5. What is the preliminary estimate of hours to complete the engagement? _____
   _____

Industry Practices and Conditions

6. In what industry does the company operate? _____
   _____
7. Describe any specialized tax or accounting practices applicable to the industry. _____
   _____
8. Describe any economic, technological or competitive conditions or other recent developments in the industry that may affect the company's operations. _____
   _____
   _____
9. Describe any special regulatory requirements applicable to the industry. _____
   _____
10. Is the company in the development stage? _____
    _____

Organization and Personnel

11. Company's Legal Name: _____ Fiscal Year End: _____

12. Type of legal entity (Corporation, S Corporation, partnership, proprietorship, etc.): _____

13. 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

14. List the principal members of management.

Name and Title	Stated Qualifications (education, training, and experience)

15. 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.

16. 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

17. Inquire about possible transactions with related parties that may affect the engagement.

Name of Related Party	**Relationship**	**Type of Transaction**

Operations

18. Describe the nature of the company's major assets and liabilities. _____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

19. What are the company's sources of revenue and marketing methods? Describe major products, customers, etc.). _____

20. If the company is economically dependent on a major customer, name the customer and approximate percentage of total revenue generated by this customer. _____

21. Describe the components of cost of goods sold and the company's production process. _____

22. What are the major expenses of the company other than cost of goods sold? _____

23. Describe the company's compensation methods, i.e., salary , hourly wage, commissions, piece work, union scale, etc. _____

24. 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

25. 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? _____

26. 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				

27. 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.

28. Describe any unusual features of the accounting system.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

29. 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

30. Who prepares the tax returns? _____

31. 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

32. 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._____

_____

_____

_____

33. Give the name of a current or former independent CPA._____

_____

a. Describe any disputes over accounting matters._____

_____

34. Describe any apparent problems or areas for improvement that were noted where our firm could provide additional service or recommendations._____

_____

_____

_____

Independence

35. 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

36. Based on inquiries with a current or former independent CPA, if applicable, indicate the amount of any unpaid fees and the reason for nonpayment. _____

_____

37. 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.)_____

38. Describe any other indications that our firm might have a problem billing or collecting our fees. _____

_____

Management Integrity

39. 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. _____
    _____

40. If management is changing accountants, why is the change being made? _____
    _____

41. Is there any reason to suspect that management would be uncooperative, unreasonable or otherwise unpleasant to work with? _____
    _____

Other Comments or Observations

42. 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. _____
    _____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

.19 Summary Monitoring/Inspection Report

I. *Planning the Inspection*

A. Inspection period _____

B. Composition of Inspection Team:

1. Captain _____ Position _____
2. Team Member _____ Position _____
3. Team Member _____ Position _____

C. Indicate matters that may require additional emphasis in the inspection and explain why.

_____

_____

_____

_____

_____

D. Development of Inspection Program:

1. Describe programs used and indicate any deviations therefrom.

_____

_____

_____

_____

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				
Attestations				
Other Accounting Services				

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 _____

_____

[*The next page is 12,001.*]

1 Includes only audits conducted pursuant to the *Government Auditing Standards*, issued by the Comptroller General of the United States ("yellow book").

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

AAM Section 12,000
State and Local Governments

TABLE OF CONTENTS

Section		*Paragraph*
12,010	Illustrative Internal Control Questions—State and Local Governmental Units	.010-.310
	I. Control Environment	.030-.100
	Integrity and Ethical Values	.060
	Commitment to Competence/Board of Directors' or Audit Committee Participation/Management's Philosophy and Operating Style	.070
	Organizational Structure	.080
	Assignment of Authority and Responsibility	.090
	Human Resource Policies and Practices	.100
	II. Risk Assessment	.110-.130
	Risk Assessment	.130
	III. Control Activities	.140-.190
	Performance Reviews	.160
	Information Processing	.170
	Physical Controls	.180
	Segregation of Duties	.190
	IV. Information and Communication	.200-.230
	Financial Reporting, Including the Accounting System	.220
	Individual Roles and Responsibilities Over Financial Reporting	.230
	V. Monitoring	.240-.270
	Evaluations	.260
	Separate Activities	.270
	VI. Administrative Controls	.280-.310
	A. General Compliance Requirements	.300
	B. Example of Specific Requirements	.310
12,100	Designing the Audit Program	.01-.47
	Financial Statement Assertions	.05
	Developing Audit Objectives	.06-.07
	Audit Tests	.08-.30
	Purpose of the Test	.11-.16
	Type of Test	.17
	Analytical Procedures	.18-.23
	Inquiry and Observation	.24-.25
	Tests of Transactions	.26-.28
	Tests of Balances	.29-.30
	Linking Audit Procedures to Objectives	.31-.32
	The Completeness Assertion	.33-.47
	Lack of Evidence	.38-.41
	Internal Control Activities Related to Completeness	.42-.43
	Substantive Tests	.44-.47
12,200	Illustrative Audit Program for State and Local Governmental Units	.010-.190
	I. Engagement Planning and Administration	.010

Section *Paragraph*

12,200 Illustrative Audit Program for State and Local Governmental Units—continued
A. Engagement Planning Procedures
B. Engagement Administration and Supervision Procedures
II. Budget Compliance 020
Financial Statement Assertions
Audit Objectives
A. Audit Procedures to Test Budgetary Information
B. Audit Procedures to Test Budgetary Compliance
III. Cash 030
Financial Statement Assertions
Audit Objectives
A. Evaluation of Internal Control
B. Analytical Procedures
C. Other Auditing Procedures
D. Overall Conclusions
IV. Investments 040
Financial Statement Assertions
Audit Objectives
A. Evaluation of Internal Control
B. Analytical Procedures
C. Other Auditing Procedures
D. Overall Conclusions
V. Receivables and Revenues—Governmental Funds 050
Financial Statement Assertions
Audit Objectives
A. Evaluation of Internal Control
B. Analytical Procedures
C. Other Auditing Procedures—Receivables and Revenues—Governmental Funds
1. General Property Taxes
2. Sales Taxes
3. Income and Other Self Assessed Taxes
4. Revenue From Federal, State, and County Agencies
5. Licenses and Permits
6. Franchise Fees
7. Fines
8. Sale of Property and Equipment
9. Rentals of Property and Equipment
10. Special Assessments
11. Other Revenues
D. Other Auditing Procedures—Receivables
1. All Receivables
2. Other Receivables
E. Overall Conclusions
VI. Expenditures, Expenses, and Payables 060
Financial Statement Assertions
Audit Objectives
A. Evaluation of Internal Control
B. Analytical Procedures
C. Other Auditing Procedures—Expenditures/Expenses
1. General

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Section *Paragraph*

12,200 Illustrative Audit Program for State and Local Governmental Units—continued
2. Payrolls
3. Other Expenditures/Expenses
D. Other Auditing Procedures—Liabilities
1. Accounts or Vouchers Payable and Encumbrances
2. Deposits
3. Taxes Levied or Collected for Other Units of Government
4. Accrued Salaries and Wages
5. Taxes or Fees Collected in Advance
6. Compensated Absences
E. Other Auditing Procedures—Prepaid Items
F. Other Auditing Procedures—Municipal Solid Waste Landfill Closure and Postclosure Care Costs
G. Overall Conclusions
VII. Inventories 070
Financial Statement Assertions
Audit Objectives
A. Evaluation of Internal Control
B. Analytical Procedures
C. Other Auditing Procedures
D. Overall Conclusions
VIII. Capital Expenditures and Related Fund and Account Group Activity 080
Financial Statement Assertions
Audit Objectives
A. Evaluation of Internal Control
B. Analytical Procedures
C. Other Auditing Procedures—Capital Expenditures—Equipment
D. Other Auditing Procedures—Capital Expenditures—Construction
E. Other Auditing Procedures—Leases
F. Other Auditing Procedures—GFAAG
G. Overall Conclusions
IX. Debt and Debt Service 090
Financial Statement Assertions
Audit Objectives
A. Evaluation of Internal Control
B. Analytical Procedures
C. Other Auditing Procedures—Notes and Tax Anticipation Warrants
D. Other Auditing Procedures—Loans and Advances
E. Other Auditing Procedures—Bond and Interest Expenditures/Expenses
F. Other Auditing Procedures—Arbitrage Rebate and Refund Requirements Under the Tax Reform Act of 1986
G. Other Audit Procedures
H. Overall Conclusions
X. Interfund Transactions and Fund Equity 100
Financial Statement Assertions
Audit Objectives
A. Evaluation of Internal Control
B. Analytical Procedures
C. Other Auditing Procedures—Interfund Transactions
D. Other Auditing Procedures—Fund Equity
E. Overall Conclusions

Section *Paragraph*

12,200 Illustrative Audit Program for State and Local Governmental Units—continued

XI. Proprietary Funds—Special Topics 110
Financial Statement Assertions
Audit Objectives
A. Evaluation of Internal Control
B. Analytical Procedures
C. Other Auditing Procedures—Proprietary Fund Revenues
D. Other Auditing Procedures—Utility or Enterprise Receivables
E. Other Auditing Procedures—Deposits
F. Other Auditing Procedures—Contributed Capital
G. Overall Conclusions

XII. Risk Financing and Insurance Related Activities 120
Financial Statement Assertions
Audit Objectives
A. Evaluation of Internal Control
B. Analytical Procedures
C. Other Auditing Procedures—Risk Related—General
D. Other Auditing Procedures—Self Insurance Funds
E. Overall Conclusions

XIIIA. Fiduciary Funds (Other Than Pension Trust Funds) 130
Financial Statement Assertions
Audit Objectives
A. Evaluation of Internal Control
B. Analytical Procedures
C. Other Auditing Procedures—Agency Funds
D. Other Auditing Procedures—Trust Funds
E. Other Auditing Procedures—PERS
F. Overall Conclusions

XIIIB. Pension Trust Funds 135
Financial Statement Assertions
Audit Objectives
A. Evaluation of Internal Control
B. Analytical Procedures
C. Other Auditing Procedures—General
D. Other Auditing Procedures—Investments
E. Other Auditing Procedures—Contributions and Related Receivables
F. Other Auditing Procedures—Benefit Payments and Payables
G. Other Auditing Procedures—Participants' Data and Plan Objectives
H. Review Procedures—Required Supplementary Information
I. Overall Conclusions

XIV. Financial Reporting 140
Financial Statement Assertions
Audit Objectives
A. Other Auditing Procedures
B. Other Auditing Procedures—Review of Subsequent Events
C. Other Auditing Procedures—Report
D. Overall Conclusions

XV. Federal Financial Assistance (Single Audit) 150
Financial Statement Assertions
Audit Objectives
A. Audit Planning

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

Section *Paragraph*

12,200 Illustrative Audit Program for State and Local Governmental Units—continued
B. Internal Control Evaluation
C. Compliance Procedures
D. Test of Subrecipient Compliance
E. Property
F. Reporting on Federal and State Financial Assistance
G. Overall Conclusion
XVI. Financial Assistance Supplement 160
A. Test of General Compliance Requirements
1. Political Activity
2. Davis-Bacon Act
3. Civil Rights
4. Cash Management
5. Relocation Assistance and Real Property Acquisition
6. Federal Financial Reports
7. Allowable Costs/Cost Principles
8. Drug-Free Workplace Act
9. Administrative Requirements
XVII. Appendix A—Auditing and Reporting Concerns 170
XVIII. Appendix B—Federal Transaction Test Criteria 180
XIX. Appendix C—Criteria for Determining Questioned Costs 190

12,210 Suggested Supplemental Reference Materials for Use With Illustrative Audit Program for State and Local Governmental Units 01
Suggested Supplemental Reference Materials 01

12,300 Partner's Engagement Review Program Supplement for Local Governmental Units 010-.120
I. General Audit Procedures 010
A. General 010
II. Working Paper Areas 020-.110
A. Cash 020
B. Receivables 030
C. Investments 040
D. Property, Plant, and Equipment 050
E. Liabilities 060
F. Deferred Revenue 070
G. Commitments and Contingencies 080
H. Fund Equity 090
I. Revenues and Expenditures/Expenses 100
J. Other 110
III. Compliance With the Requirements of the Single Audit Act of 1984 120
A. The Single Audit Act 120

12,400 Auditors' Reports on Basic or General-Purpose Financial Statements for State and Local Governmental Units 01-.39
Unqualified Opinion on General-Purpose Financial Statements 01
Unqualified Opinion on General-Purpose Financial Statements Submitted Together With Combining, Individual Fund, and Account Group Financial Statements and Supporting Schedules as Supplementary Data 02
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 03

Section *Paragraph*

12,400 Auditors' Reports on Basic or General-Purpose Financial Statements for State and Local Governmental Units—continued

Report on Primary Government Financial Statements That Omit the Financial Data of Each Component Unit 04

Qualified Opinion on General-Purpose Financial Statements That Omit One or More, But Not All, Component Units of the Financial Reporting Entity 05

Adverse Opinion on General-Purpose Financial Statements That Omit One or More, But Not All, Component Units of the Reporting Entity 06

Qualified Opinion on General-Purpose Financial Statements That Omit a Fund Type or Account Group 07

Qualified Opinion on General-Purpose Financial Statements That Omit a Fund From a Fund Type 08

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 09

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 10

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 11

Qualified Opinion on General-Purpose Financial Statements That Include an Unaudited Organization, Function, or Activity 12

Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of an Organization, Function, or Activity by Other Auditors 13

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 14

Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of All of a Fund Type by Other Auditors 15

Unqualified Opinion on Financial Statements Prepared in Accordance With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles 16

Unqualified Opinion on Financial Statements of a Department Constituting Less Than a Fund 17

Unqualified Opinion on Supplementary Schedule of Federal Financial Assistance 18

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 19

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 20

Single Audit Unqualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs 21

Single Audit Qualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Uncertainties 22

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

Section *Paragraph*

12,400 Auditors' Reports on Basic or General-Purpose Financial Statements for State and Local Governmental Units—continued

Single Audit Qualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Scope Limitation 23

Single Audit Disclaimer of Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Scope Limitation 24

Single Audit Qualified Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs—Noncompliance 25

Single Audit Adverse Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs 26

Single Audit Unqualified Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs 27

Single Audit Qualified Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs—Material Noncompliance 28

Single Audit Qualified Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs—Scope Limitation 29

Single Audit Unqualified Report on Compliance With Specific Requirements Applicable to Nonmajor Federal Financial Assistance Program Transactions 30

Report on the Internal Control Structure Based on an Audit of General-Purpose Financial Statements Performed in Accordance With *Government Auditing Standards* 31

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 32

Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs 33

Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—No Material Weaknesses When There Are No Reportable Conditions 34

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 35

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 36

Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—No Major Programs 37

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* 38

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* 39

[*The next page is 12,051.*]

AAM Section 12,010

Illustrative Internal Control Questions—State and Local Governmental Units

.010 The following is a list of illustrative internal control questions an auditor might raise concerning a state or local governmental unit. The extent of controls 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, the entity's organizational characteristics, the nature, diversity, and complexity of its operations, its methods of transmitting, processing, maintaining, and accessing information, applicable legal and regulatory requirements, and cost/benefit considerations. These illustrative questions are numbered merely for organizational 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 questionnaires based on its own needs and preferences. The auditor should also consider the illustrative questions in AAM sections 4400 and 4420. 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.

.020 Internal control consists of the following five interrelated components:

a. Control environment

b. Risk assessment

c. Control activities

d. Information and communication

e. Monitoring

I. Control Environment

.030 The control environment sets the tone of an organization, influencing the control consciousness of its people. Control environment factors include the following:

- Integrity and ethical values
- Commitment to competence
- Board of directors or audit committee participation
- Management's philosophy and operating style
- Organizational structure
- Assignment of authority and responsibility
- Human resource policies and practices

.040 The control environment is the foundation for all other components of internal control, providing discipline and structure.

.050 The following questions are to assist the auditor in obtaining an understanding of the control environment as well as assessing the control risk.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
.060 Integrity and Ethical Values							
1. Are outside parties made aware of the entity's ethical standards?	—						
2. Is the organization subject to external forces or pressures which make it vulnerable to errors?	—	—			—		
3. Does the public perceive this organization to be adequately controlled?	—						
4. Does management conduct business on a high ethical plane and insist that others do so, or pay little attention to ethical issues?		—			—		
5. Has management conveyed the message that ethics cannot be compromised and have employees received and understood that message?	—						
6. 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?	—				—		
.070 Commitment to Competence/Board of Directors' or Audit Committee Participation/Management's Philosophy and Operating Style							
1. Are goals and objectives for the organization current and in writing?	—	—					
2. Does management often enter into particularly high-risk ventures, or is it extremely conservative in accepting risks?	—	—	—		—		
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)?					—		

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
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 its concerns about the reliability of financial reporting and safeguarding assets?	—				—		
8. Has management communicated a commitment to strong internal control to employees during the past year?	—	—			—		
9. Is management's attitude that overriding or bypassing established controls is unacceptable?	—	—					
10. Is there a long-range planning process?	—	—					
11. 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)?	—						
.080 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. Do members of management fully understand their control responsibilities and possess the requisite experience and levels of knowledge commensurate with their positions?	—						
3. Do key managers possess the appropriate knowledge and experience in light of their responsibilities?	—	—					
4. Is the entity's organizational structure appropriate so as to provide the necessary information flow to manage its activities?	—	—					
5. Are the reporting relationships appropriate?	—	—					
6. To what extent are organizational modifications made in light of changing conditions?	—	—					
7. Are there sufficient quantities of employees, particularly in management and supervisory capacities?	—	—					
8. Is the organization chart current?	—	—					
9. Is the organization properly synchronized for the program/budget structure?	—	—			—		
10. Are functional statements current and in writing and consistent with the organization chart?	—	—					
.090 Assignment of Authority and Responsibility							
1. Is there an adequate definition of key managers' responsibilities and an appropriate understanding of those responsibilities?	—	—					
2. Are delegations of authority and responsibility current and in writing?	—						
3. Do the delegations of authority and responsibility reflect the segregation of duties concept?	—	—					
4. Are the job descriptions descriptive of the jobs actually performed?	—	—					
5. Do the delegations of authority and responsibility grant officials necessary authority to carry out functions for which they are responsible?	—	—					
6. Are employees held accountable for performance and results achieved?	—	—					
7. Do managers routinely follow-up on delegations of authority and responsibility to subordinates?	—	—					

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
.100 Human Resource Policies and Practices							
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. Are there sufficient training opportunities to ensure all employees are competent to perform work assigned?	—	—					
5. Are policies and procedures for hiring, training, promoting, and compensating employees in place?	—	—					
6. Are employees made aware of their responsibilities and expectations of them?	—	—					
7. Is there appropriate remedial action taken in response to departures from approved controls and violations of the code of conduct?	—						
8. Are policies regarding conflicts of interest and business practice policies established, documented, and distributed?	—						
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 control?	—						
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?	—	—			—		
18. Do written personnel policies exist?	—	—					
19. Are payroll and personnel policies governing compensation in accordance with the requirements of grant agreements?			—	—			
Phase 1:	L	L	L	L	L		
	M	M	M	M	M		
Preliminary Risk Assessment	H	H	H	H	H		
Phase 2:	L	L	L	L	L		
	M	M	M	M	M		
Final Risk Assessment—Based on audit tests of controls	H	H	H	H	H		

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

II. Risk Assessment

.110 An entity's risk assessment for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles. Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Risks can arise or change due to circumstances such as:

- Changes in the operating environment
- New personnel
- New or revamped information systems
- Rapid growth

.120 The following questions are to assist the auditor in obtaining an understanding of how management considers risks relevant to financial reporting objectives and decides about actions to address those issues. It is also structured to help the auditor assess control risk.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
.130 Risk Assessment							
1. 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.	—	—			—		
2. Do controls exist for approving decisions regarding financing alternatives and accounting principles, practices, and methods?	—			—			
3. Has management identified and analyzed entity risks relating to circumstances such as:							
a. Changes in the operating environment?	—	—			—		
b. New personnel?	—	—			—		
c. New or revamped information systems?	—	—			—		
d. Rapid growth?	—	—			—		
e. New technology?	—	—			—		
f. New lines, products, or activities?	—	—			—		
g. Restructurings?	—	—			—		
h. Other operations?	—	—			—		
i. Accounting pronouncements?	—	—			—		
4. Has management estimated the significance of the risks relevant to the preparation of financial statements?			—	—	—		
5. Has management taken appropriate steps to manage these risks?					—		
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 Activities

.140 Control activities are the policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities have various objectives and are applied at various organizational and functional levels. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- Performance reviews
- Information processing
- Physical controls
- Segregation of duties

.150 Questions for the following functional areas have been included to assist the auditor in obtaining an understanding of the control activities relevant to planning the audit:

- Cash
- Investments
- Revenues and Receivables
- Capital Assets
- Procurement and Payables
- Employee Compensation

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
.160 Performance Reviews							
1. Are there periodic performance reviews (appraisals) of all employees?	—						
.170 Information Processing							
2. Have procedures been adopted and communicated establishing authority and responsibility for transfers between budget categories?	—	—	—		—		
3. Are requests for supplemental appropriations or budget changes processed and approved in the same manner as the original budget is processed and approved?	—	—	—		—		
4. Do controls exist over preparation and approval of input transactions outside the EDP department and is the department prohibited from initiating transactions?	—	—					
5. Does the user exercise control procedures over input to ensure that all approved input is processed correctly through the system and only once?	—	—		—			
6. Do controls exist over entry of data in on-line systems to restrict access to terminals and data entry to authorized employees?	—	—					
7. 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?	—	—					
8. 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?	—	—					

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
9. Do user controls exist over rejected transactions through the use of a computerized suspense file of rejected transactions or an auxiliary manual system?	—	—					
10. Does user department management reconcile output totals to input totals for all data submitted, reconcile the overall file balances, and review outputs for reasonableness?	—	—		—			
11. Do procedures exist within the data processing control function that provide that data is properly controlled between the user and the EDP department?	—	—					
12. 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?	—	—					
13. Do program controls exist over entry of data into on-line systems?	—	—					
14. Is input data edited and validated?	—	—					
15. Do data processing controls exist over rejected transactions?	—	—					
16. Do controls exist for balancing transactions and master files?	—	—		—			
17. Do procedures exist within the data processing control function concerning review and distribution of output?	—	—					
18. Do controls exist over changes to system software?	—	—					
19. Are procedures to be followed by computer operators documented?	—	—					
20. Is the data processing system documented such that the organization could continue to operate if important data processing employees leave?	—						
21. Does the entity have adequate written statements and explanations of its accounting controls? (Written accounting controls may include such matters as:							
a. A chart of accounts accompanied by explanations of the items to be included in the various accounts.	—	—					
b. 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.	—	—					
c. 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.	—	—					
d. 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.	—	—					
e. Instructions for determining an adequate cutoff and closing of accounts for each reporting period.)	—	—					
22. Are internal control manuals updated as necessary?	—	—					
23. Are manuals distributed to appropriate personnel?		—					
24. Are there written procedures to test and implement new systems and modifications to existing application systems?	—	—					
25. Are valuation reserves or other account balances based on estimates reviewed and approved?	—			—			
26. Are all journal entries reviewed, approved, and supported by adequate descriptions or documentation?	—	—					
27. Do controls exist that ensure that only authorized individuals can initiate entries?	—						

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
28. Do procedures exist to ensure the orderly and effective accumulation of financial data?	—	—			—		
29. Do procedures exist for the orderly processing of financial data received from departments and other accounting units?	—	—			—		
30. Do procedures exist to permit the recording and review of special entries generated in the combining process?	—	—			—		
31. 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.)							
32. Is the flow of expenditures or commitments controlled through the use of an allotment system?							
33. Are measures implemented to correct weaknesses?							
34. Are controls established to ensure that payroll costs charged to grants are in compliance with grant agreements?							
35. Do reasonable procedures and controls exist to provide assurances of compliance with recipient eligibility requirements established by grants?							
36. Do procedures exist to ensure that funds received are spent in accordance with legal requirements and spending restrictions?							
37. Have the significant account balances and transaction classes been identified such as:							
a. Cash?	—						
b. Investments?	—						
c. Revenues and Receivables?	—						
d. Capital Assets?	—						
e. Procurement and Payables?	—						
f. Employee Compensation?	—						
38. Are all receipts deposited on a timely basis (preferably daily)?		—					
39. Do controls exist over the collection, timely deposit, and recording of collections in the accounting records in each collection location?		—					
40. Are daily reported receipts compared on a test basis to bank statements to verify timeliness of deposits?	—						
41. Is a restrictive endorsement placed on each incoming check upon receipt?		—					
42. Are "not sufficient funds" checks delivered to someone independent of processing and recording of cash receipts?		—					
43. Do procedures exist for follow-up of "not sufficient funds" checks?		—					
44. 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?		—					
45. Are receipts controlled by cash register, pre-numbered receipts, or other equivalent means if payments are made in person (over the counter)?		—					
46. Are receipts accounted for and balanced to collections on a daily basis?	—	—					
47. Are procedures provided for immediate notification to banks when warrant or check signers leave the unit or are otherwise no longer authorized to sign?	—	—					
48. Are invoices and supporting documents furnished to the signer prior to signing the warrant or check?	—	—		—			
49. Are reasonable limits set on amounts that can be paid by facsimile signatures?	—						

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
50. Are two signatures required on warrants or checks over a stated amount?	—						
51. 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?	—	—					
52. Is the drawing of warrants or checks to cash or bearer prohibited?	—						
53. Are bank accounts properly authorized?		—					
54. Are depositories periodically reviewed and formally reauthorized?		—					
55. Are separate bank accounts maintained for each fund, or if not, is there adequate fund control over pooled cash?			—		—		
56. Do procedures exist to ensure that collections and disbursements are recorded accurately and promptly?		—		—	—		
57. Do procedures exist for authorizing and recording interbank and interfund transfers and for providing for proper accounting for those transactions?	—	—		—	—		
58. Do procedures exist for steps essential to an effective reconciliation, particularly—							
a. Comparison of warrants or checks in appropriate detail with disbursement records?		—		—			
b. Examination of signature and endorsements, at least on a test basis?	—		—				
c. Accounting for numerical sequence of warrants or checks used?		—		—			
d. Comparison of book balances used in reconciliations with general ledger accounts?	—	—		—	—		
e. Comparison of deposit amounts and dates with cash receipt entries?		—		—			
f. Footing of cash books?		—		—			
59. 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?	—	—		—			
60. Are checks outstanding for a considerable time periodically reviewed for propriety?	—						
61. If applicable, are procedures adequate to ensure that only investments that are permitted by law are acquired?	—			—	—		
62. Is the investment program integrated with the cash management program and expenditure requirements?	—	—		—			
63. Have authority and responsibility been established for investment opportunity evaluation and purchase?	—			—			
64. Are procedures formally established governing the level and nature of approvals required to purchase or sell an investment?	—			—			
65. Are competitive bids sought for certificate of deposit purchases?	—			—			
66. Are detailed accounting records maintained for investments?	—	—		—	—		
67. Do procedures exist to ensure that transactions arising from investments are properly processed, including income and amortization entries?	—	—		—	—		
68. Do controls exist to ensure that investment earnings are credited to the fund from which resources were provided for the investment?				—	—		

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
69. Do controls exist to ensure that transactions are recorded on a timely basis?		—		—	—		
70. Do procedures exist for reconciling the detailed accounting records with the general ledger control?	—			—	—		
71. Do controls exist to ensure that additions, deletions, transfers, and abatements are properly and timely reflected in property tax records?		—		—			
72. Do procedures exist to make property assessments in accordance with the law or legislative intent with prompt adjustment of records?		—	—	—			
73. Are filed returns cross-referenced against a database of previous taxpayers?		—					
74. 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?		—					
75. If annual payments are involved, do procedures exist to ensure that previous years' records are properly updated for new registrants and withdrawals?	—	—					
76. Are updated records used as the basis for billing persons subject to payment?		—		—			
77. Are court and other records of payments due maintained and used as a basis for collections?		—		—			
78. Do procedures exist surrounding the control, issuance, and disposition of traffic violations to ensure that amounts due are assessed and collected?		—					
79. Are controls maintained that provide assurances that customer database and, where appropriate, usage records are accurately maintained to ensure that amounts due are billed?	—	—					
80. Do controls exist within the billing system to ensure that eligible property owners are billed?		—		—			
81. 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?			—	—			
82. Do controls exist to ensure that tax exemptions are within the law and properly approved?	—		—	—			
83. Are audits of returns filed to provide reasonable assurance that taxable income is properly reported?			—	—			
84. Do procedures exist providing for correlation of amounts collected with records of court proceedings?	—	—	—	—			
85. If billing is based on usage, are service readings performed in a timely fashion?	—	—	—				
86. Are assignments of meter readers periodically rotated?		—	—				
87. Do billing procedures exist providing for identification and investigation of unusual patterns of use?	—	—					
88. Are taxes and fees billed in a timely fashion?		—					
89. Do procedures exist designed for other revenue areas ensuring timely payment of amounts due?		—	—	—			
90. Are rates of taxes, fines, fees, and services periodically reviewed and approved by the legislative body?			—	—			
91. Are programs of tax exemption or relief periodically reviewed and approved by the legislative body?			—	—			
92. Are utility rate schedules authorized by the legislative body?			—	—			
93. 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?		—		—			
94. Do numerical or batch-processing controls exist over tax, fee, service, or other billings?		—					

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
95. Do controls exist over the billing of miscellaneous revenues (for example, sidewalk replacement and tree removal assessments)?	—	—	—	—			
96. Do procedures exist to prevent the interception or alteration by unauthorized persons of billings or statements after preparation but before they are mailed?		—		—			
97. Does an individual independent of receivables record keeping promptly investigate disputes with billing amounts that are reported by taxpayers or service recipients?	—		—	—			
98. Do controls exist providing reasonable assurances that restricted revenues are expended only for restricted purposes?			—	—	—		
99. Do procedures exist providing reasonable assurances that interest and penalties are properly charged on delinquent taxes, fees, or charges for service?		—	—	—			
100. Do procedures exist providing for the timely filing of liens on property for nonpayment in all cases permitted by law?			—				
101. Do controls exist surrounding the collection, timely deposit, and recording of collections in the accounting records at each collection location?		—					
102. Is the general accounting department notified of cash receipts from separate collection centers on a timely basis?		—					
103. If payments are made in person, are receipts for payment used and accounted for and balanced to collections?	—	—					
104. Are amounts collected on behalf of other governments segregated and remitted on a timely basis?			—	—	—		
105. Are delinquent accounts reviewed and considered for charge-off on a timely basis?			—	—	—		
106. Are write-offs or other reductions of receivables formally approved by senior officials not involved in the collection function?					—		
107. 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?				—	—		
108. Do controls in the system exist that provide assurances that individual receivable records are posted only from authorized source documents?	—			—			
109. Are aggregate collections on accounts receivable reconciled against postings to individual receivable accounts?		—		—			
110. Are statements of account balance mailed on a timely basis, where appropriate (for example, in proprietary funds)?			—	—			
111. Are trial balances of individual receivable accounts prepared on a timely basis?				—			
112. Are trial balances reconciled with general ledger control accounts and are reconciling items investigated by someone other than accounts receivable clerks?		—		—			
113. Do procedures exist that provide for timely and direct notification of the accounting department of billings and collection activities?		—		—			
114. Is grant activity accounted for so that it can be separated from the accounting for locally funded activities?				—	—		
115. Is there a system for obtaining grantor approval before incurring expenditures in excess of budgeted amounts or for unbudgeted expenditures?			—				
116. Are grant revenues and disbursements processed under the same degree of controls applicable to the organization's other transactions (budget, procurement, etc.)?	—	—	—	—	—		
117. Are requirements included in subgrantee agreements that the subgrantee comply with the primary grant agreement conditions as well as the grantee's standards?			—				

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
118. Is an indirect cost allocation plan established?	—		—	—			
119. Is the plan approved by all grantor agencies?			—	—			
120. Is audit cognizance established for rates generated by the plan?				—			
121. Is the amount of funds received compared with the amount anticipated by a responsible official and are unusual variances investigated?		—		—			
122. Are those individuals authorized to initiate capital asset transactions identified and is there clear definition of the limits of their authority?	—						
123. 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?	—						
124. Is a separate capital projects budget prepared?	—						
125. Is written executive or legislative approval required for all significant capital asset projects or acquisitions?	—						
126. Do controls exist for authorizing, approving, and documenting sales or other dispositions of capital assets?	—	—					
127. Do controls exist providing for obtaining grantor (federal/state) approval, if required, for the use of grant funds for capital asset acquisitions?	—			—			
128. Are grant-funded authorizations subjected to the same controls as internally funded acquisitions?	—	—					
129. Are supplemental authorizations required, including, if appropriate, those of the grantor agency, for expenditures in excess of originally approved amounts?	—	—					
130. Do controls exist to identify completed projects so that timely transfers to the appropriate accounts can be made?	—	—			—		
131. Is the accounting distribution reviewed to ensure proper allocation of charges to fixed asset and expenditure projects?				—	—		
132. If construction work is performed by contractors, do controls exist to provide for and maintain control over construction projects and progress billings?	—		—	—			
133. Do controls exist to—							
a. Distinguish between capital projects' fund expenditures and operating budget expenditures?			—	—			
b. Identify operating budget expenditures to be capitalized in the fixed asset fund?					—		
c. Distinguish between capital and operating leases?					—		
d. Govern depreciation methods and practices?				—			
134. 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?			—				
135. If not, is depreciation charged to grants adjusted accordingly?				—			
136. 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?	—		—	—	—		
137. Are purchases of goods and services initiated by properly authorized requisitions bearing the approval of officials designated to authorize requisitions?	—						
138. Are requisitions pre-numbered and are those numbers controlled?	—	—					
139. Is the appropriation to be charged indicated on the purchase requisition by the person requesting the purchase?	—				—		

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
140. Before commitment, are unobligated funds remaining under the appropriation verified by the accounting or budget department as sufficient to meet the proposed expenditure?			—	—			
141. Are requests for special purpose (nonshelf items) materials or personal services accompanied by technical specifications?	—			—			
142. Are purchasing authorizations structured to give appropriate recognition to the nature and size of purchases and the experience of the purchasing personnel?	—	—					
143. Do approval procedures exist for purchase order and contract issuance?	—	—					
144. Does the accounting department submit approval regarding availability of funds before the issuance of a purchase order or expenditure commitment?	—	—	—				
145. Are competitive bidding procedures used?				—			
146. 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?			—	—			
147. Do procedures exist for public advertisement of nonshelf item procurements in accordance with legal requirements?	—			—			
148. Is splitting orders prohibited to avoid higher levels of approval?	—			—			
149. Are price lists and other appropriate records of price quotations maintained by the purchasing department?				—			
150. Are procedures modified when funds are disbursed under grant or loan agreements and related regulations impose requirements that differ from the organization's normal policies?	—		—		—		
151. Are procedures instituted to identify, before order entry, costs and expenditures not allowable under grant (federal/state) programs?			—	—			
152. Is an adequate record of open purchase orders and agreements maintained?	—		—				
153. Are purchases made for the accommodation of employees prohibited or adequately controlled?	—			—			
154. If construction contracts are to be awarded, are bid and performance bonds considered?	—		—	—			
155. Does predetermining selection criteria exist for awarding personal service or construction contracts and is adequate documentation of the award process required?				—			
156. Are changes to contracts or purchase orders subjected to the same controls and approvals as the original agreement?			—	—			
157. Are receiving reports prepared for all purchased goods?	—						
158. Do controls exist for the filing of claims against carriers or vendors for shortages or damaged materials?	—		—	—			
159. Are steps taken to ensure that goods received are accurately counted and examined to see that they meet quality standards?	—			—			
160. Is a permanent record of material received by the receiving department maintained?	—	—		—			
161. Are receiving reports numerically accounted for or otherwise controlled to ensure that all receipts are reported to the accounting department?	—	—		—			
162. Are copies of receiving reports sent directly to purchasing, accounting, and, if appropriate, inventory record keeping?	—	—		—			
163. Do invoice processing controls provide for— *a.* Obtaining copies of purchase orders and receiving reports directly from issuing departments?	—	—					

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
b. Comparison of invoice quantities, prices, and terms with those indicated on the purchase order?		—		—			
c. Comparison of invoice quantities with those indicated on the receiving reports?		—		—			
d. Checking the accuracy of calculations?				—			
164. Are all invoices received from vendors in a central location, such as the accounting department?		—					
165. Do controls exist ensuring that the accounts payable system is properly accounting for unmatched receiving reports and invoices?	—	—	—	—			
166. Are requests for progress payments under long-term contracts related to contractors' efforts and are they formally approved?	—		—	—			
167. Do controls exist for processing invoices not involving materials or supplies (for example, lease or rental payments, utility bills)?	—	—					
168. Do controls exist ensuring accurate account distribution of all entries resulting from invoice processing?	—			—	—		
169. If applicable, is access to the EDP master vendor file limited to employees authorized to make changes?	—	—					
170. Does the accounting department maintain a current list of those authorized to approve expenditures?	—						
171. Do controls exist for submission and approval of reimbursement to employees for travel and other expenses?	—		—	—			
172. Is control established by the accounting department over invoices received before releasing them for departmental approval and other processing?	—	—		—			
173. Are payments made only on the basis of original invoices?	—			—			
174. 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?				—			
175. Are differences in invoice and purchase order price, terms, shipping arrangements, and quantities referred to purchasing for review and approval?	—			—			
176. Does the accounting department record and follow up on partial deliveries?		—		—			
177. Are the accounting and purchasing departments promptly notified of returned purchases, and are such purchases correlated with vendor credit advices?	—			—			
178. Is the program and expenditure account to be charged reviewed for propriety and budget conformity?				—	—		
179. If applicable, do procedures exist to ensure adjustment of the reserve for encumbrances (obligations) when invoices are prepared for payment?	—			—	—		
180. Are invoices and supporting documents canceled by or in the presence of the signer at the time of signing?	—			—			
181. Are warrants or checks cross-referenced to vouchers?	—			—			
182. Do controls exist ensuring that warrants or checks that have been signed and issued are recorded promptly?	—	—		—	—		
183. Are encumbrance (obligation) entries recorded only on the basis of approved purchase orders?	—				—		
184. Do controls exist ensuring that accounts payable and encumbrances (obligations) are applied against the appropriate account?	—			—	—		
185. Do controls exist ensuring that department heads are notified of payments made against accounts payable and encumbrances (obligations)?	—			—	—		

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
186. If liabilities and expenditures are recorded on an encumbrance or obligation basis, are there controls to ensure knowledge of outstanding commitments?	—	—	—		—		
187. Are trial balances of reserve for encumbrances (obligations) and accounts payable prepared on a regular basis?		—		—	—		
188. Are transactions between funds in all affected funds posted in the same accounting period and on a timely basis?				—	—		
189. Are grants disbursed only on the basis of approved applications?	—			—			
190. Are purchase orders and contracts issued under numerical or some other suitable control?							
191. If an invoice is received from a supplier not previously dealt with, are steps taken to ascertain that the supplier actually exists?							
192. Are all changes in employment (additions and terminations), salary and wage rates, and payroll deductions properly authorized, approved, and documented?	—	—		—			
193. Are notices of additions, separations, and changes in salaries, wages, and deductions promptly reported to the payroll-processing function?		—		—			
194. Are appropriate payroll records maintained for accumulated employee benefits (vacation, pension data, etc.)?		—		—			
195. Are terminating employees interviewed as a check on departure and as a final review of any termination settlement by the personnel department?	—	—		—			
196. Are wages at or above the federal minimum wage?				—			
197. Do records and controls exist for timekeeping and attendance?	—	—					
198. If time cards are used, are they punched only by the employees to whom they are issued?	—						
199. Do procedures exist for authorizing, approving, and recording vacations, holidays, and sick leave and is compensatory time controlled and approved?	—			—	—		
200. Do controls exist over payroll preparation?	—	—		—			
201. Are changes to the EDP master payroll file approved and documented?	—			—			
202. Is a separate, imprest-basis, payroll bank account maintained?	—			—			
203. 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?					—		
204. Are accrued liabilities for unpaid employee compensation and benefit costs properly recorded and disclosed?		—	—	—	—		
205. Are payroll advances to officials and employees prohibited or are they subjected to appropriate review?							
206. Is a log maintained that reconciles the counter on the check-signing machine with the number of checks issued in each payroll?							
207. Are employees required to provide identification before being given checks or pay envelopes?							
.180 Physical Controls							
1. 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.)	—						
2. Do procedures exist to protect against a loss of important files, programs, or equipment?	—	—					

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
3. Do controls exist over use and retention of tape and disk files, including provisions for retention of adequate records to provide backup capabilities?	—	—					
4. Do controls exist that limit access to data processing equipment, tape, disks, system documentation, and application program documentation to authorized employees?	—	—					
5. Are equipment, programs, and data files covered by insurance?	—						
6. Do facilities exist for protecting undeposited cash receipts?	—	—					
7. Does control exist over warrant or check-signing machines as to signature plates and usage?	—	—					
8. Are signature plates maintained in the custody of the person whose facsimile signature is on the plate when not in use?	—						
9. Are signed warrants or checks delivered directly to the mailroom making them unaccessible to persons who requested, prepared, or recorded them?	—						
10. Are controls maintained over the supply of unused and voided warrants or checks?	—	—					
11. Do controls and physical safeguards exist surrounding working (petty cash) funds?	—						
12. Is adequate fidelity insurance maintained?	—	—	—				
13. Are bank statements and paid warrants or checks delivered in unopened envelopes directly to the employee preparing the reconciliation?	—	—			—		
14. Do adequate physical safeguards and custodial procedures exist over—							
a. Negotiable and nonnegotiable securities owned?	—		—				
b. Legal documents or agreements evidencing ownership or 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?			—				
20. Are tickets for fines, arrests, and so forth sequentially numbered and satisfactorily accounted for?		—					
21. Are project cost records established and maintained for capital expenditure and repair projects?	—	—		—			
22. Are detailed property records maintained for all significant self-constructed, donated, purchased, or leased assets?	—	—					
23. Is the accountability for each asset established?	—	—					
24. Do controls exist for periodic inventory of documents evidencing property rights (for example, deeds, leases, and the like)?	—	—		—			
25. Do physical safeguards over assets exist?	—	—					
26. Do controls 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)?	—	—					
27. Are differences between records and physical counts investigated and are the records adjusted to reflect shortages?	—			—			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
28. Do procedures exist ensuring that capital assets are adequately insured?	—			—			
29. Are lease transactions subjected to control procedures similar to those required for other capital expenditures?	—	—	—				
30. Is equipment properly identified by metal numbered tags or other means of positive identification?	—			—			
31. Are fully depreciated assets carried in the accounting records as a means of providing accounting control?	—	—					
32. Are an adequate number of price quotations obtained before placing orders not subject to competitive bidding?				—			
33. Do procedures exist for disbursement approval and warrant or check-signing?	—	—					
34. Do controls exist to notify banks when a new signer is authorized or a previous signer leaves the employ of the government?	—						
35. Is the signer furnished with invoices and supporting data and are they reviewed prior to signing the warrant or check?	—	—		—			
36. Are reasonable limits set on amounts that can be paid by facsimile signatures?	—						
37. Is there control over the signature plates and usage of the warrant or check-signing machines?	—						
38. Are signature plates maintained in the custody of the person whose facsimile signature is on the plate when not in use?	—						
39. 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?	—			—			
40. Are signed warrants or checks delivered directly to the mail room, making them inaccessible to persons who requested, prepared, or recorded them?	—						
41. Are warrants or checks controlled and accounted for with safeguards over those unused and voided?	—	—					
42. Are funds disbursed to grantees only on an as-needed basis?	—			—			
43. Does the level of grant approval authority appear appropriate?	—	—					
44. Is access to the EDP master payroll file limited to employees who are authorized to make changes?	—			—			
45. 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?	—						
46. Is the supply of unused payroll checks controlled?	—			—			
47. Are employees prohibited from accepting another employee's pay?	—						
48. Are unclaimed wages returned to a custodian independent of the payroll department?	—				—		
49. Do employees who distribute checks or pay envelopes make a report of unclaimed wages directly to the accounting department?	—				—		
50. 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?	—						
51. Is there general ledger control over all assets and transactions of all departments of the organization?	—	—		—			
.190 **Segregation of Duties**							
1. Are responsibilities for budget preparation, adoption, execution, and reporting segregated?	—	—			—		

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
2. Are the responsibilities for maintaining the general ledger segregated from those for maintaining subsidiary ledgers?	—	—					
3. Are the responsibilities for maintaining the general ledger and custody of assets segregated?	—						
4. Is access to the general ledger and related records restricted to those who are assigned general ledger responsibilities?	—						
5. Are the preparation and approval functions for journal entries segregated?	—	—		—			
6. Is the EDP department independent from the accounting and operating departments for which it processes data?	—						
7. 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?	—	—					
8. In smaller and minicomputer installations with limited opportunities for segregation of duties, do procedures exist for user departments to—							
a. Utilize batch or other input controls?	—	—		—			
b. Control master file changes?							
c. Balance master files between processing cycles?							
9. 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?	—						
10. Is the final review and approval of financial reports segregated from the responsibility for preparation of the reports?	—	—					
11. Are responsibilities for collection and deposit preparation functions segregated from those for recording cash receipts and general ledger entries?		—					
12. Are responsibilities for cash receipts functions segregated from those for cash disbursements?		—					
13. Are responsibilities for disbursement preparation and disbursement approval functions segregated from those for recording or entering cash disbursements information on the general ledger?	—	—		—			
14. Are responsibilities for the disbursement approval function segregated from those for the disbursement, voucher preparation, and purchasing functions?	—			—			
15. Are responsibilities for entries in the cash receipt and disbursement records segregated from those for general ledger entries?	—	—					
16. Are responsibilities for preparing and approving bank account reconciliations segregated from those for other cash receipt or disbursement functions?	—	—			—		
17. If EDP is used, is the principle of segregation of duties within processing activities maintained?	—	—					
18. Are responsibilities for initiating, evaluating, and approving investment transactions segregated from those for detail accounting, general ledger, and other related functions?	—	—		—			
19. Are responsibilities for initiating investment transactions segregated from those for final approvals that commit government resources?	—			—			
20. Are responsibilities for monitoring investment market values and performance segregated from those for investment acquisition?	—			—			
21. Are responsibilities for maintaining detail investment accounting records segregated from those for general ledger entries?	—			—			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
22. Are custodial responsibilities for securities or other documents evidencing ownership or other rights assigned to an official who has no accounting duties?	—		—	—			
23. Are the responsibilities of billing property taxes and services segregated from collection and accounting?		—		—			
24. Are the responsibilities for maintaining detail accounts receivable records segregated from collections and general ledger posting?	—	—		—			
25. Are the collection, control, and deposit of funds activities segregated from the accounting records maintenance function?	—	—		—			
26. Are property tax assessment rolls maintained by individuals not engaged in any accounting or collection function?	—	—		—			
27. Are responsibilities for entries in the cash receipts records segregated from those for general ledger entries?	—	—					
28. 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?	—	—					
29. Are responsibilities for initiating capital asset transactions segregated from those for final approvals that commit government resources?	—	—		—			
30. Are responsibilities for the project accounting and property records functions segregated from the general ledger function?	—	—		—			
31. Are responsibilities for the project accounting and property records functions segregated from the custodial function?	—	—					
32. Are responsibilities for the periodic physical inventories of capital assets assigned to responsible officials who have no custodial or record keeping responsibilities?	—	—					
33. Are responsibilities for the requisitioning, purchasing, and receiving functions segregated from the invoice processing, accounts payable, and general ledger functions?	—	—					
34. Are responsibilities for the purchasing function segregated from the requisitioning and receiving functions?	—	—					
35. Are responsibilities for the invoice processing and accounts payable functions segregated from the general ledger functions?	—	—		—			
36. Are responsibilities for the disbursement preparation and disbursement approval functions segregated from those for recording cash disbursements and general ledger entries?	—	—		—			
37. Are responsibilities for the disbursement approval function segregated from those for the disbursement preparation function?	—	—					
38. Are responsibilities for entries in the cash disbursement records segregated from those for general ledger entries?	—	—		—			
39. If practical, are contract or purchasing officer's areas of responsibility rotated on a regular basis?	—						
40. If a receiving department is not used, do adequate controls exist to ensure that goods for which payment is made have been received?	—	—		—			
41. Are these goods verified by someone other than the individual that approves payments by verifying that goods have been received and meet quality standards?	—	—		—			
42. Are responsibilities for supervision and timekeeping functions segregated from personnel, payroll processing, disbursement, and general ledger functions?	—	—					

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
43. Are responsibilities for the payroll processing function segregated from the general ledger function?	—	—		—			
44. Is payroll distribution supervised by employees—							
a. Who are not responsible for hiring or firing employees?	—						
b. Who do not approve time reports?	—						
c. Who take no part in payroll preparation?	—						
45. Are responsibilities for initiating payments under employee benefit plans segregated from accounting and general ledger functions?	—	—		—			
46. Is the payroll bank account reconciled regularly by employees independent of all other payroll transaction processing activities?	—	—		—			
Phase 1:	L	L	L	L	L		
	M	M	M	M	M		
Preliminary Risk Assessment	H	H	H	H	H		
Phase 2:	L	L	L	L	L		
	M	M	M	M	M		
Final Risk Assessment—Based on audit tests of contols	H	H	H	H	H		

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

IV. Information and Communication

.200 The information system relevant to financial reporting objectives, which includes the accounting 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, liabilities, and equity. The quality of system-generated information affects management's ability to make appropriate decisions in controlling the entity's activities and to prepare reliable financial reports. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

.210 The following questions have been included to assist the auditor in obtaining sufficient knowledge of (*a*) the information system relevant to financial reporting and (*b*) the means the entity uses to communicate financial reporting roles and responsibilities and significant matters relating to financial reporting.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
.220 Financial Reporting, Including the Accounting System							
1. Is a budget calendar used for the orderly submission and approval of the budget?	—	—					
2. Are budgets prepared for all significant activities regardless of whether mandated by law?	—	—					
3. Is the budget prepared in sufficient detail providing a meaningful tool with which to monitor subsequent performance?	—	—			—		
4. Are interfund and interdepartmental transfers included in the budget?	—	—			—		
5. Is the type of budgeting performed compatible with the accounting system?	—	—			—		
6. Are budgets published if required by law?	—				—		
7. Are estimated revenues and appropriations recorded in the accounting records for later comparison to actual amounts realized or incurred?	—	—		—	—		
8. Is citizen input obtained through budget hearings?							
9. Is the budgeting system integrated with the planning process?							
10. Are actual results of operations against budget published if required by law?	—	—		—	—		
11. Are policies and procedures current and in writing?	—						
12. Are policies and procedures consistent with statutory authorities?	—	—	—				
13. Are all policies and procedures clearly stated and systematically communicated (manuals, handbooks, etc.)?	—	—					
14. Do the policies and procedures support internal control?	—	—					
15. 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.)	—	—					
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?	—	—		—	—		
18. 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?	—	—					

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
19. Are controls for closing the accounts for a reporting period sufficient to ensure that accounts are closed, adjusted, and reviewed on a timely basis?	—	—		—			
20. Do procedures exist to ensure that the financial reporting information system has included all transactions applicable to the reporting period?		—					
21. Do procedures exist to ensure that financial reports are supported by either underlying account records or other documentation?	—						
22. Do procedures exist providing reasonable assurances that all data required to be included in legal as well as public reports are properly disclosed?		—			—		
23. Do procedures exist to ensure that financial reports are prepared on a consistent basis?	—	—			—		
24. Are financial reports reviewed and approved at appropriate levels of management and, if appropriate, by the legislature before public release?	—				—		
25. 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)?	—	—		—			
.230 Individual Roles and Responsibilities Over Financial Reporting							
1. Is there a formal plan of organization for the unit of government under which reporting responsibilities are clearly defined and reasonably aligned?	—	—					
2. Are plans and budgets effectively communicated throughout the organization?	—	—			—		
3. Do all journal entries include approval in accordance with management's general or specific authorization?	—	—					
4. Are statistical or data reports that form the basis for revenue distribution reviewed by a responsible official before submission?	—			—			
5. Do reporting controls exist for in-progress and completed projects?					—		
6. Are reporting and compliance requirements defined (for example, regulations) and communicated to grantees?					—		
7. Are actual expenditures compared to budget timely with reasonable (monthly) frequency?		—		—	—		
8. Are reports discussed with departmental personnel and are there explanations for significant variations from budget?		—		—	—		
9. Are executives and legislative branches notified of expenditures in excess of appropriations or budgets?	—		—		—		
10. Are there clearly established levels of operational and financial accountability?	—	—					
11. 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?	—	—	—	—	—		
12. Does the principal accounting officer of the entity have adequate authority over accounting employees and principal accounting records locations?	—	—					
13. Are the principal accounting, treasury, and custody functions segregated?	—	—					
14. 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.)	—	—		—			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
15. Are there channels of communication for people to report suspected improprieties? *a.* Is there an ability to contact someone other than a direct supervisor? *b.* Is anonymity permitted? 16. Is feedback provided to people who report suspected improprieties and do they have immunity from reprisals? *a.* Is management receptive to such reports? 17. Is there timely and appropriate follow-up action by management resulting from external party communications, such as: *a.* Customer complaints? *b.* Notification of errors in billings? *c.* Notification of inappropriate behavior by an employee?							
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		

V. Monitoring

.240 Management monitors the controls it has established to consider whether they are operating as intended and that they are modified as appropriate for changes in conditions. 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. This process is accomplished through ongoing activities, separate evaluations, or by various combinations of the two.

.250 The following questions have been included to assist the auditor in obtaining sufficient knowledge of the major types of activities the entity uses to monitor internal control over financial reporting, including how those activities are used to initiate corrective actions.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Completeness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
.260 Evaluations							
1. Are program evaluations/management reviews routinely performed?	—	—			—		
.270 Separate Activities							
1. Are hours worked, overtime hours, and other special benefits reviewed and approved by the employee's supervisor?	—	—		—			
2. Are time cards or other time reports reviewed for completeness and approved by the employee's supervisor?	—	—					
3. Is the time clock placed in a position where it can be observed by a supervisor?	—						
4. Are completed payroll registers reviewed and approved before disbursements are made?	—			—			
5. Are documents supporting employee benefit payments (such as accumulated vacation or sick leave) reviewed before disbursements are made?	—	—		—			
6. Are comparisons (reconciliations) of gross pay of current and prior period payrolls reviewed for reasonableness by a knowledgeable person not otherwise involved in payroll processing?	—	—		—			
7. Is the payroll (including an examination of authorization of changes on reconciliations) reviewed by an employee not involved in its preparation?	—	—		—			
8. 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?				—	—		
9. Is a comparison to amounts appropriated and budgeted included in the review?				—	—		
10. Is the payroll bank account reconciled on a regular basis?	—			—			
11. Are payroll check endorsements compared, on a test basis, with signatures on file by someone independent of the payroll department?	—						
12. Is someone independent of the payroll department comparing payments made in cash, which require signed receipts, with signatures on file on a test basis?	—			—			
13. Are W-2 forms compared to payroll records and mailed by employees not otherwise involved in the payroll process?		—		—			
14. Do procedures exist for investigating returned W-2s?	—			—			
15. Are payroll checks periodically distributed by the internal auditors to ascertain that employees exist for all checks prepared?	—						
16. Are the adequacy and effectiveness of controls relevant to the entity's transaction classes and account balances periodically evaluated?	—	—			—		

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
17. Are EDP department employees supervised for all shifts?	—	—					
18. Is the principal accounting officer over accounting records and accounting employees supervised at all locations?	—	—					
19. Are investment policy guidelines formally established and periodically reviewed?	—				—		
20. Is the performance of the investment portfolio periodically evaluated by persons independent of the investment portfolio management activities?	—	—		—			
21. Is the nature of investments included in general ledger balances periodically reviewed?	—			—	—		
22. Are periodic comparisons made between income received and the amount specified by the terms of the security or publicly available investment information?	—			—	—		
23. Are returns reviewed for mathematical accuracy?				—			
24. Are current year's taxpayers' returns correlated with prior year's returns and are differences reviewed and accounted for?		—		—			
25. Are claims for refunds reviewed and approved separately?	—			—	—		
26. Are current year receipts compared to those for prior years and are explanations of variations reviewed by senior officials?		—		—			
27. Are taxes and fees collected by another unit of government monitored to assure timely receipt and are amounts received subjected to reviews for reasonableness?		—	—	—			
28. Are aged accounts receivable balances periodically reviewed by supervisory personnel?				—	—		
29. Is responsibility for monitoring grant activities properly fixed?			—				
30. Is grant activity monitored from a centralized location?	—		—				
31. Do procedures exist to monitor compliance with—							
a. Financial report requirements?			—				
b. Use of funds and other conditions in accordance with grant terms?	—		—	—			
c. Timely billing of amounts due under grants?		—	—				
32. Is a qualified employee or independent firm engaged to inspect and monitor technically complex projects?	—	—		—			
33. Does the unit of government have the right to audit contractors' records?	—	—	—	—			
34. Is the right to audit contractor records during project performance exercised?	—		—				
35. Do audits of contractors cover compliance with EEO, Davis Bacon, and other regulations and contract terms, in addition to costs?	—	—		—	—		
36. Do controls exist for monitoring the appropriate disposition of property acquired with grant funds?	—		—				
37. Are detailed property records periodically reconciled with the general ledger control accounts?	—	—		—			
38. Are purchase prices periodically reviewed by a responsible employee independent of the purchasing department?				—			
39. Are recurring purchases and documentation of the justification for informal rather than competitive bids periodically reviewed?	—			—			
40. Is a record of suppliers who have not met quality or other performance standards by the purchasing department maintained?	—	—					
41. Is a government technical representative assigned to monitor and evaluate contractor performance and approve receipt of							

	ASSERTIONS					Tests of Controls	Substantive Tests
	Existence/ Occurrence	*Complete-ness*	*Rights/ Obligations*	*Valuation/ Allocation*	*Presentation/ Disclosure*	*Program or W/P Reference*	*Program Reference*
services with respect to procurements of special purpose materials, services, or facilities?	—	—		—			
42. Are statements from vendors compared on a regular basis with recorded amounts payable?	—			—			
43. If an encumbrance (obligation) system is used, are outstanding purchase orders reconciled for encumbrances (obligations) on a monthly basis?	—			—	—		
44. Is the distribution of charges in the accounting department reviewed by a person competent to pass on the propriety of the distribution?				—	—		
45. Does a senior employee review and approve invoices by checking the clerical accuracy and examining the supporting documentation?	—	—					
46. 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?		—		—	—		
47. Do procedures exist to monitor grantee compliance with grant terms?			—		—		
48. Are financial operations of grantees subjected to periodic and timely audit?	—	—	—	—			
49. Are recipients monitored sufficiently and on a timely basis to permit curtailment of any abuse before complete funds disbursement?	—	—	—	—			
50. Is failure by grantees to meet financial reporting requirements investigated on a timely basis?			—	—	—		
51. Are grantees required to evidence correction of previously detected deficiencies before approval of an extension or renewal of a grant?	—		—		—		
52. Do entitlement controls exist ensuring that statistics or data used to allocate funds are accurately accumulated (for example, census bureau forms)?				—	—		
53. Are statements of recipient compliance with entitlement conditions (for example, statement of assurances) required to be filed and does a responsible official review them?			—		—		
54. Are audited financial statements or other compliance requirements of entitlement recipients reviewed on a timely basis and are unusual items investigated?			—	—	—		
55. Does management periodically review internal control to ensure that it is being enforced?	—	—					
56. Are detailed property records periodically compared with existing assets?	—	—		—			
57. Are audits routinely performed?	—	—			—		
58. Are procedures in place and adhered to which require prompt implementation of resolved audit findings or program/management review results?	—	—			—		
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		

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

VI. Administrative Controls

Note: The Single Audit Act Amendments of 1996, which supersede the Single Audit Act of 1984, were enacted July 5, 1996 and are effective for fiscal years beginning after June 30, 1996. At the current time, the revised OMB Circular A-133 and Compliance Supplement have not been issued. The compliance requirements identified below follow the Single Audit Act of 1984.

.280 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.

.290 These controls are normally established by an entity based on the major requirements with which the entity must comply. AAM section 12,010.300 and .310 are common control procedures which need to be documented and tested to support the auditor's report on internal administrative controls.

.300 **A. General Compliance Requirements**

1. Political Activity (Compliance Supplement)

a. Control Environment

(1) Ordinance exists prohibiting partisan political activity.

(2) Posters exist stating the prohibition against partisan political activity.

b. Risk Assessment

(1) Management understands and has identified key compliance objectives and risks.

(2) New and other employees who require close supervision are identified and monitored.

c. Control Activities

(1) Employee policy statement, handbook, or policy manual prohibiting partisan political activity are written and communicated.

(2) Expenditures are reviewed by a person who is knowledgeable of the restriction.

d. Information and Communication

(1) The accounting and information system provide accurate information.

(2) Employees' duties and control responsibilities are effectively communicated.

(3) Channels of communication for people to report suspected improprieties exist.

e. Monitoring

(1) Ongoing monitoring exists through staff meeting feedback, supervisory review, and internal audits.

2. Davis-Bacon Act (Compliance Supplement)

a. Control Environment

(1) Management understands its responsibility for compliance and communicates the requirements to staff, contractors, and subcontractors.

b. Risk Assessment

(1) Contractors and subcontractors most at risk of not paying the prevailing wage rates are identified.

(2) Management has identified how compliance will be monitored.

c. Control Activities

(1) Provisions in contracts expressly require compliance with Davis-Bacon Act.

(2) Responsibility for monitoring contractors for compliance with contract terms, including the Davis-Bacon provision has been assigned.

d. Information and Communication

(1) Prevailing wage rates and the provisions of the Davis-Bacon Act are posted at job sites.

(2) Reports received include sufficient information to determine if requirements are being met.

e. Monitoring

(1) Prevailing wage rates published in the Federal Register or obtained from the Department of Labor are compared with rates paid by contractors or subcontractors based on payroll records submitted to the grantee.

(2) Contractors' or subcontractors' laborers are interviewed to verify their wage rates and to compare them to the prevailing wage rate.

3. Civil Rights (Compliance Supplement)

a. Control Environment

(1) A civil rights policy exists prohibiting discrimination.

(2) An affirmative action policy exists that encourages the use of small and minority owned firms and employment of individuals from minority groups.

b. Risk Assessment

(1) Program managers and staff understand and have identified key compliance objectives.

(2) Self-evaluation procedures to ensure compliance are in place.

c. Control Activities

(1) Policies and procedures are clearly written and communicated.

(2) A designated compliance officer receives and processes civil rights inquiries and complaints.

d. Information and Communication

(1) Data and periodic reports reflect status in achieving established goals.

(2) Policies and grievance procedures are distributed via the employee handbook.

(3) Open meetings are held to ensure the public is knowledgeable of the grantee's management philosophy and major policies.

e. Monitoring

(1) The practice of periodically requesting from the Division of Labor Standards the existence of any discriminatory practices by the grantee.

4. Cash Management (Compliance Supplement)

a. Control Environment

(1) Responsibility for requesting grant drawdowns is assigned to a knowledgeable person.

(2) Adequate and realistic cash forecasting methods are used.

b. Risk Assessment

(1) Programs that receive cash advances are identified.

(2) Management is aware of cash management requirements.

c. Control Activities

(1) Written policies and procedures exists relative to requesting and approving cash advances and other cash management activities.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

(2) Request for reimbursement is deferred until after the related expenditure is incurred.

(3) Grant drawdowns requests are reviewed and approved by a person knowledgeable of the cash management restrictions.

(4) Pertinent requirements are included in investment policies and requests for banking services.

(5) Depository agreements stipulate FDIC's Bank Insurance Fund (BIF) or Savings Association Insurance Fund (SAIF) and segregation of account requirements.

d. Information and Communication

(1) A cash log exists showing expenditures and cash balances for federal financial programs.

(2) Information is reported between a pass-through entity and subrecipients regarding cash needs.

(3) Cash reports are prepared and variances between actual and expected investigated.

e. Monitoring

(1) Subrecipient requests for federal funds are evaluated.

(2) Periodic independent evaluations and reviews of cash management activities are performed.

5. Relocation Assistance and Real Property Acquisition (Compliance Supplement)

a. Control Environment

(1) Management is committed to ensuring compliance with the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970.

(2) A policy statement that is compatible with federal regulations regarding relocation assistance and real property acquisition exists.

(3) Responsibility for monitoring compliance with federal requirements is assigned to a knowledgeable person.

b. Risk Assessment

(1) Management has identified the risk that relocation will not be conducted in accordance with federal requirements.

c. Control Activities

(1) Individuals who have responsibility for administering programs involving relocation or real property acquisition are properly trained and have access to copies of regulations and other procedures.

(2) Persons responsible for administering programs involving relocation or real property acquisition use checklists or other control procedures.

(3) Pamphlets are sent to persons being relocated to inform them of their rights and the prescribed procedures.

(4) Written acknowledgment is requested from persons being relocated that the required procedures and rights were made available to them.

d. Information and Communication

(1) Management has established a system to adequately document and communicate relocation assistance and real property acquisition.

e. Monitoring

(1) A review function exists over relocation assistance and real property acquisition.

6. **Federal Financial Reports (Compliance Supplement)**

   a. Control Environment

   (1) Responsibility for preparing reports (perhaps included as a duty in the employee's job description) is assigned.

   b. Risk Management

   (1) Management has identified risks of incorrect reporting.

   c. Control Activities

   (1) A tickler file exists to ensure reports (including grant closeout reports) are filed timely (preferably centralized).

   (2) Review and written approval of federal financial reports for accuracy and timeliness of submission is required.

   d. Information and Communication

   (1) An effective system exists for preparing and reporting financial and performance information.

   e. Monitoring

   (1) Periodic documented reconciliations of federal reports to the general ledger are performed.

7. **Allowable Costs/Cost Principles (OMB Circular A-87)**

   a. Control Environment

   (1) Written policies exist regarding expenditures eligible for federal reimbursements.

   (2) Responsibility for reviewing indirect cost allocations is assigned to a person knowledgeable of the requirements.

   b. Risk Assessment

   (1) A process exists for identifying and assessing risks of charging federal awards with unallowable costs and those not in accordance with the applicable cost principles.

   c. Control Activities

   (1) A person knowledgeable of the provisions of OMB Circular A-87 is involved in the grant application/budget process.

   (2) A checklist is used denoting allowable, unallowable and possibly unallowable costs by persons authorizing and/or reviewing expenditures charged to grant programs.

   (3) Person knowledgeable of indirect cost principles are utilized when preparing the plan.

   d. Information and Communication

   (1) Cost information, requirements, and training are provided to individuals preparing and reviewing cost data.

   (2) Communication lines exist between management and staff regarding costs.

   e. Monitoring

   (1) Periodic documented reconciliation of costs accumulated in the indirect cost pool to the general ledger is performed.

   (2) Independent periodic reviews are performed of the indirect cost allocation plan and other cost data.

8. **Drug-Free Workplace Act**

   a. Control Environment

   (1) A drug-free workplace policy exists.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

(2) A compliance officer has been designated.

(3) Responsibility for reporting violations to the federal government has been assigned.

b. Risk Assessment

(1) Management and staff have identified key compliance objectives and risks of noncompliance.

c. Control Activities

(1) A tickler file exists to ensure grant certifications are filed timely for each grant.

(2) Checklist or sign-off sheet exists to ensure policy is distributed to employees paid with federal funds.

d. Information and Communication

(1) Information is accumulated and communicated to those who need it.

(2) Internal and external communication channels have been established.

e. Monitoring

(1) Ongoing monitoring built in through staff meeting feedback, reviews, and internal audits.

9. Administrative Requirements (Common Rule)

a. Interest earned on advances:

(1) Control Environment

(*a*) Responsibility is assigned to remit such interest to the appropriate federal agency at least quarterly.

(2) Risk Assessment

(*a*) Management understands the objective and identified the risks of noncompliance.

(3) Control Activities

(*a*) Written policies and procedures exists relative to interest earned on advances.

(4) Information and Communication

(*a*) Cash log exists showing interest earned on advances.

(5) Monitoring

(*a*) Periodic reviews are conducted to ensure proper treatment of interest earned on advances.

b. Period of availability of funds and revolving fund repayments:

(1) Control Environment

(*a*) Management understands and is committed to complying with period of availability requirements.

(*b*) Responsibility is assigned to liquidate all obligations incurred under the award no later than 90 days after the end of the funding period.

(*c*) Policy exists that ensures revolving fund repayments are made on a timely basis.

(2) Risk Assessment

(*a*) Requirements and risks of noncompliance are identified.

(3) Control Activities

(*a*) Tickler file exists to ensure liquidation of obligations and submission of annual Financial Status Report (SF269).

(*b*) Procedures exist to ensure that repayments of revolving funds are made on a timely basis.

(4) Information and Communication

(*a*) Reports of unliquidated balances are prepared and distributed to appropriate individuals.

(*b*) Reports of period of availability and deadlines are prepared and distributed to appropriate individuals.

(*c*) Revolving fund records exist that include information necessary to track repayments.

(5) Monitoring

(*a*) Expenditures are reviewed to ensure charges result from obligations of the funding period unless carryover of unobligated balances is permitted.

c. Program income:

(1) Control Environment

(*a*) Responsibility is assigned for ensuring that current program income is deducted from current allowable costs in determining federal drawdowns or reimbursements.

(*b*) When authorized by federal agencies, responsibility is assigned for ensuring that 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.

(2) Risk Assessment

(*a*) The risk of unrecorded or miscoded program income has been identified.

(3) Control Activities

(*a*) A grant "Master Control" sheet has been established that indicates how program income is to be used on each grant.

(4) Information and Communication

(*a*) Records exist to track program income (and costs to generate program income if federal agency authorizes netting of income and costs).

(5) Monitoring

(*a*) Variances between expected and actual income are analyzed and investigated.

d. Real property, equipment, and supplies:

(1) Control Environment

(*a*) Management is committed to providing proper stewardship for property acquired with federal awards.

(*b*) Responsibility is assigned 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.

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

(c) Policy and procedures exist regarding unused and unneeded supplies and the requirement to compensate the awarding agency for its share.

(d) Manuals include documentation relating to frequency of conducting inventory (every two years), transfer, property utilization, property disposition, and accounting.

(2) Risk Assessment

(a) Risk of misappropriation or improper disposition of property acquired with federal awards have been identified.

(3) Control Activities

(a) Property, equipment, and supplies inventory records exist of acquisitions and dispositions, including sources of financing, percentage of federal ownership, cost, and other pertinent information.

(4) Information and Communication

(a) Accounting system provides for identification of property acquired with federal and non-federal funds.

(b) A channel of communication is established for reporting suspected improprieties in the use or disposition of property, equipment, and supplies.

(5) Monitoring

(a) Periodic reviews are made to ensure that property, equipment, and supplies are used for the originally authorized purposes.

(b) Purchases, maintenance, safeguarding, transfers, and dispositions are reviewed by a person knowledgeable of the requirements.

e. Procurement, suspension, and debarment:

(1) Control Environment

(a) Codes of conduct and other policies exist relative to procurements, suspension, and debarment.

(b) Responsibility is assigned for ensuring that transactions and awards are not conducted with any debarred or suspended parties.

(c) Federal procurement standards are incorporated in the grantee's purchasing policy.

(2) Risk Assessment

(a) Management understands the requirements for procurement, suspension, and debarment and has identified where noncompliance could occur.

(3) Control Activities

(a) Segregation of duties exist between employees responsible for contracting, accounts payable, and cash disbursement.

(b) Procedures exist to verify that vendors and subawardees have not been suspended or debarred.

(c) Individuals who are knowledgeable of procurement requirements and restrictions are involved in the review and award of contracts and the review of purchase requisition and/or purchase orders.

(4) Information and Communication

(a) Employees' duties and responsibilities are established and communicated.

(*b*) "Lists of Parties Excluded from Federal Procurement or Nonprocurement Programs," issued by the General Services Administration (updated for current changes) are provided to staff.

(*c*) Changes of communications exist to report suspected improprieties.

(5) Monitoring

(*a*) Periodic reviews are conducted to determine whether policies and procedures are being followed.

f. Subgrants:

(1) Control Environment

(*a*) A provision for compliance with the Common Rule and other significant provisions are included in every subgrant.

(*b*) Policy exists to make subgrantees aware of the regulations imposed on them.

(2) Risk Assessment

(*a*) Risks of possible noncompliance have been identified.

(3) Control Activities

(*a*) Procedures exist to identify and follow up on noncompliance.

(4) Information and Communication

(*a*) Record keeping system is in place to provide information to and from subgrantees.

(*b*) Award documents used included applicable compliance requirements and an understanding and acceptance statement signed by the subgrantee.

(5) Monitoring

(*a*) Periodic reviews are conducted to determine compliance by the subgrantee.

.310 B. Example of Specific Requirements

Major Program—Specific Compliance Requirements
Community Development Block Grant

Besides documenting and testing the internal control over the general compliance requirements, the internal control 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 control over specific program requirements.

A. Types of services allowed or unallowed

1. Control Environment

a. 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?

b. 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?

2. Risk Assessment

a. Do controls exist to identify where unallowable activities could be charged to a federal program and not be detected?

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

3. Control Activities

   a. Do adequate segregation of duties exist between approving and recording transactions?

4. Information and Communication

   a. Are there accounting and reporting information systems in place to provide data for management's review on a timely basis?

   b. Are training programs held for employees?

   c. Are there open communication channels to report noncompliance?

5. Monitoring

   a. Are reviews and audits conducted periodically to determine compliance?

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. Control Environment

   a. Do the persons preparing, reviewing, and approving the reports possess the required knowledge?

   b. Does management promote fair and accurate reporting?

2. Risk Assessment

   a. Do procedures exist to identify the risks of noncompliance with reporting requirements?

3. Control Activities

   a. 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?

   b. 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?

4. Information and Communication

   a. Does an accounting or information system exist that provides for the reliable processing of financial and performance information for federal awards?

5. Monitoring

   a. Are internal reviews performed of performance information?

E. Special tests and provisions

1. Control Environment

   a. Does management respect and adhere to compliance requirements?

   b. Are responsibilities assigned?

2. Risk Assessment

   a. Do program managers and staff understand requirements and identified risks of noncompliance?

3. Control Activities

   a. What accounting process is used beginning with initiating a 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. Also, 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.)

   b. What control procedures exist to ensure that program funds are not obligated or expended before the receipt of HUD's approval of a Request of Funds (RROF) and environmental certification?

   c. How does the entity ensure that all projects requiring an environmental review receive one?

   d. What procedures are employed to ensure that income earned under this program, if any, is properly accounted for and utilized?

4. Information and Communication

   a. Does the reporting system provide accurate and timely information?

   b. Do internal and external communication channels exist?

5. Monitoring

   a. Are periodic reviews and audits conducted?

[*The next page is 12,101.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. In planning the audit, the auditor should consider the nature, timing, and extent of work to be performed and should prepare a written audit program (or set of programs) for every audit. 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.

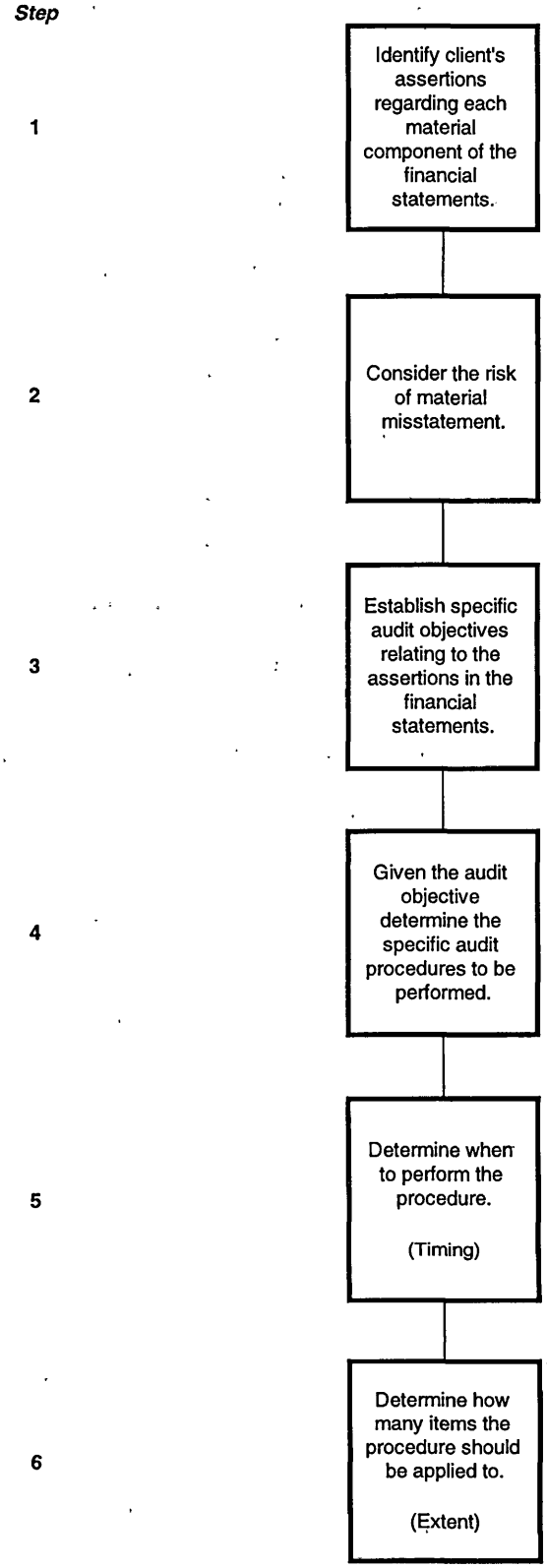
.04 The six steps illustrated in flowchart 1 result in a determination of the nature, timing, and extent of audit tests.

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



Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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.	____	____	____

	Done by	Date	W/P Ref.
i. Extent of client assistance to be provided.	____	____	____
j. Timing of preliminary audit work, inventory observation, confirmation procedures, final audit work, etc.	____	____	____
k. Due dates for delivery of report(s).	____	____	____
l. Disposition of prior year findings and questioned costs.	____	____	____
m. 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.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	Done by	Date	W/P Ref.
c. Perform analytical procedures to identify unusual or unexpected transactions, amounts, ratios or trends that might have planning ramifications. Compare recorded amounts to:			
(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. Turnover and qualifications of key personnel.	____	____	____
k. Qualifications in auditors' reports for prior years.	____	____	____
l. 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			
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.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

	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.	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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	

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.

.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

[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.	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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

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.

.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. ____ ____ ____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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;

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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	

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.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.	____	____	____
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			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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	

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

.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.			

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.			
	k. Consider confirming property taxes receivable where the client does its own billing and collection procedures.			
	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.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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 or receivable 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.			
	d. Test for classification (i.e., operating, sales, and direct financing type) as well as proper accounting of leases.			
	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.			

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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:			
	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	

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

.060

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. Loss contingencies other than remote, 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 having a direct and material effect on financial statement amounts. (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.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.			Done By	Date	W/P Ref.
		(9) Authorized check signer.			
		(10) That purchase was recorded in the period received.			
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.			
[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.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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. (If an engineer is used, SAS No. 73 [AU Section 336] must be followed.)	____	____	____
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).	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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:

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.	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.
	F. Property transferred between GFAAG and proprietary funds is appropriately recognized.			
	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.	____	____	____
	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.	____	____	____

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

Obj.			Done By	Date	W/P Ref.
	3.	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	4.	Ascertain amounts of contracts payable, including retainage withheld, which are due but unpaid and trace to liability accounts in general ledger.			
[B]	5.	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	6.	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 and deletions 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.			
	6.	Determine that property transfers between the GFAAG and proprietary funds are appropriately recognized.			

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

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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.

.090

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. ____ ____ ____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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	

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.

.100

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. ____ ____ ____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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:			
	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	

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

.110

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	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

.120

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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	

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

.130

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.	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

.135

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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).			

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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	

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

.140

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

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.			

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

.150

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

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).	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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;	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.			

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

.160

	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.	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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

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-

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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:

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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. ____ ____ ____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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;

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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

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

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 _____ _____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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

Compliance Audits (Attestation Engagements) of The Federal Student Financial Assistance Programs at Participating Institution (June 1995)

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.*]

Copyright © 1997, American Institute of Certified Public Accountants, Inc.

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

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

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?	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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?	____	____	____

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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-			

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

	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.*]

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.]

---

[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.]

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

---

[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.]

---

[1] See AAM section 12,400.01, footnote 2.

[2] See AAM section 12,400.01, footnote 3.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

---

[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.]

---

[1] See AAM section 12,400.01, footnote 1.

[2] See AAM section 12,400.01, footnote 2.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

---

[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.]

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

---

[1] See AAM section 12,400.01, footnote 2.

[2] See AAM section 12,400.01, footnote 3.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

---

[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.]

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

---

[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.]

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

---

[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).]

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

---

[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.

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.]

---

[1] Describe any departure from the standard report.

[2] Major programs need to be clearly identified in the Supplementary Schedule of Federal Financial Assistance.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

---

[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.]

---

[1] Describe any departure from the standard report.

[2] Major programs need to be clearly identified in the Supplementary Schedule of Federal Financial Assistance.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.26 Single Audit Adverse Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs

Independent 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.]

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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

---

[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).]

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

---

[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.]

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

[3] If a separate letter has not been issued, this paragraph should be omitted.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

---

[1] See footnotes to AAM section 12,400.33.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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]

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

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

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).]

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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).]

---

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

.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.]

[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.

Copyright © 1996, American Institute of Certified Public Accountants, Inc.

AAM TOPICAL INDEX

References are to section and paragraph numbers.

[*Reserved.*]

007258